

Network Rail's response to the ORR's PR18 working paper 5: Options for the treatment of enhancements in PR18

14 October 2016

KEY POINTS

Network Rail is pleased to respond to the ORR's working paper on options for the treatment of enhancements in the 2018 Periodic Review (PR18). The key points are summarised below.

- Funders require flexibility as to their preferred approach to funding enhancements, either through the periodic review process or the investment framework. Both approaches need to be reviewed to make sure they are fit for purpose and address the key points set out below.
- A more flexible approach is required to the funding framework for enhancements to facilitate the incremental 'pipeline' approach to the development and delivery of enhancements set out in the MoU between Network Rail and DfT.
- The enhancements framework must support the introduction of third party financing and funding.
- There needs to be a change control process that facilitates incremental commitments as enhancements progress through the agreed joint decision points, that facilitates the incorporation of additional enhancements funded outwith the periodic review and that can adjust Network Rail's existing commitments and funding as necessary as a consequence of these additional enhancements.
- There needs to be a clear understanding of the respective roles of funders and ORR in determining the efficient cost and value for money of individual enhancements and in the overall framework for holding Network Rail to account.
- The SoFA must provide certainty of funding for the enhancements specified in the HLOS for delivery in CP6. The SoFA should also make an appropriate allowance to manage scope and cost changes as the portfolio develops as well as funding for development of other enhancements in the pipeline.
- In order to plan efficiently and to address deliverability and affordability of the enhancements programme, it would be helpful to have an understanding of the potential overall funding envelope for CP6 and a view of further development priorities in preparing our CP6 Plans. We recognise this is an evolving picture which will require continuous dialogue between Network Rail and funders.

The remainder of this response follows the structure of the consultation paper.

1. INTRODUCTION AND CONTEXT

Context

As set out in our response to the ORR's initial consultation on PR18, the review 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. This will be of particular importance for the treatment of enhancements in PR18.

Network Rail's reclassification as a public sector organisation in September 2014 has led to a number of changes that are relevant to enhancements. In particular, reclassification has removed the benefits of the company's previous funding and financing structure. Network Rail must now borrow directly from the UK government and there is a binding borrowing limit in place for CP5. In respect of enhancements, our reclassification means that we can no longer raise additional debt to manage the risk of overspend, for example, in response to project costs increasing or requests to deliver additional benefits.

Reclassification has also necessitated a closer working relationship with the Department for Transport (DfT). The terms of this relationship are set out in the [Memorandum of Understanding](#) which has been agreed between the DfT and Network Rail.

The Memorandum of Understanding was agreed in response to the recommendations of the [Bowe Review](#) into the planning of Network Rail's enhancements programme for CP5. The review concluded that in CP5 many decisions to fund projects through PR13 were taken whilst projects were immature and without adequate understanding of the risk and uncertainty for cost or delivery that this entailed.

The Memorandum of Understanding describes a different approach to planning and funding projects than was followed in PR13. It supports a continuous planning approach and moves away from a rigid five-year cycle for enhancement planning linked to control periods. It establishes a lifecycle for enhancements with joint decision points covering development, design and delivery. These are formal gateways to proceed to the next stage of work, supported by joint commitments to fund and deliver work, and informed by the Treasury's business case guidance. Joint decision points can only be passed when there are sufficiently mature cost, benefit and risk estimates, and will ensure there is a clear line of sight between funding, outputs, outcomes and benefits. The framework for enhancements in PR18 should support the principles of this approach.

2. DRIVERS FOR CHANGE

Network Rail recognises the drivers for change described in the ORR's working paper. The lack of maturity in the development of a number of projects specified by the DfT and Transport Scotland in their 2012 HLOSs at the time of Network Rail's 2013 Strategic Business Plan (SBP) submission was a key reason for the challenges experienced in delivering the enhancements portfolio for CP5.

While the enhancements cost adjustment mechanism (ECAM) process mitigated this to some extent, it required Network Rail to develop a large volume of complex, high value projects simultaneously. A shift to a "pipeline" of projects would allow Network Rail to devote the necessary feasibility and development resources in a planned and controlled manner. This would result in projects that are initiated as the need is identified, and committed to in alignment with decisions on franchises or other key interfaces.

