Network Rail's response to ORR's PR18 working paper 8: Managing change affecting the PR18 settlements

27 April 2018

Executive Summary

Network Rail welcomes the opportunity to respond to ORR's working paper on managing change affecting the PR18 settlements. Our response builds on the points we made in our response to the PR18 overall framework consultation. No part of this response is confidential and we are content for it to be published in full.

In its Final Determination, ORR will determine settlements for each route and the System Operator (SO). We recognise that ORR will want to protect the benefits of individual settlements for routes and the SO. These include the ability to plan in a stable funding environment and to allow ORR to monitor routes' and the SO's performance, including through reliable comparison. ORR will therefore want to understand (and possibly challenge) changes that materially impact the basis on which it determined the PR18 settlements. As ORR describes, such changes could include new enhancements, changes to the funding of individual routes or the SO, and changes to our organisational structure (including changes to the number of routes or changes to the roles and responsibilities of routes and the SO).

The working paper sets out ORR's proposed policy and process for managing changes relative to the PR18 settlements. We welcome ORR's continued support for Network Rail being able to respond to changing circumstances and priorities and we will update our plan annually to reflect these changes. For CP6, this will start when we issue our delivery plan in March 2019 which will be an update relative to the PR18 settlements, reflecting the fact that time has moved on and circumstances may have changed. In CP6 we assume that ORR will monitor routes and the SO against their annually updated plans (providing we have been clear about why they have changed). This aligns to the proposal on reporting financial performance set out in ORR's consultation on its approach for assessing efficiency and wider financial performance in CP6. Therefore, we consider that the policies and processes described in the working paper predominantly relate to managing changes that Network Rail makes to its plan.

We assume that there will be circumstances in which ORR may wish to change the settlements and associated PR18 baselines, for example if there was a change to the number of routes. The paper does not specifically comment on the policy or process to manage changes to the settlements but it will be important to understand the extent to which ORR may want to change the settlements. We would welcome further discussion with ORR about how this could work, particularly given the experience of measuring against the old route structures in the PR13 settlements.

Policy on Managing Change

In part one of the working paper, ORR describes the requirements it has of Network Rail to engage early and report transparently in relation to managing material change relative to the settlements. We recognise that we will need to provide ORR and relevant stakeholders with appropriate opportunities to comment on and challenge material changes to our plan or organisational structure before a decision to implement a change is made. ORR proposes that the types of changes that it will want to be informed about 'ex ante' are those that originate outside a route or the SO. We support these policy points in principle because it sends a clear signal that ORR's focus is on big changes that impact routes and the SO but that are outside their direct control.

We also recognise that when changes are implemented we need to report transparently how these have impacted our plans and our organisation. Transparency is fundamental to creating trust in the new framework for CP6.

In summary, we largely support the policy principles that ORR describes in part one of the working paper, but want to highlight the following key points:

- A key aspect of ORR's policy is that Network Rail engages with ORR ex ante for material changes relative to the PR18 settlements. These would include a reduction in funding below the route/SO plan, a change to the number of routes, a material change in route boundaries, a material change in responsibilities of a route or the SO, or a change that materially impacts outputs. We acknowledge that defining the criteria for a 'material' change is difficult and it is important that we continue to develop a clear, shared understanding and where possible, improve the definitions. The risk is that without a clear and consistent definition, the interpretation of the criteria is dependent on interpretation by ORR and Network Rail and this could change over time.
- We support the principle of ORR's policy to focus on changes originating outside a route or the SO. This can be readily applied for changes that impact our overall organisational structure or funding of individual routes/the SO because these will largely be classified as extra route. Where changes impact outputs it is not always straightforward to categorise a change as intra or extra route. Outputs are impacted by many different changes, and it is not always be possible to link an impact to a precise change event. However, we would discuss material changes with ORR.
- When reporting level I changes, we expect to report all changes to the plan regardless of whether the underlying causes of change are intra-route or extra-route.

We include further comment on policy points within our responses to the working paper's first three questions below.

The Managing Change Process

In part two of its working paper ORR proposes a process to manage change based on categorising levels of change in relation to the scale of the impact of a change on outputs, funding and organisational structure. We support the principle of categorising levels of change as 'material' (level II), where Network Rail will be required to engage with ORR ex ante, and 'fundamental' (level III), where ORR would issue a formal opinion of a proposed change. The criteria used to define the different levels of change need to be easily understood so that we are clear when we need to engage ex ante and when ORR would issue a formal opinion. We propose that the levels of change could be summarised as below and we set out more detail in our response to question four:

- A level I change is an extra route change to our plan or organisation that is not a material change. As set out above, we will report all changes to the plan regardless of where they originate.
- We agree that a level II change is a material change relative to the settlements. We will inform ORR and other relevant stakeholders about these changes ex ante.
- A level III change is a more significant change in relation to the criteria for level II. ORR will issue a formal opinion where it considers a change is a level III change.

We would like to clarify with ORR what happens if there is more than one change to the plan. Our proposal is that, if we were to make a material change relative to the settlements, the baseline would effectively be re-set, provided that we have satisfied the requirements of the managing change process. If we were to make a subsequent change, the categorisation of change would therefore be considered relative to the updated baseline.

