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Deputy Director EMS

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15 January 2021

Dear Oliver and Paul

ORR's review of Network Rail's delivery plan update (RF8) for the financial year 2020-21

As you know, Network Rail (NR) updates its control period 6 (CP6) delivery plan for its operating, maintenance and renewals activities (OMR) on an annual basis. ORR reviews the updated plans to help hold NR to account against the PR18 Final Determination. The Department for Transport (DfT) also uses our reviews to provide assurances to senior officials and Ministers that NR is on track to deliver the high-level output specification (HLOS) within the agreed funding envelope for CP6. This includes the process for the Secretary of State's (SoS) approval of any major changes in the updated delivery plan.

Our letter dated 27 November 2020 (the November letter) set out our review process, which ORR, NR and DfT agreed. That letter explained that ORR would conduct its review of the CP6 delivery plan update in two stages. This letter documents the first stage of our review. It reviews NR's re-forecast of the plans at period 8 (known as RF8). We agreed with DfT and NR that we will use this review to help identify issues for NR to consider for its period 11 re-forecast (RF11). Our second stage review will be on NR's RF11 re-forecast of the plans in February/March 2021.

We have reviewed the RF8 plans that NR submitted to us following a review by its National Strategy Committee. We recognise that NR is developing its plans in difficult circumstances as it is managing the effects of Covid-19 on its business. We also note that we have had good engagement with NR's regional and central business unit teams.

However, we are concerned with the lack of improvement in the quality of the information provided. For example, there was a lack of explanation/commentary in the RF8 plans provided to us. This is not consistent with the requirements set out in the 'Information Log' attached to our November letter. NR also provided some of the information later than agreed. We will need to revisit these issues in time for next year's review.

We note that these issues were major weaknesses with last year's plans and are the issues we have all been working together to resolve. These issues seem to be partly because NR's process is too internally focused. This has made our review more challenging, especially as we already had a very tight timetable to fit in with NR and DfT's processes. As a result, we have recently placed this issue on our regulatory escalator at level 1 (the lowest level).

For RF11, it is essential that NR both keeps to the agreed timescales, and improves the quality of the information provided to us. In particular, NR should clearly explain at RF11 (including an overview of the key issues at a GB level), the changes since RF8 and how it has addressed the further areas of work identified in this letter.

Below we present a summary of our emerging views and issues for NR to consider for RF11. The Annex contains our high-level analysis of the plans and provides some further detail of the issues we have identified. We note that the quality of information NR has provided to us has had an adverse impact on our review and the extent to which we can be confident of our emerging views. As such, it is worth noting that our views may change as and when further information becomes available.

RF8 appears broadly aligned with the current delivery plan

We have not identified any major changes[1] in the RF8 plans that could require future sign-off from the SoS. This is with respect to the current delivery plan for the 2020-21 financial year and for the remaining years of CP6. Overall, the RF8 plans remains broadly aligned with the current delivery plan and the PR18 Final Determination. We note this is our emerging view based on the information provided. In addition, and more widely, the current level of economic uncertainty makes it difficult to predict future changes to the RF8 plans.

There are some key positive reasons for NR not planning any major changes at RF8. For example, NR has handled the effects of Covid-19 well and has not reported any major delivery problems over the Christmas period. As such, our early view is that the RF8 plans still appear broadly deliverable. Further, despite NR reporting some new challenges, it also appears to be on track (and is confident) to deliver its efficiency commitments[2].

[1] Note: NR has planned to use further risk funding given the challenges this year, e.g. from the impact of Covid-19. However, as we understand it, this is not a major change for DfT as this funding was provided to pay for risks, which it is doing.

[2] We also note that a large proportion of network costs remain largely fixed and do not significantly vary with future passenger demand. This is the case for operations and renewal costs, and maintenance costs to a lesser extent, as these costs are required to sustain train performance, asset sustainability and safety over the control period and beyond.

In addition, we note that the risk funding process has provided planning stability. In particular, NR has used £1.1bn of risk funding[3] to manage the impact of Covid-19 and weather-related events (e.g. the Carmont derailment).

We have identified areas for further consideration for RF11

Our early view is that the RF8 plans appear broadly deliverable. However, NR needs to do further work on its plans and we expect some changes for RF11.