An additional driver for change in the treatment of enhancements in PR18 is Network Rail's view that financial sustainability should be a key priority for PR18. In respect of enhancements, this should include limiting the future increases in debt, increasing the proportion of enhancements which are grant funded and improving the railway's attractiveness to third party investors.

3. KEY CONSIDERATIONS FOR PR18

Planning and Reporting

We agree that it is for the DfT and Transport Scotland to decide to what extent the commitment to fund enhancements is made through the periodic review. However there should be certainty of funding for the projects to which Network Rail and funders have committed, whether this is as part of PR18 or otherwise.

The framework used by funders should also facilitate the principles described in the Memorandum of Understanding between Network Rail and the DfT, in particular the development of a continuous planning approach to enhancements in which funding is only committed to projects once they are sufficiently developed.

An advantage of including enhancements within the periodic review is that it allows detailed planning of the delivery of enhancements projects to be integrated with plans for renewals and other areas of Network Rail's business. This is particularly important on major programmes of enhancements with complex timetable changes. Commitment to enhancements through the periodic review also provides certainty to the supply chain, allowing suppliers to plan their businesses efficiently, and to operators that outputs will be delivered and that they will be able to make changes to their operations accordingly.

In order to mitigate the uncertainty potentially created by a progressive approach to committing to enhancements, Network Rail and funders will need a shared understanding of the potential overall portfolio of projects to be delivered and scale of funds likely to be available. Recognising this may change over time, this will require a process of continuous dialogue with funders on the overall pipeline of projects in development and delivery as we develop and deliver our overall plans for CP6. This will allow Network Rail to plan with a reasonable degree of certainty to deliver enhancements efficiently alongside renewals and maintenance and to manage our resources and access effectively.

If funders choose to make significant commitments to enhancements outside the periodic review it is essential that there is a clear process to capture the impacts upon other areas of Network Rail's business.

In our response to the ORR's working paper on the outputs framework we set out that our routes and the System Operator will work with customers and funders to agree our core priorities for CP6, which will form the basis of our scorecards. These will enable our businesses to set, track and achieve their objectives.

Our response proposed that the regulated status of each measure on the scorecard will be made clear and its forecast will be updated through the control period, rather than having a hard target set at the start of CP6. This will allow the impacts of progressively announced investments in enhancements to be flexibly taken into account and appropriate adjustments made. Planning for

delivery of renewals and maintenance works could also be affected and there will need to be a clear process for updating plans to take account of the impact of new enhancements in agreement with relevant customers.

Network Rail is strongly supportive of retaining ring-fenced funds funded through PR18 in CP6, provided that there is clarity on the funds' objectives and the appropriate fund governance is in place to allow industry decision making on the allocation of the fund. This means of funding is flexible and allows relatively small investments to be made to improve outputs efficiently by directing them through the industry party best able to deliver the benefit. A further benefit is that funds can provide a means of leveraging small scale third party investment into the rail industry that would not otherwise be realised.

Network Rail believes that the Enhancements Delivery Plan is a useful way of providing transparency to funders, customers and stakeholders of the outputs which Network Rail has committed to deliver. We would need to agree what the scope and purpose of this document, including with funders, as it may not be appropriate to include all enhancements in this document.

The structure of the plan will be reviewed to best align with the principles of the Memorandum of Understanding and the funding and regulatory arrangements for CP6, including the potential for increased third party funding of enhancements.

Regulatory Treatment

The decision to fund projects outside of PR18 must be accompanied by an assessment of the impact of developing and delivering the project on Network Rail's business as a whole. Where funders wish to purchase enhancements which impact other outputs there will need to be a transparent process for making changes to these outputs involving consultation with customers and the ORR.

