

Route-by-route regulation: the right move for rail

Speech by Joanna Whittington, CEO, Office of Rail and Road

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Thank you for inviting me to speak today.

The Office of Rail and Road is an organisation which, at its heart, has been set up to protect the interests of road and rail users – improving the safety, value and performance of railways and roads today and in the future.

Regulation is sometimes seen as being a backwards looking function – reporting on performance that has been delivered.

And that is an important part of our role. It can give confidence to funders whether they be in the public or private sector and to the passengers and freight customers who use the network that the outputs they rely on are being delivered. At the same time transparency strengthens the incentive on service providers to fulfil their obligations and meet the needs of their customers.

However, ORR is clear that our function is not just to report latest facts and figures. Our role is also to provide commentary and insight to infrastructure owners and service operators in a way that supports future delivery and improvements to the railways.

And it is in this context that I want to talk more about the work we are doing in preparing for Network Rail's next funding period in 2019 or in regulatory speak PR18.

As those of you who have been involved in periodic reviews previously will understand, this is a really important opportunity for all those involved in the railways (who are best able to articulate the views of passengers and freight customers) to have a say in what its future looks like for the following five years.

It is the regulatory process through which the costs and outputs delivered by Network Rail for a five year period are determined – a process we kicked off in May with the publication of our initial consultation document, and which will conclude two and half years later with our final determination in October 2018.

Unlike periodic reviews in other sectors, which have historically focussed on the relationship between the regulator and the regulated company, the periodic review in railways has usually attempted to do more. It provides an opportunity to determine not only the outputs, and cost of those outputs to be delivered by Network Rail, but to look much more widely at the incentives it creates on users of the rail network. That breadth necessitates a process which clearly recognises the issues that the rail industry faces today - something which can only be done with proper dialogue with a wide range of stakeholders and an opportunity for us as a regulator to demonstrate that we are listening

So what are those important issues that face the railway today and importantly how are they impacting on Network Rail? I will touch on three, though there are clearly others, before going on to consider how we can build on developments within the industry to support our regulation of Network Rail.

First of all, growth. There has been sustained growth in passenger numbers over many years, which is a success story. As a result, Network Rail's network is increasingly busy, with train kilometres up by nearly 25% since 2005-06. Capacity improvements have benefitted passengers and freight customers and allowed more services to run, but passenger numbers are forecast to continue to grow - albeit that any forecast of demand comes with uncertainty around the rate of growth in particular.

A busier network increases the challenge for Network Rail across its roles: there are more constraints on the time available to maintain and renew the infrastructure; timetabling additional services is more complex; greater passenger numbers need to be accommodated at stations and when boarding trains; and capacity constraints limit the expansion of services despite the strong demand for them.

Meanwhile, passengers are funding an increasing proportion of the costs of running the railway, with the balance met by taxpayers. Understandably, there is a very public focus on fares, value for money and the level of service and performance that passengers expect in return.

And for Network Rail's freight customers, we are seeing some significant shifts. There have been substantial declines in coal volumes, set against growth in intermodal and construction-related freight over recent years. These shifts pose questions; how can the network best support freight growth, and provide it with the flexibility required to meet the needs of its new customers?

Turning to the reclassification of Network Rail, while we are all now familiar with this as a concept, some of the implications for the industry are only beginning to play out. It means that Network Rail now competes much more directly for funding with hospitals, schools and defence and that the binding borrowing limit provides a much harder constraint on Network Rail than previous arrangements, which rightly or wrongly allowed it to raise its own debt off the regulatory asset base.

When coupled with the constraints on public spending, this highlights the need to:

- make the best use of the current network, as opportunities for additional investment – beyond the major committed schemes – might be limited;
- identify alternative additional sources of funding for the railway which is at present almost exclusively limited to receipts from the farebox and from taxpayers, via central government.

And finally there continue to be challenges on Network Rail's efficiency, where some costs have risen in the last couple of years, when we had expected them to fall. This has been discussed at length in the context of enhancements which resulted in Sir Peter Hendy's replanning of the enhancement programme. But it is also the case that the cost of renewals has increased.

In our most recent Monitor which we published last week reviewing Network Rail's performance over the first 6 periods of 2016-17, the cost of the renewal work Network Rail has planned for the current financial year is £295 million higher than expected against NR's budget due to a number of reasons, including less work being delivered by high output plant; additional contractor claims; reduced volumes and not delivering against its planned efficiency initiatives.

Together the effect of this overspending on capital expenditure has been to place additional pressure on Network Rail's financial position, so that in May we estimated that this would lead to the deferral of £9.5 billion of enhancements expenditure and £2.5 billion of renewals expenditure from the current funding period to the next funding period.

Importantly - and as we have already heard from Mark - Network Rail has already started to respond to these challenges through its Transformation Plan - most significantly from my standpoint through the establishment of a system operator and the devolution of its activities from the centre into its route businesses.