Our main issue is that at RF8 only £0.8bn of risk funding remains unallocated for the rest of the control period (this is largely consistent with a P65[4] position). This is £0.6bn below NR's analysis of financial CP6 risks (£1.4bn, which would be largely consistent with a P80 position). The £0.8bn of remaining risk funding appears to be relatively low given the risks around renewals delivery, weather and climate change, work on Track Worker Safety, and efficiency delivery. It is not clear to what extent NR has factored some of these issues into its views on financial risk. Moreover, we note that the Schedule 8 outturn could be better than the forecast in the RF8 plans, for example, this could happen if demand recovers more slowly from the effect of Covid-19. There could also be further on-going Covid-19 related costs.

Given the effect of Covid-19, this position is not unexpected. While we do consider the remaining level of risk funding is an issue, we do not consider that it cannot be managed by NR.

For RF11, NR should clearly explain in its plans, why it considers £0.8bn of risk funding is adequate and the key risk mitigation strategies it is considering. This explanation should include how it would manage financial risk in other ways if necessary. For example, it should identify the projects that could be re-prioritised in the future and possibly deferred to CP7. As part of this, NR should clearly identify the projects that can be easily 'turned on and off' to manage its remaining risk funding position efficiently.

We note that NR has agreed, through the UK Government's Spending Review process, to deliver additional cash efficiencies of £250m over the Control Period, of which £100m (mostly forecast to be delivered in 2020-21) will be reflected in the revised OMR network grant funding levels.

Below, we provide a list of the other key areas our high-level review has identified for further consideration and where NR needs to do further work for RF11 (more detail is included in the Annex to this letter):

1. **Renewals phasing and transition to control period 7 (CP7).** NR should further consider how a smooth renewals profile could help efficient delivery in CP6, e.g.

[3] In addition, £0.3bn of risk funding has been used for new activities.

[4] The letter P followed by a number represents the confidence that NR has in delivering its plans within that level of funding. In this case, 65%.

this would help the supply chain to deliver efficiently. In addition, NR should also consider CP7 when phasing work in CP6. For RF11, DfT has an opportunity to provide some further direction on future funding scenarios (we note that it has already provided an indicative forecast for year 1 of CP7), to facilitate renewals planning for a smooth transition into CP7. However, we recognise that this may be difficult for DfT.

2. **Budget flexibility rules.** It would be useful for NR to provide us with additional analysis on budget flexibility for RF11. In particular, it would be helpful to understand how NR plans to manage its forecasts to stay within the rules and whether it thinks it may not be able to use some funding over CP6 because of budget flexibility issues. This is because, in a normal year, given the uncertainty of forecasts, NR's plans assume that it will not be able to drawdown some funding each year. For example, we note that NR could not use £90m after the transition from 2019-20 to 2020-21, but this was an exceptional year.

3. **Long-term scorecards.** NR needs to update its scorecard measures for RF11. This includes the train performance measures.

4. **Demand forecast.** The demand forecast affects key aspects of the plans such as outputs and funding levels (e.g. station income and Schedule 8). For RF8, most regions have assumed that a normal level of train services resume early in 2021-2022. We acknowledge that this is very uncertain but it is probably not a realistic planning assumption for RF11. NR has confirmed that for RF11 it is reviewing this assumption.

5. **Headcount challenges.** NR still has to consider the full implications of its review of recruitment. We have asked NR to further explain this for RF11.

Overall, NR needs to do further work to refine its plans for RF11. We have some confidence that RF11 will not include a major change, compared with the current delivery plan, that would require SoS sign-off. However, the current level of economic uncertainty makes it difficult to predict this.

I am happy to discuss any of the points in this letter with you, and my team look forward to working with you on this further.

Yours sincerely,

Carl Hetherington

Carl Hetherington

Annex – High-level review of the RF8 plans

Deliverability

Based on our high-level review, all regions are currently planning to deliver the renewals volumes broadly in line with the PR18 Final Determination for the remainder of CP6. However, there are some changes. For example, there have been increased volumes of earthworks and drainage renewals in some regions to deal with adverse weather events related to climate change. We note some slippage in the delivery of building, signalling, electrification and some structures renewals. This is partly due to NR deferring some renewals volumes into the rest of CP6, in part due to Covid-19 impacts.

