Network Rail’s response to ORR’s 2018 periodic review of Network Rail – initial consultation

10 August 2016

Executive Summary

Network Rail is pleased to respond to ORR's 2018 periodic review of Network Rail (PR18) initial consultation document.

ORR's consultation is the first consultation in what will be a nearly three-year process. At this stage of the review, ORR's discussion is necessarily high-level and focused on what the approach and priorities for PR18 should be (as opposed to detailed policy consideration).

PR18 coincides with a significant period of change in the industry. The approach and outcomes of PR18 must support the rail industry in meeting the challenges and opportunities ahead in delivering benefits for passengers and freight users.

Network Rail's Board has provided significant input to this response. The Board recognises the critical role that Network Rail must play in contributing to the future success of the industry. Equally, it is clear about the changes that are required to the regulatory framework to make it more aligned with the company's corporate objectives and to deliver more for passengers, freight users, rail operators and taxpayers.

Network Rail needs a regulatory settlement that allows us to build our reputation and succeed, rather than one that is based on unattainable targets, where failure is inevitable. PR18 is an important vehicle through which the necessary changes can be made. It should support Network Rail's strategy of moving from a centralised organisation to one comprising devolved businesses operating within a national framework. We are creating devolved businesses that understand and are focussed on their customers, and can make quick decisions that meet customer needs and expectations. We have also reformed the performance management systems and scorecards to make them transparent to our customers and the public.

This strategy will enable customers to more effectively hold Network Rail to account for its performance based on the route scorecards. Route-based regulation will reinforce our strategy of devolving accountability to routes. In turn, this should allow ORR to take a more strategic, targeted approach to regulation. It is important that ORR avoids the risk of an increased regulatory burden as a result of the introduction of route-level regulation, recognising that it continues to regulate Network Rail as a whole.

Network Rail considers that the following issues should be a priority for PR18:

- **Route-level regulation** – Network Rail agrees with ORR's proposal that the implementation of route-level regulation should be a priority in PR18. Setting outputs and revenue at the route-level will support our devolution and reinforce the role of routes as customer-focused businesses, ultimately delivering for passengers and freight users.
- **Financial sustainability** – it is critical that PR18 delivers a financially sustainable outcome for Network Rail. Potential balance sheet restructuring, cash funding for some enhancements and a regime that supports the introduction of third-party capital in the funding and financing of Network Rail are key priorities. The introduction of third-party capital is important for Network Rail and the industry in meeting the growing demands for capacity. A determination that supports reasonable levels of profit will be an important factor in our ability to attract private investment. We understand that ORR is planning to consult on Network Rail's financial framework for CP6 in December 2016. There are a number of issues that will require detailed discussion with ORR, funders and other stakeholders prior to the publication of this consultation.

- **Outputs and monitoring framework** – we consider that this area requires significant reform in PR18, particularly in light of route-level regulation. The framework should provide more flexibility and fewer targets, which should include the ability to make trade-offs between different output targets. Such an approach should build on the recent introduction of customer-focused scorecards, which align our targets and priorities much more closely with those of local train operators, route-by-route.

ORR has proposed an ambitious work programme for PR18. It is important that expectations are realistic about what can be achieved in PR18 and that some changes may need to be implemented in the subsequent periodic review.

Network Rail will respond separately to ORR's PR18 working papers on system operation, implementing route-level regulation, the regulatory treatment of enhancements and the outputs framework. While Network Rail notes that these do not form part of ORR's formal consultation process, there are many elements of crossover between the working papers and the PR18 initial consultation document. This response, therefore, responds to ORR's five consultation questions and makes some high-level points relating to each of the working paper topics. More detailed policy considerations and issues will be set out in Network Rail's responses to the working papers.

Network Rail notes that ORR expects to conclude on its consultation in late Autumn 2016. Prior to ORR's conclusions, Network Rail would welcome further discussion with ORR and industry stakeholders on the points we make in this response, and of course continued engagement on the detailed planning and policy aspects throughout PR18.

Responses to ORR's consultation questions

Question 1

Context for the review: stakeholders are invited to comment on whether they agree or whether they consider there are other significant points (and if so, to explain how these might affect the review).