We agree on the need for clarity around RAB additions in PR18. Network Rail must have confidence about when and how it will be reimbursed for the cost of enhancements projects to which it commits. The process for determining RAB additions and the efficient cost of projects should be aligned to the project lifecycle and the decision points established in the Memorandum of Understanding. It is our view that the efficient cost of a project should be agreed at the final decision point, the commitment to deliver. Network Rail is continuing to develop this process and will use this work to inform the ongoing development of the periodic review.

It will be essential to have a clear framework to fund projects outside PR18 and the current investment framework should be reviewed to determine whether it is fit for purpose. Its ability to support third party funding and financing of enhancements, and to provide a mechanism to incorporate projects committed to outside PR18 into the regulatory framework, will be key factors in determining the current investment framework's suitability.

Financial

It is critical that the borrowing limit and HLOS affordability assessment take account of the potential to commit to projects outside the periodic review so that Network Rail can be given certainty of funding when these projects are committed to. This could be achieved either through making an allowance within the borrowing limit for future schemes to draw down upon as they are developed,

or by making adjustments to the borrowing limit as new schemes are committed to. These options are not mutually exclusive and both mechanisms could be used during CP6.

As discussed, above, long-term financial sustainability is a key priority for Network Rail in PR18. We propose a change in the funding arrangements for future enhancements to avoid the continuing accumulation of debt and impact on Network Rail's balance sheet. Potential solutions include grant funding of the proportion of new enhancements that deliver socioeconomic benefits and better sharing of the costs of investment between the beneficiaries (potentially including Train Operating Companies and local businesses). Currently projects that have major socioeconomic benefit are mainly funded by Network Rail through increased debt. Such projects could be funded by stakeholders who will benefit from the socioeconomic changes and therefore could realistically contribute to the expenditure.

Network Rail will shortly write to the ORR to set out our views on key aspects of the CP6 financial framework, which will include changes in the financial arrangements for future enhancements.

4. PRINCIPLES OF ORR'S ROLE IN ENHANCEMENTS

It is important that there is no ambiguity over the roles and responsibilities of ORR, funders and Network Rail. In particular it must be clear who is holding Network Rail to account for the delivery of agreed outputs. This is in accordance with the principles described in the Memorandum of Understanding and the findings of the Bowe review. The future agreement of Memoranda of Understanding between Network Rail and Transport Scotland, and between the DfT and the ORR should further clarify roles and responsibilities.

We would welcome the ORR playing a role which supports further political devolution and encourages third-party funding and financing, including from the private sector.

5. POTENTIAL APPROACHES FOR REGULATORY TREATMENT OF DFT AND TRANSPORT SCOTLAND PROMOTED ENHANCEMENTS

Criteria for an overall approach

Network Rail agrees with the criteria set out in the working paper. In addition it is essential that the approach supports the principles of the Memorandum of Understanding and gives certainty of funding for committed projects.

Options for the DfT and Transport Scotland

Network Rail agrees that the three options described in the working paper are all viable and are not mutually exclusive. A fourth option could also be explored of enhancements being grant funded through the periodic review. This would support our ambition to improve our long-term financial sustainability through PR18 which we have discussed in sections 2 and 3, above.

Network Rail is committed to implementing the principles of the Memorandum of Understanding with all funders to allow the most effective management of projects and the minimisation of risk across Network Rail's entire portfolio. The Memorandum of Understanding describes joint investment decisions between the funder and Network Rail, rather than decisions solely by the funder as

described in the working paper. These principles should be implemented regardless of the funder and the funding mechanism that is employed.

Commitment to schemes through the periodic review allows links between enhancements and other areas of Network Rail's business to be considered at the time of the periodic review and gives increased certainty to the supply chain and other industry parties. However it is essential that schemes committed to through the periodic review process are adequately developed to avoid the risk that Network Rail and funders are required to commit to projects without sufficient certainty of outputs and costs.

Commitment to schemes separately from the periodic review by funders allows Network Rail to develop a pipeline of schemes which are only committed for delivery when they are sufficiently developed and their costs and outputs are well understood. However it means that these schemes cannot be considered alongside other areas of Network Rail's business at the periodic review and potentially it reduces visibility for the supply chain and other industry parties. In order to mitigate these impacts it will be essential for the overall regulatory framework to include a mechanism so that the impact on other outputs of new commitments to enhancements can be taken into account.