ORR is strongly supportive of the work NR has already undertaken in devolving operations further into the routes – we think that it provides a real opportunity for Network Rail to improve the way it is able to meet the needs of its freight customers, passengers and funders. Now the onus falls on the rest of us to understand what further changes are needed in the way we interact with Network Rail to maximise the benefits and opportunities which the new structure provides.

The benefits from devolution come in two parts:

- The opportunity for NR to be closer to and understand better the needs of its customers; and
- The opportunity for stronger incentives on Network Rail a publically owned company to be applied through meaningful comparison between 8 route

businesses each striving to efficiently meet the targets it has agreed with its customers.

Already Network Rail routes are in a better position to articulate the needs of their customers when this year they introduced route-based scorecards, agreeing with each train operator the outputs that are of importance to them. Inevitably there is still more work to do. We have been pleased to see the way the process is being revised in particular to allow for more time this year for those conversations to take place between train operators and the Network Rail route before scorecards are determined for 2017-18.

This will take time to bed down and ultimately its success will depend on the Network Rail routes delivering against the scorecards to build credibility with the train operators. Nonetheless we can see real benefit in a mechanism which strengthens the relationship between train operators and Network Rail, allowing the regulator to step back and also creating a stronger line of sight to the passenger or freight customer through the system.

We want this engagement between Network Rail and train operators and ultimately passengers to go much further and to be hardwired into the periodic review process so that Network Rail's business planning process builds off this local engagement. We published last week our draft guidance to Network Rail routes on how they prepare their plans for the five years from 2019 and in particular set out the engagement which they should seek in preparing their plans.

We expect them to meet local stakeholders – train operators, passenger groups and others in February next year before they have prepared their plans and again once they have produced the plans. We will want to understand how they have incorporated the feedback into their plan and we will prioritise our review around the quality of that engagement. The essential point and what I hope comes across clearly is that the success of routes and operational devolution depends on all of us – regulator included – in stepping up and changing the way we engage.

Which takes me on to my second point – how can we use the new structure to strengthen further incentives on Network Rail to deliver.

We think in due course that we will be able to make much better use of the information coming out of routes so that comparison between routes will provide on an on-going basis for stronger incentives on those working within Network Rail to improve. While we have started to increase our attention on routes over the last couple of years, to be effective our regulatory approach going forward will need to change further still. Not least because we do not as an office have the resource to regulate Network Rail in the same way, eight times. And to do so would be to miss the huge opportunity which comparison gives to incentivise change.

Already we are publishing more route based information in our six monthly reporting of NR's performance –

- In the 2015-16 Annual Monitor of Network Rail performance we compared route level expenditure by category against budget for the first time and;
- In our half yearly Monitor, published last week you can see for the first time how asset performance has changed by route over the first half of CP5.

At this stage, no single piece of information will on its own be a fair basis to compare routes but our hope is that we will over time be able to produce a comprehensive set of data at route level across the full range of a routes responsibilities – health and safety, asset management, train service performance, enhancements and finance which will give that picture.

Importantly we must also publish this information in a way which is accessible and usable to a wide audience and enables those local stakeholders who will be so critical in setting the outputs of a route to also challenge the route against delivery. I want the Monitor to become required reading for Route Managing Directors and their local stakeholders as they prepare for their regular face to face meetings.

I have talked a lot about routes but routes on their own won't deliver the railway we want without strong system operation foundations, too.

A national system operator that excels at timetabling capacity management and analysis can effectively mitigate the risk that increased devolution to routes could undermine the quality of service to those operating across the routes including freight operators.

Following consultation we have said that in setting the periodic review, Network Rail will prepare a separate business plan for the National System Operator and we will determine a separate settlement for it. Such an approach will:

- improve the transparency of the National System Operator role so that funders and operators are better informed about the decisions it makes, their impact and rationale;
- sharpen the incentives to manage the network more effectively both in terms of optimising the performance of train services and improving the use of capacity; and
- support longer term investment in better data, processes and technology so that the National System Operator has the tools and capability to be the system operator that delivers and enables the rest of the industry to deliver the benefits of a joined-up railway.

To make this work - much more needs to be done specifically so that we can measure the success of the National System Operator captured in a scorecard, in

the same way as we can measure route performance. Arguably the range of stakeholders interested in the system operator is as complex, if not more, than for a route. Those interested will include all Network Rail routes, all operators including both passenger and freight, all funders, as well as passenger groups, and ourselves in relation to our role in allocating track capacity. It may well be the case that the National System Operator will need to go further to get the right level of engagement and input, and establish different fora for different types of stakeholders, both as it develops its plans but also when it is held to account for their delivery.

We have welcomed the transformation plan that Network Rail has started to roll out in creating a route based business model supported by a national system operator. We don't need to wait until the next control period starts in 2019 to pass the benefit on to passengers and freight customers. As a regulator we are already making changes to the way we regulate which build on the new structure. But if we are really going to maximise the benefit that this new structure can bring then all of us – regulator, operators and funders need to think about the opportunity that devolved route businesses create and what we need to do differently to realise that.

Thank you