The next decade will be challenging with significant planned industry investment, a large refranchising programme and forecasts of increases in passenger and freight demand. The timing of PR18 provides an opportunity to review how Network Rail's outputs and funding settlement for CP6 and the regulatory framework can help meet the industry changes, challenges and opportunities ahead.

We agree with the context that ORR has set out in its consultation and that its approach to regulating Network Rail needs to reflect the changing environment. As ORR notes, Network Rail's reclassification as a public sector organisation is of particular significance. This has removed the benefits of the company's previous funding and financing structure, including that Network Rail can no longer raise additional debt to deal with cost shocks. While Network Rail is seeking to address this in CP5 through its assets disposal programme, this is not a sustainable course of action in the longer-term. ORR's approach to regulating Network Rail must adapt to recognise the impact of reclassification. In particular, we need to be able to manage risk and uncertainty for CP6 and beyond, in combination with a more flexible approach to outputs delivery.

ORR states that Network Rail's public sector status has also raised questions about the company's incentives. In particular, ORR notes that the increased public / political scrutiny on the company raises the importance of reputation. It also notes that the financial incentives to improve performance and efficiency are now different.

Reputation is clearly important and always has been, particularly in relation to the company's ability to attract and retain the talent it needs to run the business. The introduction of route-based regulation will lead to reporting and monitoring of the performance of each route. We agree that this should highlight both areas of the company that are performing well and areas that require improvement. This will impact the reputation of each route, although this is likely to be in the context of Network Rail's overall performance.

We note the discussion on the financial sustainability of Network Rail's legacy debt and servicing costs in ORR's 2013 long term regulatory statement. ORR reiterates that this remains an issue.

Network Rail strongly considers that financial sustainability is critical for the company's success in the long-term, including its ability to attract third-party investment.

The regulatory framework must support Network Rail's achievement of a credible financial position, including the level of its debt, the affordability of servicing its debt and an appropriate level of profitability. As ORR's consultation states, the scope for new capital investment by governments to accommodate growing demand is likely to be reduced. Therefore, creating the right environment for third-party investment and attracting new money into the industry should be a priority.

In respect of political devolution and changes to industry structures and incentives, the regulatory regime should be adaptable to potential changes in funding arrangements and customer needs.

ORR refers to the UK Government's Summer 2015 announcement that it intends to channel a greater proportion of industry funding in England & Wales through franchised train operators (as opposed to Network Rail) and that this could unlock benefits. We note that this could provide much greater clarity on the scale of government subsidy being provided to each part of the railway. We will work with funders, ORR and other industry stakeholders on assessing the implications of this over the coming months.

We also note the UK Government's intention to explore how franchised train operators might be exposed to a wider set of changes in network charges at each periodic review. ORR's consultation suggests that this could improve incentives on train operators to work with Network Rail to reduce system-wide costs. While we agree that this could lead to franchised train operators being more likely to develop ways to help Network Rail minimise costs and maximise outputs, this will have important implications for the overall franchising regime which should not be underestimated.

In addition to the points of context that ORR sets out, Network Rail notes the importance of the government's large refranchising programmes over the next five years, in particular. This will provide an opportunity to seek alignment between train operators' franchise obligations and Network Rail's regulated outputs, particularly in terms of train performance.

Currently, the incentives framework is not well-aligned and does not always encourage the right behaviours. For example, the current regime has inconsistent train performance targets for Network Rail and train operators. Train operators are also monitored by different organisations. Network Rail proposes to work with government on improving alignment and would welcome ORR's support in taking this forward.

Question 2

Focusing the review where it can have most impact for passengers and freight customers: ORR welcomes views on the proposed relative priorities for the review, as well as any other areas that should be prioritised (in which case, it would particularly value views on what should not be prioritised as a consequence).

Network Rail agrees that the outcomes ORR sets out in its consultation are important. Given the scope of change that will be required in PR18 – in particular the implementation of route-level regulation – we agree that ORR will need to prioritise its work programme and focus on the most material issues that ultimately, will deliver benefits to passengers and freight customers.

We also agree that ORR should maintain its focus on safety, and that safety has a significant role in the approach to PR18. However, safety should not be considered in isolation. It needs to be considered together with business performance and financial value, with appropriate consideration of the value for money of potential investment in safety improvements.

