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Dear Paul

Possible breach of condition 1 of Network Rail's network licence with regard to its delivery of its enhancement programmes

I wrote to you on 31 March 2015 to advise Network Rail (NR) that the Office of Rail Regulation (ORR) was investigating the delivery of your enhancement programmes. We would like to take this opportunity to thank you for NR's co-operation and the information it has provided to ORR during the investigation.

The purpose of this letter is to summarise our preliminary findings following our investigation, and to give NR the opportunity to make any additional substantive representations. ORR's Board will decide if NR is in breach of its network licence.

The purpose of our investigation has been to establish whether NR did, or is doing, everything reasonably practicable to meet its licence obligations in relation to achieving its regulated outputs for CP5 in particular the planning, management and delivery of the enhancements projects in NR's Enhancements Delivery Plan.

It is important to set out how this investigation fits in with other related reviews concerning NR, including the 'Hendy review' of the enhancements programme. While this investigation has been undertaken due to NR missing milestones in the current programme, the underlying weaknesses that we have focussed on relate to NR's management capability to develop and deliver projects. Addressing this is vital if NR is to deliver either the current programme or any proposals emerging after the review. Therefore, rather than carrying out a specific deliverability assessment of individual projects and programmes, we have examined what steps NR is taking across the business to tackle the identified weaknesses. We also expect these areas for improvement to be included as part of the wider capability assurance framework; on which Mark Carne and Richard Price exchanged letters in July.

Our investigation has focused on the late completion of NR's development and delivery milestones because these are regulated outputs. We have also considered if there is evidence of systemic weaknesses relating to the delivery of these regulated outputs, with a particular focus on the following concerns we have previously raised with NR:

- project development (including estimating costs, assessing risks, compliance with legislation and ensuring safety by design);
- project delivery;
- delivering major complex programmes (such as Great Western Route Modernisation); and
- management of the CP5 investment portfolio.

As part of its investigation our team has considered information provided by NR and relevant passenger and freight train operators and funders. We have met NR and also taken account of all of the information it has provided including NR's draft improvement framework and plan. We have also taken note of the work being done as part of other enhancement reviews. We have considered whether there are any factors which could be affecting the delivery of enhancements which may be, in part or completely, outside NR's control.

Our investigation has also looked at NR's emerging Enhancements Improvement Plan (EIP) to assess the extent to which it addresses the issues we have raised during our investigation and whether the plan is sufficiently finalised.

Having carried out this work, our preliminary view is that NR may not have done, and is not doing, everything reasonably practicable to comply with condition 1 of its network licence in relation to the delivery of its enhancements programme. This view is, of course, subject to any substantive representations from NR. A summary of our findings and reasons is set out below.

Regulatory outputs milestones and systemic weaknesses

In our PR13 final determination, we defined the regulated outputs for enhancements in CP5 as scheme development milestones (for early stage projects) and scheme completion milestones. Given the early life-cycle status of much of the CP5 portfolio we clearly could not expect NR to set completion milestones, however our focus on the timely delivery of GRIP 3 gives an early indication of the level of stress in the programme. These milestones are set out in NR's CP5 Enhancements Delivery Plan, which is published on NR's website and revised quarterly using a regulated change control process. We commonly refer to these regulated output milestones using NR's GRIP stage-gates, as set out below:

- GRIP 3 completion (single option development) – scheme development regulated output
- GRIP 6 completion (infrastructure ready for use) – scheme delivery regulated output

NR missed 16 of 44 (36%) GRIP 3 regulated outputs and 14 out of 40 (35%) GRIP 6 regulated outputs in 2014-15. Our analysis has shown that the 30 missed milestones (36% of all milestones) in 2014-15 relate to projects that vary by size, type, location and complexity.