NR has handled the effect of Covid-19 well and has not reported any major delivery problems over the Christmas period. Overall, our early view is that the RF8 plans still appear broadly deliverable. However, we are keeping a watching brief on the signalling delivery programme, which is becoming increasingly back-end loaded.

The renewals phasing also shows a peak in year 3 (2021-22) relative to years 4 and 5. Although we note that NR is planning to move £0.3bn of expenditure to later years of the control period, which reduces this peak. However, we still think the phasing of renewals spend is an issue and we discuss it further in the next sub-section.

Based on the current renewals forecast we would expect the levels of asset sustainability achieved at the end of CP6 to be in line with our PR18 Final Determination. However, one issue is with Metallic Structures[5], e.g. bridges, which continues to be an area of concern. This is because we consider that in estimating the required expenditure, NR has only included targets for the most urgent level 1 priority activities to maintain passenger services. Therefore, there remains a risk that it might have to implement either weight or speed restrictions, as the assets continue to deteriorate.

We are aware of concerns from some freight operating companies that NR may not be meeting its obligations in this area. This issue will need further consideration by NR. If it did decide to spend more on these assets, this would need to come from risk funding, or a re-prioritisation from other areas, given the pressure on risk funding.

We do not have any specific concerns over NR not actively managing maintenance risks. However, we have previously highlighted that NR has not reported accurately, the volumes of maintenance activity it has undertaken. Therefore, we required NR to provide a plan to address its reporting of maintenance volumes. NR has now submitted its plan, but it will not have improved reporting in place before early to mid-2021-22.

[5] This is more of an issue for Southern, Wales & Western, and Eastern than the other regions.

We also note that the UK Government's Spending Review required a £1.0bn reduction in the CP6 DfT funded enhancements portfolio (which could eventually amount to £1.5bn). The changes to the portfolio are likely to be agreed by DfT and NR at the end of January 2021. This will be too late to be factored into the next re-forecast of each region's OMR plans. However, we understand the impact of these changes is not likely to be significant.

Renewals phasing and transition to CP7

As discussed above, the phasing of renewals expenditure has changed since the re-forecast for period 4 (RF4) with more work forecast to be carried out in year 3 (2021-22) relative to years 4 and 5. This causes issues as the forecast for capital expenditure in 2021-22 is £0.3bn higher than the available funding. NR will adjust this in RF11 back to the RF4 phasing levels.

NR should further consider how a smooth renewals profile can help renewals be delivered efficiently in CP6, e.g. this would help the supply chain to deliver efficiently. NR should also consider CP7 when phasing work in CP6. For RF11, DfT has an opportunity to provide some further direction on future funding scenarios (we note that it has already provided an indicative forecast for year 1 of CP7) to facilitate renewals planning for a smooth transition into CP7. But, we recognise that this may be difficult for DfT.

Risk funding

A key issue we have identified in the RF8 plans relates to risk funding. There is a balance between planning to use risk funding now, making sure there is enough funding to cover future risks and not leaving unused funding at the end of the control period. We recognise that getting this balance right is difficult.

In PR18, NR was provided with £3.0bn of risk funding (cash prices). This funding was to cover any financial risks, which emerged over the control period, or for other activities as appropriate. In some cases, this should be renewals.

At the beginning of 2020-21, the balance remaining on risk funding was £2.2bn. This was because £0.8bn had been used for additional schedule 8 costs (£0.4bn), additional maintenance and renewals activity (£0.3bn) and Putting Passengers First (PPF) costs (£0.1bn).

In the year to date, NR has allocated a further £1.4bn of the risk funding (£1.1bn to cover financial risks and £0.3bn for additional activities[6]) and, as such, only £0.8bn of risk funding remains at RF8 (this is consistent with a P65 position). Network Rail has said that the £1.1bn of financial risks includes:

- the impact of Covid-19 on NR's costs and income (£0.5bn);

[6] These include performance improvement and environmental initiatives (£0.1bn) and work on Track worker Safety (£0.2bn).

- higher earthworks costs following the Carmont derailment and the impact of climate change (£0.2bn);
- track renewal cost increases (£0.1bn); and
- a provision for business rates on advertising hoardings (£0.1bn).