The following section sets out areas that Network Rail considers to be a priority, which have either not been included in ORR's discussion or where Network Rail has a different view on prioritisation.

Financial sustainability as an outcome

We strongly consider that an outcome of improving Network Rail's financial sustainability for PR18 should be included.

Potential balance sheet restructuring, cash funding for some enhancements and how the regime should support the introduction of third-party capital in the funding and financing of enhancements are key priorities for Network Rail in PR18. Network Rail is already working with government on these issues and would welcome ORR's support as it takes these discussions forward.

In particular, a framework that supports the introduction of third-party capital is important for Network Rail and the industry in meeting the growing demands for capacity. To create the right environment for and to maximise third-party investment, it is important that the company (and each route) has a credible financial position. This includes the affordability of servicing Network Rail's debt and an appropriate level of profitability, in order for third-party investment to earn a sufficient return for it to be attractive.

We understand that ORR plans to consult on the financial framework for PR18 in December 2016. We will work closely with ORR, funders and other industry stakeholders on the relevant issues prior to the publication of this document.

Changes to the outputs and monitoring framework

ORR's consultation proposes that the outputs and monitoring framework should be an area for incremental improvement and simplification. Network Rail, however, considers that fundamental change is required. In particular, we consider the development of a more flexible approach to output targets is needed to support route-level regulation. This would be underpinned by Network Rail's routes working with customers, funders and other stakeholders to determine what the outputs should be, with ORR's role focused on the monitoring of the delivery of these through Network Rail's customer-focused scorecards. It is essential that Network Rail is enabled to focus on its customers rather than on meeting detailed targets set by ORR.

We consider that rather than being based on specific targets, broader parameters that reflect uncertainty / potential changes through CP6 are needed (for example, minimum thresholds or ranges) and that the flexibility to make trade-offs between different outputs is required. This will be important to support alliancing arrangements and our ability to evolve our plans to reflect the priorities of the alliance. More generally, the use of broader parameters will allow us to work closely with all our customers and continually adapt our plans in light of emerging local requirements.

The current outputs framework is based on a series of specific outputs that are assessed individually. Instead there needs to be a balanced scorecard approach, in which a basket of measures are determined, with assessment of them together (rather than individually) at a route-level. The assessment should be based on our customers' and stakeholders' views more than data interrogation by the regulator. A regulatory regime that allows our customers to take a much greater role in holding Network Rail to account should result in ORR taking a more targeted and risk-based approach to monitoring, allowing it to focus on more strategic issues.

Charges and incentives

We note ORR is planning to issue a further consultation on charges and incentives in December 2016. It is important that ORR's work continues to build on RDG's recently concluded two-year Review of Charges. This review was carried out at an early stage in CP5 with engagement across the industry including ORR. It provided an opportunity for passenger and freight train operators and Network Rail to clearly set out their own views on the appropriate structure of charges and incentives, prior to PR18 starting.

Network Rail notes ORR's proposal to focus on incremental improvements to Schedules 4 and 8 in PR18. As Network Rail set out in its response to ORR's December 2015 consultation on charges and incentives, it considers Schedules 4 and 8 to be key areas of focus for PR18 (alongside the

Capacity Charge). This is consistent with RDG's Review of Charges conclusions, which also identified that the current Capacity Charge should be prioritised for reform, along with improving the allocation of fixed costs between train operators.

ORR's consultation refers to the need to strengthen incentives to accommodate additional traffic or to identify better ways to use the current network. While ORR identifies the potential role of the System Operator in achieving this, broader options should also be considered. These could include the role of charges, the Volume Incentive, the performance and possession regimes, and output targets. Network Rail is currently considering this in more detail but we would stress that all changes to the regime should meet RDG's judgement criteria of predictability, simplicity, transparency and low transaction costs.

Network Rail would welcome further discussion with ORR on how it is proposing to take forward its work on the areas discussed in this section. We suggest that they should form a substantive part of ORR's December 2016 consultation.

More broadly, there is some concern whether the current incentives regime, together with the franchising arrangements, achieve the right balance on different parts of the network between capacity utilisation and network resilience. We are keen to explore this with government and ORR in more detail.