The reasons for NR missing GRIP 3 development milestones and GRIP 6 completion milestones are mixed. Our investigation, together with NR's own analyses, has identified the following areas of weakness:

- poor setting of project requirements (front-end definition) with inadequate change control against a baseline;
- inadequate governance and challenge of projects as they pass through development gateways;
- inconsistent consideration of safety issues during design and optioneering;
- the accountabilities of the client, sponsor and deliverer are blurred, as projects move through their lifecycle;
- cost estimation and risk functions are not adequately resourced or governed through the early project lifecycle;
- no defined framework, tools and techniques for managing complex infrastructure programmes resulting in underestimates of timescales, costs and impact on operational performance;
- absence of portfolio management capability to validate project reporting in terms of cost and schedule, for example by peer reviewing and challenging projects to provide early warning of failure or by better identification of shortages in critical resources
- late requirements identified when handing asset over to operator;
- land and consents issues underestimated;
- unknown asset condition, resulting in late increases to scope and re-planning;
- productivity is lower than planned;
- weak assurance of compliance with safety legislation and standards;
- inadequate and late technical files for authorisation under interoperability regulations;

We consider that the wide range of identified weaknesses indicates that NR's project development and delivery weaknesses are systemic, rather than the result of individual project failings or adverse circumstances. This is also evidenced by the wide range of causes and the scale of the required long-term improvements that NR needs to develop and embed into its business.

Assessing NR's response to missed outputs

We first raised concerns about the high number of slipping and / or missed milestones with NR in July 2014 through our regulatory escalator – our standard method of raising regulatory concerns. Due to an unsatisfactory response we further escalated the issues through formal letters sent from November 2014.

We have similarly been discussing concerns (and indeed taking safety enforcement action locally) regarding NR's approach to risk assessment and safety by design since early 2014. We also agreed a set of actions for NR to take to improve its approach to securing interoperability authorisations in April 2014.

NR's response to our concerns has been slow, localised and patchy, but began to be properly coordinated in February 2015 by the initiation of a review led by one of NR's non-executive directors who now chairs a specially convened task force known as the Major Projects Delivery Committee (MPDC).

During the course of the investigation, NR has presented several iterations of its Enhancements Improvement Plan (EIP). The EIP has been produced under the auspices of the MPDC and is designed to draw together a range of cross-NR actions to improve its capability and address ORR's concerns.

As part of the investigation we have analysed whether the above issues have been adequately addressed by the plan. We have concluded that, at the time of our assessment, the EIP contained some omissions and underdeveloped actions, particularly in relation to our concerns around NR's authorisation submissions, its approach to improving on 'safety by design' and its ability to manage major infrastructure programmes with timetable performance risks.

We also note that we have not seen clear analysis of the causes of missed milestones with a link to the associated actions in its plan. We therefore do not have complete confidence that NR has yet identified every issue.

The wide-ranging and long-term actions in the EIP acknowledge and demonstrate the scale of the changes needed across the company. The plan shows how far NR's capability needs to improve to deliver what is required in CP5, and is another indication that the weaknesses are systemic rather than isolated issues. Some actions in EIP are not yet dated and some will not be completed until November 2016. It will be a significant and long-term challenge for NR to embed the improvements into business as usual. This will require significant on-going effort, particularly in further developing and refining the EIP to ensure it is tackling the root causes.

On the basis of our findings, we cannot be satisfied that NR is doing everything reasonably practicable to achieve its regulated outputs, until:

- the EIP is sufficiently finalised; and
- there is evidence of improvement following effective implementation of the finalised EIP.

Next steps

In light of the above, we invite NR to make any further representations by 1 September 2015 in relation to the points set out in this letter. This could include any further information on how NR is addressing these issues,

mitigations or offers of reparation for consideration in line with our published economic enforcement policy. Following receipt of these representations we will consider what recommendations to make to our Board about whether or not NR is in breach, or has breached, its Network Licence. This is likely to be at the Board's next scheduled meeting in September 2015.

I am copying this letter to Patrick McLoughlin, Claire Perry, and officials at the DfT, Derek Mackay and officials at Transport Scotland, Mark Carne and Francis Paonessa at NR. A copy will also be placed on our website.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'A. Price', with a horizontal line underneath.

Alan Price