Where a change impacts the funding of a route or the SO, we consider that the criteria to meet a level II or III change should be more significant than those proposed in ORR's working paper.

We propose to meet ORR's requirements around engagement and reporting primarily through our business planning process. Changes to our organisational structure will occur on an ad hoc basis and where these are material, we will engage with ORR and relevant stakeholders ex ante. Our process to manage enhancements is well developed and ORR is already part of this process.

Question 1: ORR welcomes comments on its proposed approach for focusing on changes originating outside the route and whether this concept should be adapted for the FNPO or the SO

In addition to the points we make on this issue in the summary above, we comment here specifically on changes that impact FNPO and SO plans.

FNPO's plan will need to respond to changes driven by geographic routes as part of the way it operates. For example, a change to the volume of renewals carried out by a geographic route may have an impact on national FDM and FNPO's plan will need to reflect this impact within its normal business model.

The SO plan has been developed to respond to anticipated changes to the funding and specification environment in CP6, and we therefore recognise that the SO plan will need to react to the needs of funders. The SO plan considers a range of potential risks and assumptions, and the provision of both SO headroom and the Group Portfolio Fund is intended to provide the SO with a level of capability to respond to risks materialising.

We would not expect these changes to be treated as extra route changes and would report on changes when we update our plans alongside other intra route changes.

Question 2: ORR welcomes views on its proposed approach for categorising and treating different changes depending on their impact on the PR18 settlements

ORR describes requirements of Network Rail to engage and report that depend on the scale of the impact of change. We support the principle of a proportionate approach and agree that, for material changes to our plan or organisational structure, it is important that ORR has the opportunity to comment on and challenge (where appropriate) the proposed change. When we engage with ORR, we will want to discuss the rationale and business case for change, where this is relevant.

Question 3: ORR would like to know if there are some exceptional changes that it should be able to prevent

The working paper considers cases where ORR may wish to prevent a change being implemented. ORR has significant powers of enforcement under both the Railways Act 1993 and the network licence to investigate potential matters of licence compliance. ORR proposes that these powers

would only apply where there were 'exceptional' changes or where there has been a failure to follow the necessary process. We agree with the examples that ORR suggests in its working paper and that the types of changes that ORR could consider to be exceptional include:

- drastic reductions to the funding available to individual routes or the SO
- changes to the organisational structure, for example, a reduction in the number of routes or fundamental change in responsibilities of a route.

Question 4: ORR welcomes views on its definitions of levels of change and suggestions of improvements to these definitions

ORR's working paper defines levels of change in relation to the degree to which they impact outputs, funding and the organisational structure. As described in our summary above, we think that this approach could be improved to clarify better when Network Rail should engage with ORR ex ante.

Where a change impacts <u>outputs</u>, we largely agree that we would expect to engage with ORR ex ante where we think a change may materially impact the plan. As stated previously it is difficult to define materiality and, as ORR recognises, the impact of a change on outputs will not always be clear at the outset. We would welcome further discussion with ORR to agree how this should work in practice.

The working paper also considers how a change impacts the <u>funding</u> of individual routes or the SO. ORR has proposed criteria relative to the impact on the confidence levels (e.g. P50) of delivery of routes' or the SO's plan. Given the degree of subjectivity around assessing confidence levels, we propose that these confidence levels are expressed as financial thresholds in the Strategic Business Plan (updated to reflect the final determination). We propose that the criteria for the levels could be defined as follows:

- Level I change: any reduction in funding below the route/SO plan including the route/SO specific allocation from the Group Portfolio Fund (GPF) included in the SBP (which was based on a P60 confidence level)
- Level II change: any reduction in funding below the route/SO plan excluding Group Portfolio Fund (which was based on a P50 confidence level)
- Level III change: a material reduction in funding below the route/SO base plan.

We have suggested that a level II change is a reduction in funding below the route/SO base plan, excluding any re-allocation from the GPF. We consider that a level III change should be set at level that is materially below the base plan in the SBP (or ORR's final determination). If it is set at the level of the base plan, the threshold would be at a P50 level which means that there would be a significant risk of 'fundamental' change compared to the agreed baseline. We believe that the level that triggers a formal opinion should be set at a lower threshold and would like to discuss this further with ORR.

It is also important to note that a reduction in overall funding of a route or the SO could be as a result of a reduction in the cost of a national function, for which costs are allocated to routes.

Where changes impact our <u>organisational structure</u>, the types of changes that we think would signal that we need engage to with ORR ex ante are those that result in significant change including:

- a change to the number of routes (increase or decrease)
- a material change to route boundaries that impacts the funding and outputs of a route
- a material change to the responsibilities of the routes or the SO, or our governance framework as specified within our Business Performance Management Framework.

It would be helpful to discuss with ORR what a 'material' change represents recognising the difficulty of defining the criteria in this area.

Question 5: ORR would welcome any suggestions to improve the managing change process such that the objective of maintaining the benefits of the settlements can be achieved while allowing Network Rail as a whole the ability to flexibly manage the business

We agree with the principles that ORR sets out for the managing change process to be proportionate, consistent and transparent. In addition to these principles, we consider that the process needs to be straightforward so that it can be widely and consistently understood over time and by colleagues across Network Rail and ORR.