Prioritisation

ORR is undertaking an ambitious work programme for PR18. It is important that realistic expectations are set out at an early stage on the scale and pace of change that can be achieved in the review. Limited industry resources will need to focus on areas that will require significant attention in PR18, such as the successful implementation of route-level regulation.

In respect of what could be deprioritised, we would encourage ORR to consider limiting its work on charges and incentives to areas of the regime that require genuine change, and ultimately, will deliver benefit to passengers and freight users. For example, we understand that ORR is considering the disaggregation at route-level of the variable usage charge. We do not consider that this should be prioritised, particularly since RDG's Review of Charges concluded that VUC was not considered a priority for change for CP6 and that it received broad industry support in its current form.

Question 3

ORR's proposed approach to the review: ORR would like to know whether stakeholders agree with the overall approach that it has set out for the review. It would also welcome additional suggestions and proposals for how its regulation might adapt to the current context and asks that comments are arranged around: route-level regulation; system operation; outputs and monitoring; charges and incentives; approaches for enhancements; and ERTMS and related technology.

Introduction

Many of the issues relating to ORR's proposed approach are discussed in detail, in the working papers that ORR has published alongside the consultation. Network Rail's response to this question, therefore, focuses on the key issues associated with each topic. A more detailed discussion of the issues is set out in Network Rail's responses to the working papers.

Route-level regulation

Network Rail agrees that its devolved structure provides an opportunity to improve how it is currently regulated. The implementation of route-level regulation would support Network Rail's strategy for increased devolution and further embed the role of route businesses and Network Rail's System Operator function.

In its consultation, ORR notes the importance of route-level regulation to provide effective incentives for a large publicly owned business, specifically referring to a potentially enhanced role for reputational techniques in how it regulates Network Rail. We agree that there could be an enhanced role for reputation in CP6 as a regulatory tool, and that it could be used to highlight areas of the business that are performing well and areas that require improvement. The role of reputation also reinforces the need for a regulatory settlement that allows Network Rail to build its reputation and succeed, rather than one that is based on unattainable targets.

Network Rail needs to consider the extent to which management incentives for staff in routes should be based on route performance, while recognising their importance in delivering overall network performance.

ORR's consultation sets out different techniques that could underpin the approach to route-level regulation. These include customer involvement in the planning process, increased route ownership of plans and benchmarking routes' data (which, ORR notes would reduce the need for international comparisons which are likely to be unreliable).

PR18 will require significant focus on how to make these techniques work and overcome related issues. For example, any inter-route benchmarking will need to take into account structural differences between routes to enable effective comparisons.

We will seek to engage our customers in the development of route-level plans and consider that this process will result in our plans being more robust and better aligned to current and future passengers' and freight users' needs. However, we recognise that the process for seeking customer input into the planning process will be an iterative one, which will continue beyond PR18.

Network Rail agrees that route-level regulation should not result in eight times as much regulatory scrutiny and that it must not add to the overall costs of regulation. Taking a risk-based approach to the review of our plans and making fundamental changes to the outputs and monitoring regime will be critical to the work being successful. Our customers should be able to play a greater role in holding us to account, thus reducing the need for detailed data interrogation and interventions by ORR. As set out in the discussion on outputs, below, there should also be a move away from the current focus on indicators and enablers. These can be perceived as regulatory targets and in turn, create a way of working that inadvertently treats ORR as the customer.

There also needs to be sufficient flexibility in the regulatory regime to recognise that Network Rail's current eight routes are not static geographies and will likely be subject to change during CP6 and beyond.

Network Rail agrees that it may not be possible to deliver route-level regulation in full in CP6 and that its implementation may need to be phased. We consider that it will be important for ORR to conclude at an early stage of the review (for example in its conclusions to this consultation) the scope of what can be implemented for CP6. Realistic expectations will be required, particularly on the extent to which customers can be involved in the development of the company's plans given the likely limited industry resources and timing constraints. We consider that maximising customer engagement is more important than setting very detailed targets and plans.