If schemes are committed to separately to the periodic review and are debt funded there will need to be a mechanism to increase the borrowing limit, if it has been fixed in PR18. Alternatively headroom could be assigned in the borrowing limit set at PR18. As the costs of enhancements projects will not be well understood at this time this would need to take the form of an allowance without specific outputs attached which would be drawn upon until it was fully utilised.

In all options there would need to be clarity about the allocation of risk between Network Rail and the funder. Allowances would need to be made in Network Rail's funding for additional risk to enhancements delivery and other areas of the business created by commitments made to deliver additional enhancements.

Areas that may be impacted by the options selected

In PR18 Network Rail supports moving away from having outputs specified by the ORR and instead publishing scorecards that we can update, with clear statements of the regulatory status of each measure. Additional commitments to enhancements projects outside the periodic review and their effects on other measures would be reflected in updates to these scorecards. This approach was described in our response to the ORR's working paper on the outputs framework.

As has been described, visibility of the forward enhancements pipeline and the priority projects for CP6 would allow Network Rail's renewals and maintenance works to be planned efficiently. The impact of new commitments on the core business and the deliverability of the existing enhancements portfolio will be a key consideration for Network Rail at joint investment decision points for enhancements.

Access planning is a key constraint for the delivery of rail enhancements. The progressive commitment to enhancements separately from the periodic review could affect Network Rail's ability to plan access efficiently and there will be a trade-off to be managed between the desired flexibility and the stability of the portfolio to plan access and resources in an efficient manner. Commitments to deliver projects separately from PR18 will need to be taken in sufficient time to allow integration into the existing work bank planning.

Network Rail would expect to take a portfolio approach to the management of enhancement projects in CP6, regardless of the option through which funders choose to commit to enhancements. Projects could be added to the portfolio progressively over CP6. If the impact of a new enhancement on the deliverability of the overall portfolio would be likely to be significant then this would need to be assessed as part of the decision to commit to the project. Management of enhancements as a portfolio, rather than these projects having discrete budgets, allows Network Rail to balance over and under spends on projects within the portfolio. As noted in the working paper, the required risk uplift from a group of projects treated as a portfolio is statistically less than the sum of individual project risk so the portfolio approach can offer significant value.

We would expect to treat funding for enhancements as ring-fenced from funding for other purposes, including renewals and maintenance.

We agree that the introduction of new enhancements schemes into the portfolio has an impact on Network Rail's level of risk, both for the delivery of the enhancements portfolio and for other activities. An allowance would need to be made to reflect this increased risk. This means that even for grant funded enhancements an adjustment to the borrowing limit might be required to reflect the risks of delivering the enhancement to Network Rail's wider business.

Incentivisation could be achieved by a number of different mechanisms, depending on the allocation of risk between Network Rail and funders, and further discussion is required to establish the appropriate approach consistent with the overall framework.

6. OPTIONS FOR OTHER FUNDERS OF ENHANCEMENTS

As discussed, above, the ability to support third party funding should be a key consideration in determining the framework for enhancements in PR18. Since reclassification, the allocation of all of Network Rail's financing capacity for enhancements to HLOS projects has meant that there has been no ability to RAB finance third party projects, as was previously done through the investment framework. PR18 should create a framework in CP6 that supports more third party involvement in the funding, financing and delivery of CP6 outputs.

The existing investment framework should be assessed to determine whether it is able to deliver this objective. It is important that this mechanism is understandable and transparent to non-rail industry parties.

Network Rail would welcome an exploration of the proposal for a ring-fenced fund allowance for third party schemes to be explicitly included in the determination and reflected in our loan agreement. Such a fund would be similar to the Stations Commercial Project Facility that was successful in delivering profitable enhancements at stations in CP4 and CP5. However, other options could also be considered as facilitating third party investment in the rail network is a key objective for Network Rail in PR18.