We note that NR has not spent all of the £1.4bn in 2020-21. Instead, it has either spent this money or allocated the funds to be spent, across the current and future years of the control period.

It is difficult to determine whether the £0.8bn of risk funding remaining is adequate for the rest of CP6. We note that NR's latest risk modelling shows £1.4bn of financial risks for the last three years of CP6, which would be largely consistent with a P80 position. NR has said that it would manage challenges to the risk funding by re-prioritising its workbanks, identifying opportunities for deferral or through additional efficiencies to keep the overall plans affordable.

We think that the remaining level of risk funding appears to be relatively low. For example, after reviewing the plans we have identified some work that could have been underestimated and may require further funding[7]. Further elements of funding could also be required for work on Metallic Structures and reactive recovery works to address the effects of storms and other extreme weather events on earthworks.

In addition, the challenge of delivering its efficiency commitments is a key financial risk (we explain the efficiency challenge in the section below) as are the normal risks with renewals delivery. It is not clear to what extent NR has factored some of these issues into its views on financial risk. Moreover, we note that the Schedule 8 outturn could be better than the forecast in the RF8 plans, for example, this could happen if demand recovers more slowly from the effect of Covid-19. There could also be further on-going Covid-19 related costs. We also note that some risk funding will inevitably not be used each year due to the budget flexibility rules as explained below.

Given the effect of Covid-19, this position is not unexpected. While we do consider the remaining level of risk funding to be an issue, we do not consider that it cannot be managed by Network Rail.

Overall, the risk funding process has provided planning stability. It is important that NR has a clear understanding of financial risks and the money needed to fund these risks. This is especially important to consider for RF11 given the financial risks mentioned above that could require funding, and which could affect each region differently.

For RF11, NR should clearly explain in its plans why it considers £0.8bn of risk funding to be adequate and the key risk mitigation strategies it is considering. This

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[7] For example, some regions might have underestimated some of the costs of the Track Worker Safety work (e.g. the cost of additional track access points that might be needed).

should include NR clearly explaining how it would manage financial risks in other ways if necessary. For example, it should identify the projects that could be re-prioritised in the future and possibly deferred to CP7. As part of this, NR should clearly identify the projects that can be easily 'turned on and off' to manage its remaining risk funding position efficiently.

Efficiency

The PR18 Final Determination challenged NR to deliver £3.5bn of efficiency improvements in CP6 and NR is now seeking to achieve an additional £0.5bn of efficiency improvements.

As we have previously reported, we consider that NR has made a good start, achieving slightly more efficiency in year 1 than its target. However, the efficiency challenge increases through CP6 and NR also has to manage the on-going impact of Covid-19 on its business. We are currently reviewing regions' year 2 and year 3 efficiency plans. Although our review is not finished, at this stage we are broadly satisfied with the majority of the plans that we have reviewed. However, we have identified some areas of concern, where we will be looking for improvement.

In addition, we note that the regions are facing increased cost pressures including for the renewal of track, earthworks, structures and major signalling contracts. We recognise that some of this is due to the impact of Covid-19. However, raw material cost increases suggest cost-planning estimates at the start of CP6 were too optimistic. We also understand that the recently let national framework contracts may not be delivering the level of cost efficiencies originally envisaged.

Budget flexibility rules

It would be useful for NR to provide us with additional analysis on budget flexibility for RF11. In particular, it would be helpful to understand how NR plans to manage its forecasts to stay within the rules and whether it thinks it may not be able to use some funding over CP6 because of budget flexibility issues (in the transition from 2019-20 to 2020-21, this was £90m, but that was an exceptional year[8]). In a normal year, given the uncertainty of forecasts, its plans normally assume that it will not be able to drawdown some funding each year.

Long-term scorecards

For train performance, regions' RF8 forecasts for 2021-22 and the future years of CP6, remain equivalent (after accounting for managed changes) to the trajectories

[8] For example, the impact of Covid-19 in March 2020, when it was too late to adjust NR's budgets for the year.

set out in the PR18 Final Determination. This is the case for passenger performance (as measured by CRM-P[9]) and freight performance (as measured by FDM-R[10])[11].