System operation

Network Rail's System Operator function includes balancing the needs of its passenger and freight customers, delivering the requirements of its public funders, building a cohesive national timetable and providing the necessary engineering access to build and maintain the railway. Network Rail plans to introduce a System Operator scorecard which will allow transparent reporting of the network-wide activities, which aim to make best use of network capacity.

ORR's consultation sets out a number of options that the form of System Operator regulation could take. Network Rail agrees that the System Operator should have its own regulated outputs, although we consider that a separate revenue requirement is not required, as the functions cut across other activities. Instead, a plan would be developed for Network Rail's System Operator function. We could report against ORR's assumptions on System Operator expenditure during CP6. For the purposes of calculating track access charges at a route-level, System Operator expenditure could be allocated to each route.

As part of the System Operator work in PR18, Network Rail does not expect the reopening of matters such as introducing new charges that are linked to the relative 'value' of different parts of the network. This has already been discussed (and subsequently closed down) as part of ORR's charges and incentives workstream.

Outputs and monitoring

Network Rail will be able to build on the recent implementation of customer-focused scorecards for CP5 to increase the involvement of train operators and other local stakeholders in setting appropriate outputs for CP6. These discussions should also consider how the regulatory regime supports stronger alignment between Network Rail's outputs and the requirements set out in franchise agreements, where possible. Further consideration of how to include measures of long-term management of the network in the scorecards and the respective roles of customers, funders and ORR will also be required.

In respect of specific regulated outputs, Network Rail considers that the Passenger Disruption Index (PDI) should be removed in CP6. Inevitably there are costs associated with reporting PDI performance. In our experience it has not been widely used by the industry to monitor network availability. We would welcome further discussion with ORR and industry on other suitable measures of the extent to which the network is available to run trains.

We note the National Task Force's (NTF) work on how train performance is measured, and in particular whether the Public Performance Measure (PPM) is appropriate. Network Rail has contributed to this work, and as ORR notes, it is important that PR18 builds on NTF's findings.

In respect of the monitoring framework, Network Rail considers that customer-focused scorecards should allow ORR to rely more on Network Rail's customers to hold it to account, as well as its Board to provide oversight and assurance. ORR should then be able to focus on simpler and transparent monitoring and reporting of Network Rail's performance, consistent with the customer-focused scorecards.

Network Rail also considers that the approach to how indicators are used needs to change. The current approach creates the wrong behaviours in both Network Rail and ORR, where indicators are treated as regulatory targets. This results in ORR being treated as Network Rail's customer. While Network Rail considers that indicators should continue to be used for managing the business, it should not be required to publish forecasts of them in CP6.

We recognise that ORR may find our performance against indicators useful for monitoring purposes. However, we are keen to reduce the regulatory burden of the Annual Return reporting requirements where possible. A possible means for sharing our performance against indicators with ORR in the future is the National Data Trends Portal. We also consider there is an opportunity to simplify financial reporting with a reduction in the amount of detail included in the regulatory accounts. We believe this would increase transparency by making financial reporting more accessible and would reduce the significant regulatory burden relating to production of the regulatory accounts. We could again provide supplementary data through the data portal. We would welcome further discussion with ORR on this as we consider early changes could be made in CP5.

Charges and incentives

Network Rail set out its initial views on the charges and incentives framework in its response to ORR's December 2015 consultation. In summary, Network Rail stated its support for ORR's proposals to prioritise the development of the infrastructure costs package and closing down the value-based package for CP6.

Network Rail notes ORR's reference to potentially calculating some charges based on each route's costs to improve cost reflectivity. While the consultation does not go into further detail, Network Rail understands that a potential option could be the disaggregation of the variable usage charge (VUC) (rather than the current single network-level charge). Based on previous work carried out by Network Rail on this issue, it is important to be mindful of the perverse incentives that route-based VUC could create. In addition and as previously discussed, RDG's Review of Charges concluded that VUC received broad industry support in its current form and was not considered as a priority for change.