We describe below how we will use our existing process to meet ORR's requirements to engage early and to report transparently. This is largely framed around our business planning process. Where changes occur outside the business planning process (for example, the decision to fund an enhancement or a proposal to significantly change our organisational structure or strategic direction) we also describe how we would meet ORR's requirements.

<u>How we will meet ORR's requirements with respect to changes to our plans</u>

The business planning process is an annual process to update and agree our medium term plans. Accountability for managing this process is with our Business Review Team (BRT). The business planning process comprises a series of steps:

- issuance of guidance and planning assumptions to routes and national functions
- initial submission of plans by routes and national functions
- internal assurance and Executive review
- a final submission of plans that reflect the key points of feedback from our internal assurance and Executive review process.

At the beginning of the planning process, guidance and planning assumptions are issued to routes and national functions by BRT. This provides the framework and the constraints within which routes and national functions update their plans. The planning assumptions will provide an indication of where and how we consider changes will impact the funding available to individual routes and the SO before the decision to implement is taken. It will also update planning guidance for volumes and the programme of enhancements.

We propose to engage with ORR about the planning assumptions as they emerge. When the guidance is issued, we would then share and discuss the guidance and planning assumptions with ORR. This will create opportunities for ORR to review and comment on changes to our plan

originating outside a route or the SO, ahead of a decision to implement through the submission of plans.

Routes and national functions will submit updated plans and scorecards to BRT in line with the planning cycle. At this stage, the full impact of a change is crystallised and evident in the funding and outputs of the plan. The changes to route and the SO plans will reflect decisions taken outside these business areas as well as changes driven by a route or the SO. Following our internal assurance and Executive review, we would share and discuss these submissions with ORR and relevant stakeholders. This would create a further opportunity for stakeholders, including ORR, to comment ahead of the final plan submission. It would also be at a point in time when routes and the SO will have engaged with their stakeholders and we would expect routes and the SO to describe what engagement has taken place and what stakeholder views are of the proposed changes.

If there was a significant change to funding outside the business planning cycle, we would discuss this with ORR at our regular business planning liaison meetings and with relevant stakeholders and communicate material provided to Network Rail's Board.

We will transparently explain and report changes to our plan. This will include commentary on why the change to the plan has taken place, what stakeholder engagement has been carried out (where this is appropriate) and what stakeholder views are. It will also point to the evidence base that stands behind the change. The detailed approach within the annual business planning cycle (including the frequency and the materiality threshold) is still being developed. We will discuss in more detail with ORR how we propose this will work in upcoming business planning liaison meetings.

How we will meet ORR's requirements with respect to changes to scorecards

Changes to scorecard trajectories will fall within our business planning process outlined above. Where we are considering changes to the definition or calculation methodology of a measure on the route comparison scorecard, we agree that ORR will need to consider our proposals ahead of implementation. We will create this opportunity through the regular business planning liaison meetings between ORR and Network Rail ahead of a decision being taken. Relevant supporting evidence for any change, the proposed impact, alongside relevant stakeholder engagement and views would be discussed at these meetings.

How we will meet ORR's requirements with respect to changes to our organisational structure or the strategic direction of Network Rail

Examples of these changes could include a change in the number of routes, a significant change to a route boundary or a significant change to the responsibility of a route or the SO. This type of change will be rare and, where this is material, we will discuss with ORR ex ante at the appropriate forum. Where relevant a business case would be discussed, and we would expect routes and the SO to provide supporting evidence of how they consider they may be impacted.

How we will meet ORR's requirements with respect to changes to enhancements

Where impacts on the plan are driven by a decision to fund a new enhancement or make changes to an existing enhancement, ORR is already part of these processes (including the enhancements change control process). In CP6 the impacts of an enhancement scheme on Network Rail's route businesses and the periodic review settlements will be assessed as part of the preparation of a Final

Business Case for the enhancement and through Network Rail's and the funder's internal and joint processes to agree and commit to an enhancement. These impacts would be considered as part of the joint decision making process for enhancements to which the funder, the SO and affected routes will be a party.

We would therefore anticipate that the role of the regulatory change control process would include seeking to confirm that this analysis had taken place and been appropriately incorporated into decision making. As the working paper notes, the role of the regulatory change control process should not be to approve or seek to prevent an enhancement from proceeding. We anticipate that the ORR's forthcoming Monitoring and Enforcement Policy consultation will provide more detail on how ORR wishes to assure itself of this process. It would also be helpful to understand what issues ORR would be considering if it issues a formal opinion in respect of plan changes as a result of enhancements.

The funder, Network Rail System Operator and Network Rail routes will commit to the delivery of an enhancement at a Final Investment Decision, at which point Network Rail will commit to a cost and schedule for delivery of the enhancement. This would incorporate all impacts on the routes of delivering the enhancement and implementing and operating the proposed service changes. Where ORR expresses views these will need to be incorporated into the existing processes ahead of the Final Investment Decision being taken to proceed with the scheme.