We note that:

- this reflects that regions have not yet developed more refined forecasts;
- regions are still at an early stage in their engagement with train operating companies on customer-specific targets; and
- NR is planning to produce updated forecasts for RF11, based on assumptions about changes to service levels and passenger numbers.

We recently reported that reduced service levels and passenger numbers have been a key factor in helping NR and the industry deliver exceptionally high levels of train performance. If it is assumed that these conditions are to continue then performance forecasts should take account of this. We expect NR and train operators to continue to agree stretching yet realistic trajectories. We will review progress at RF11, monitor levels of agreement in customer scorecards and assess alignment between customer scorecards and long-term trajectories.

NR's regions also remain committed to the asset management outcomes in PR18 (as measured by the composite sustainability index (CSI)). They are forecasting to outperform their delivery plan targets relating to asset reliability (measured by the composite reliability index (CRI)) and service affecting failures. However, we consider that Wales & Western, North West & Central and Southern could have produced more challenging forecasts, given current train service levels.

Demand forecasts

The demand forecast affects key aspects of the plans such as outputs and funding levels (e.g. station income and Schedule 8). In RF8, most regions have assumed that a normal level of train services will resume early in 2021-22.

The position for next year and the remainder of the control period is uncertain but this is probably not a realistic assumption for the RF11 plans. NR has confirmed that for RF11, it is reviewing this assumption.

Headcount

In the latest RF8 forecast, headcount is expected to be 43,221 at the end of CP6, this represents a reduction compared with NR's original PPF requirement of 44,398. The RF8 plans do not explore the implications of the forecast lower headcount. We have asked NR to explain this further in RF11. However, we note that NR has recently told us that it does not expect any impact on outputs resulting from the

[9] The Consistent Route Measure of Performance.

[10] The Freight Delivery Metric.

[11] Where we identified significant discrepancies to PR18 trajectories, the regions have confirmed that these were errors that they will correct for RF11.

reduced headcount versus the PPF requirement. It is likely that NR will use the supply chain for additional delivery if necessary.

In response to funding pressures, NR is reviewing recruitment and trying to minimise new recruitment where possible. It is not currently clear whether NR's financial numbers in RF8 reflect this approach. We note this is not a recruitment freeze, especially as some posts are committed (e.g. graduate and apprentice programme) and/or are safety critical. Overall, headcount is currently forecast to increase by 168 posts over the remainder of CP6, from 43,053 at P8 in 2020-21.

Safety

We have reviewed the safety aspects of the RF8 plans and we have no comments. We note that risk funding is available to strengthen the network, especially following the Carmont and Polmont incidents.

Problems with the quality and timing of NR's submission

We recognise that NR is developing its plans in difficult circumstances as it is managing the effects of Covid-19 on its business. We also note that we have had good engagement with NR's regional and central business unit teams.

We agreed an improved process for the information NR would provide to us (as set out in the 'Information Log') and how we (and DfT) would review the plans. This was set out in full in the November letter. This was the culmination of our respective organisations' work together over six months of last year.

However, we are concerned with the lack of improvement in the quality of the information provided. For example, there was a lack of explanation/commentary in the RF8 plans. This was not consistent with the requirements set out in the 'Information Log'.

Furthermore, NR provided us with certain information later than agreed. For example, we did not receive an overview of the key issues emerging from the RF8 plans at a GB-level until 18 December (though we appreciate that NR's Business Planning Team provided us with some draft RF8 information in the week commencing 7 December). Overall, we will need to revisit all these issues in time to address them for next year.

The other issues were:

- NR's process appears to be too internally focused; and
- the Business Planning Team does not appear to have clearly communicated our agreed improvements to the process to the regions and other business units.

We note that all these issues were major weaknesses with last year's plans and are the issues we have all been working together to resolve. This has made our review more challenging, especially as we already had a very tight timetable to fit in with NR and DfT's processes. As a result, we have recently placed this issue on our regulatory escalator at level 1 (the lowest level).

For RF11, it is essential that NR both keeps to the agreed timescales, and improves the quality of the information provided to us. In particular, NR should clearly explain at RF11 (including an overview of the key issues at a GB level), the changes since RF8 and how it has actioned the issues identified in this letter.