We note ORR's intention to continue its work to identify incremental improvements to the incentives for possessions and performance (Schedules 4 and 8). The Capacity Charge, Schedule 8 and Schedule 4 are closely linked. We consider, therefore that they should be reviewed in the round and, as previously discussed, as a priority for CP6. We consider that the following aspects should be reviewed:

- Ensuring that the evidence for compensation payments to operators in Schedules 4 and 8 is up-to-date and robust.
- Reforming the Capacity Charge, for example by directly absorbing it into the Schedule 8 regime.
- Improving the incentives on passenger operators to reduce reactionary delay which they cause.
- Reviewing the Sustained Poor Performance arrangements in Schedule 8, to ensure that they are fit for purpose.
- Refining the calculation of the Access Charge Supplement in Schedule 4.

Network Rail supports ORR's approach to simplifying or abolishing track access charges that do not deliver sufficient benefits. For example, Network Rail considers that PR18 could review whether the Coal Spillage Charge should be retained. There would be a cost to the industry of re-calibrating the Coal Spillage Charge for CP6. This cost should not be disproportionate to the value of the charge itself.

It will be important that ORR concludes on the overall charging and incentives framework as soon as possible, such that Network Rail has sufficient time to focus on the detailed policy and calculation of access charges for CP6 in collaboration with our customers.

We would welcome further discussion with ORR and industry stakeholders on all these issues prior to the publication of its charges and incentives consultation in December 2016.

Approaches for enhancements

ORR's consultation sets out a number of questions relating to the treatment of enhancements in PR18 and what criteria might apply in determining the overall approach. Network Rail will provide detailed thoughts on these questions in its response to the enhancements working paper.

In considering the overall approach to enhancements, it is important that clarity is provided on how the governments will fund enhancements, even for schemes agreed outside of PR18. This could be through the governments' SoFAs or otherwise. In particular, we consider that we should receive direct grant funding for the part of enhancements that deliver wider benefits to society. Absent such an approach, it means that the railway pays for the wider society benefits and the level of Network Rail's debt and the associated servicing costs will increase.

The enhancements framework should also be consistent with the core principles set out in the Memorandum of Understanding (MoU) between Network Rail and DfT. In particular, there needs to be clarity of the commitments being made as enhancement schemes progress through the project lifecycle from early stage planning, development, design and ultimately delivery.

ERTMS and related technology

Network Rail notes ORR's view that insufficient clarity will exist about the timing and funding of Digital Railway for it to be included in its CP6 determination. However, it is critical that we are able to confirm the funding arrangements as soon as possible with DfT and ORR. This will allow the rolling programme of delivery to start across the network, as planned, in CP6. In addition, the arrangements will need to recognise that the programme spans multiple control periods.

As part of the development of the Digital Railway programme, we will need to agree funding arrangements for the wider industry's costs of deployment that support efficient and effective delivery. There are discussions already underway and we would welcome further clarification through engagement with governments, operators and ORR on the potential industry arrangements.

Whilst noting the above, ORR should be clear that Network Rail's core operations, maintenance and renewals plans for CP6 will be based on the roll-out of Digital Railway in CP6. It will be equally important to recognise that there are a number of R&D activities that are not included in the Digital Railway programme, but are integral to its success. We will need to ensure that there is sufficient funding for these activities in PR18.

Question 4

Developing the high-level framework for the review: ORR welcomes views on how its high-level approach could be implemented and on the potential framework set out in the chapter. As part of this, it invites thoughts on what it is practicable to achieve in PR18 and in CP6, and what might be more realistic to achieve in the subsequent periodic review.

ORR would welcome any further suggestions and ideas on how it might improve how it regulates Network Rail (noting that readers may wish to read and comment separately on the working papers that have been published following the consultation document).

Network Rail's response to this question does not seek to address all of the points which ORR makes in this section of its document. Many aspects will be covered in Network Rail's responses to the working papers or have been addressed in other consultation questions.

A potential framework for the determination

Network Rail agrees that routes should have separate revenue requirements and outputs as part of ORR's overall determination for CP6. We consider that our central functions and System Operator costs should be allocated to routes as part of that process. As ORR notes, RAB and debt will also need to be allocated to routes to support the calculation of route revenue requirements (although it is important to note that any borrowings will be made by Network Rail centrally, and not on a route-by-route basis).

We consider that route revenue requirements should be based on individual plans, which will include the route scorecards. Separate plans would be available for Network Rail's central and System Operator functions.

Outputs

Network Rail considers that regulated outputs should be determined for each route (including separate outputs for the freight route) and Network Rail's System Operator function. These should be based on the route and System Operator scorecards, developed in consultation with customers.

Revenue requirement and duration of CP6

Network Rail supports ORR's proposal to retain the building blocks approach to calculating Network Rail's revenue requirement for CP6.

ORR's consultation discusses the need for ORR to decide on whether Network Rail's efficiency assumptions should be based on what a fully efficient company would be expected to achieve or a more realistic level of challenge for the company. It is important that ORR's efficiency assumptions for CP6 are realistic and recognise the pace of change that is possible. It should also be noted that the overall level of efficiency will be influenced by the level of funding and financing that is available in CP6.

Network Rail agrees that considering all sources of its income together, whether from regulated access charges or commercial income, (i.e. the single-till approach) remains appropriate. This approach has the advantage that any profits the company makes from its 'non-core' railway activities reduce the size of the overall revenue requirement (although as ORR notes, Network Rail's asset disposals programme is likely to significantly reduce the level of single-till income in the future).

In respect of the duration of the control period, Network Rail agrees that five-yearly settlements remain appropriate. We consider that the certainty of funding for a five-year period is critical to effective planning, although we recognise that this requires commitment from government.

It is important that five-yearly settlements are considered in the context of the railway's much longer planning horizon. Some projects do not fit 'neatly' into a single control period. Other projects will straddle the end of a control period, and clarity is required as to how these will be funded. It is also important to recognise that our plans will continue to evolve within and beyond each funding period.

The financial framework and change control

Financial framework

Network Rail agrees that the mechanism for financing and funding Network Rail, the borrowing limit and the process for agreeing these are critical for the company and the PR18 process.

Network Rail will continue to invest to deliver enhancements to the rail network in CP6. Establishing how the funds to pay for these are provided is key. Money for these enhancements could be provided through government grants, funding from third parties or via loans from DfT.

If the majority of CP6 enhancements are debt-funded, this will have a significant adverse impact on the level of Network Rail's debt and the associated servicing costs, which are already a significant proportion of its revenues. It would also impact the long-term financial sustainability of the company and the attractiveness to third-party investment. As discussed, above, we consider that there would be merit in the costs of enhancements that deliver benefits to society being cash-funded in CP6.

To enable Network Rail to develop business plans, and for ORR to develop its policy on Network Rail's financial framework, DfT's SoFA should cover the mechanisms through which funds will be provided to Network Rail. This should include debt, which has not been included in previous SoFAs (noting that these were prior to reclassification). During PR18 we will be working with governments and ORR to agree the funding and financing arrangements for CP6, including the approach to our loan agreement.

Managing uncertainty and change control

The approach to managing financial risk and uncertainty for CP6 and beyond is one of Network Rail's priorities for PR18. As ORR notes, we face a number of both controllable and uncontrollable risks. The ability to manage interest rate and inflation risk over the course of CP6 will be of particular concern (since reclassification has impacted our ability to manage these risks).

We consider that the PR18 determination should provide flexibility for Network Rail to respond to changing circumstances without jeopardising the safety and sustainability of the GB rail network. Network Rail therefore agrees with ORR's proposal that the settlements it determines for CP6 should include a specific financial buffer to recognise potential changes in circumstances during the control period. However, we also consider that the framework should allow for trade-offs between outputs and expenditure which would be reported in the route scorecards.

The approach to risk should recognise the different types of risk that Network Rail faces. We consider that there are three broad categories of operational risk:

- route-level uncertainty – route costs that 'expected' to arise for which specific activity or cost is unknown, e.g. increased volume/cost of embankment renewals in a route;
- network-level uncertainty – costs that are 'expected' to arise for which the specific route location as well as activity or cost is unknown, e.g. localised costs caused by flooding; and
- contingent risks – potential higher expenditure (or lower income) from risks that are 'unexpected', particularly in terms of frequency and the scale of unknown events.

ORR's consultation specifically asks for views on the use of a "central risk reserve mechanism". We strongly support the use of a central risk reserve which would be used to manage network-level uncertainty and contingent risks, as described above. It would need to be based on a proportionate risk allowance and included in Network Rail's central plan. There will also need to be appropriate mechanisms in place relating to financial risks (e.g. interest costs and inflation) and enhancement costs.

Out / under performance at a route-level

As ORR notes, route-level regulation has further implications for how Network Rail and its routes manage out- and under-performance against the baselines that ORR sets. We are pleased that ORR recognises that we will need the ability to move money between the routes to ensure financial sustainability and best value for money, across the company. We also agree that this will require a clear reporting process of over- and under-expenditure at route-level.

Incentives framework

We note ORR's view that route-level regulation could have implications for the contractual incentives framework which it sets. Specifically, it suggests that the Schedule 8 contractual performance regime may need to change since the current benchmarks are not route-specific.

We are unclear on the benefits of making this change, particularly since it could result in more complexity. Our understanding is that trains crossing a geographic boundary would be required to deliver different levels of performance which could result in some significant differences. Given the even greater focus on delivering for the customer, it is important that we establish if this change would be beneficial for operators, passengers and freight users. We expect that it may be more valuable for Network Rail to deliver a good, consistent level of performance across a train service, rather than changing the targeted level of performance at a route boundary. Also, we believe that this could be a considerable change in the Schedule 8 recalibration for PR18, and would welcome early clarity on the proposal. We would also welcome further discussion with ORR to understand its rationale for this suggestion.

Similarly, we understand that ORR is considering geographic disaggregation of the Variable Usage Charge (VUC). As stated earlier, we have concerns about this proposal.

Monitoring and encouraging good performance

We agree that the shift to regulating Network Rail at route and System Operator level provides an opportunity for major change to the way in which we are currently monitored.

As discussed in response to question three, above, we consider that route scorecards should have a fundamental role in ORR's monitoring of Network Rail in CP6. Network Rail's Board would provide oversight and assurance through the route scorecards and they should facilitate our customers taking a greater role in holding us to account. This should allow ORR to focus on simpler and transparent monitoring and reporting, and should reduce the need for detailed data interrogation.

With the implementation of route-level regulation, it will be important to ensure that the reporting burden is proportionate. As discussed above, a key aspect of this will be reviewing the approach to forecasting indicators and enablers in CP6, as well as ensuring that reporting requirements are adding genuine value.

Question 5

Process and engagement: ORR would be grateful for comments on the proposed phases of its review, including any views on the draft timetable and its proposed approach to engagement. It also invites high-level views on the process for customer engagement by Network Rail's routes and the system operator to inform their business plans, in terms of what is achievable for this review.

PR18 timetable

We note ORR's proposal that Network Rail's Strategic Business Plans (SBPs) should be published in October 2017. This would have significant implications, not least reducing the time available for the development of and consultation on the route strategic plans. We need to ensure that there is sufficient time for routes to produce robust and evidenced-based plans together with effective customer consultation.

We welcome the increased role for customers in the development of our plans and agreeing the outputs that each route and the System Operator should achieve in CP6. We do note, however, that franchised operators currently are not financially exposed to changes at periodic reviews. This could impact the way in which they seek to influence the outputs that they wish to see delivered in CP6. The PR18 approach to customer engagement, therefore, will need to manage such challenges.

Implementation

In respect of ORR's discussion on implementation of PR18, we would stress that sufficient time needs to be set aside for drafting changes to track and station access contracts, and our Network Licence. This will ensure that all relevant parties understand the revised provisions and have the opportunity to contribute, as well as minimising the risk of drafting error.

We note ORR's observations about industry stakeholders' engagement in the contractual drafting process for the implementation of the PR13 Final Determination. If industry stakeholders are to take more of a role for drafting in PR18, as ORR suggests, policy decisions need to be finalised sufficiently early in the process. Network Rail considers that this would need to be well in advance of its PR18 Final Determination. This is also the case for making changes to Network Rail's billing systems. Sufficient time needs to be allowed for understanding requirements, code development, testing and implementation.

Finally, we agree that there would be merit in PR18 exploring how an individual route settlement (or indeed any aspect of ORR's Final Determination) could be challenged without challenging the whole determination, as is currently the case. However, in the event that we were to object and ORR was to refer our challenge to the Competition and Markets Authority, we are unclear how it could do so without referring the whole determination. We would welcome further discussion with ORR on how this could work in practice.