



Assessment of Network Rail's Management of Inflation – Executive Summary

Prepared for the Office of Rail Regulation

June 2013

Notice

- This document represents a summary of Credo's main report of the same title
- This report has been prepared by Credo Business Consulting LLP ("Credo") on the basis of the Agreement signed with the Office of Rail Regulation, One Kemble Street, London WC2B 4AN ("ORR") on the 11th January 2013
- This report is solely for the benefit and information of the ORR and any parties mentioned in the Agreement. We will not accept responsibility or liability to any other party to whom the report may be shown or who may acquire a copy of the report
- All surveys, observations, analysis and forecasts contained in the Report have been made on the basis of the information available at the time of the assignment and has been prepared as at 15th March 2013. We have not undertaken to update our report for events or circumstances arising after that date. Credo cannot be liable for any subsequent changes
- In preparing the report, Credo relied upon, and assumed the accuracy of, information obtained from a variety of sources, including but not limited to: interviews with current suppliers, former suppliers, potential suppliers, competitors and industry experts; financial, government and economic statistics and forecasts; management statements and estimates; published market research; published academic and economic research and public filings of financial information. Credo accepts no responsibility and will not be liable in the event that information provided to Credo during the course of the assignment from such sources and relied upon by Credo is subsequently found to be inaccurate. This report makes reference to 'Credo Analysis'; this indicates only that we have (where specified) undertaken certain analytical activities on the underlying data to arrive at the information presented; we do not accept responsibility for the underlying data and the analysis has relied on estimates and assumptions that appear reasonable but have not been rigorously tested
- Network Rail has had the opportunity to review the report and some changes have been made to ensure factual accuracy. Clarification questions and other feedback have been addressed outside this report, directly with Network Rail
- The Report comprises information upon the market Network Rail operates in, within the Specification of Services described in the Agreement. Save as aforesaid Credo does not give any representation or warranty (express or implied) of the accuracy or completeness of the Report

Summary – the impact of inflation and how it is managed within NR

NR considers inflation to be beyond their direct control

NR bears the cost of inflationary rises through indexed contracts and RPI-linked salary increases

The procurement function exercises most control over inflation risk, overseeing c.£5.2bn p.a. of spend

NR's (regulatory) incentives serve to drive efficiency savings, rather than to explicitly manage inflation

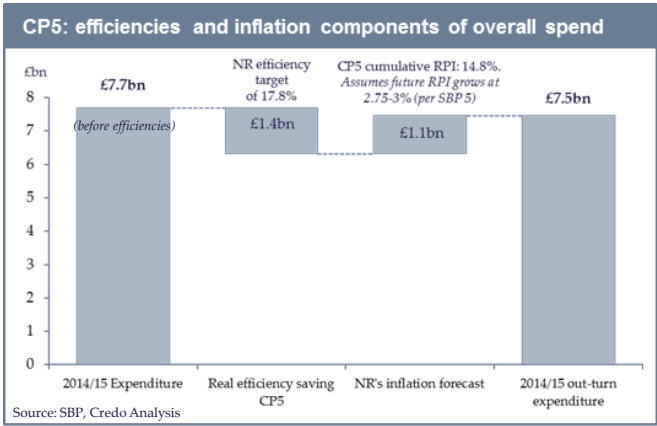
Cumulative general inflation is significant: 16% compared to efficiencies of 23.5% in year 5 of CP4*

During CP5 efficiencies and inflation become comparable

- Network Rail (NR) manages its expenditure to hit efficiency targets with inflation layered on top, at RPI. Inflation is generally thought to be a factor that is beyond NR's direct control. NR's paramount drive is to manage down overall costs and this means there is no explicit emphasis on managing inflation risk, it is just one of several factors that drive commercial outcomes
 - In the externally procured cost base, c.£5.2bn of expenditure is linked to RPI/ CPI or other input indices. The choice of contract structure depends on market liquidity and the party most suitable to bear inflation risk
 - In the employed cost base (c.34,200 employees, £1.24bn opex), NR pursues a 'constructive IR environment' to achieve cost reduction targets. Over two-thirds of the workforce are on contracts indexed to RPI+0.5%
 - Income from property is based on a variety of contracts – half the income is determined by rents that are driven market forces (e.g. advertising revenues or demand for commercial property) which offer little direct protection from inflationary rises. The remaining rents offer some inflation protection through and RPI+x% indexation or dynamic turnover rents
- Note: income from track access was outside the scope of this study

- Responsibility for procurement sits with Infrastructure Projects (650 FTE staff overseeing 5 spend categories and £3.1bn of spend p.a.), Contracts and Procurement (150 FTEs, 15 categories and £1bn spend p.a.) and the National Delivery Service (50 FTEs, 9 categories, £1.1bn spend p.a.). Together, they contract with 375 suppliers who account for 80% of spend
- Inflation risk is managed through the contract structure (e.g. target cost, fixed price), consideration of inflation drivers and selection of an inflation index. Category managers determine pre-contract inflation risk and commercial managers monitor in-contract inflation movements. The diversity of procurement calibre and limited knowledge sharing/ training results in some pockets of excellence and equally, some sub-optimal practices across the 29 categories

- The company, as a whole, is incentivised to manage costs down and outperform the Regulator's assumptions for RPI, but the emphasis is very much on driving down overall costs rather than managing inflation risk explicitly
- The inflation component of expenditure is a material factor – cumulative general inflation accounts for 16% of total expenditure by year 5 of CP4 (c.£1bn) compared to cumulative efficiencies of 23.5%* (£1.4bn)
 - RPI has seen a marked variance relative to the ORR's inflation assumption of 3% p.a. during CP4 ranging from -0.5% to 5.2%; in the first 3 yrs of CP4, this equates to £13m net additional spend
- During CP5, cumulative inflation (15%) increases relative to efficiencies (18%) which stresses the need for a more explicit stance to managing inflation (see chart right)



* CP4 forecast efficiencies

Our discussions with NR Management reveal key tenets to their approach to managing inflation risk (general and input price)

The over-arching company view is to drive efficiency savings in the cost base, rather than to explicitly manage inflation

- The cost base is managed to efficiency targets and inflation is layered on top, at RPI. NR contends that the mirroring of costs and income to RPI achieves the economic balance experienced in all other regulated industries; it vigorously defends any departure from this arrangement
- The company, as a whole, is incentivised to manage costs down and outperform the Regulator’s assumptions for RPI, but the emphasis is very much on driving down overall costs rather than managing inflation risk explicitly
- Were the relative balance of inflation vs efficiencies to change (e.g. a high inflation environment or a maturing industry with diminishing value from efficiencies) NR accepts, a more aggressive approach to managing inflation risk may be considered appropriate

NR contends that expenditure should be inflated by RPI (for funding purposes)

In the externally procured cost base (supply chain), the choice of commercial terms depends on market liquidity and the party most suitable to bear inflation risk

- NR manages its supply chain by category. The category manager will select from a variety of contractual arrangements, depending on market liquidity, to manage inflation risk. For example, where the end product is a commodity or of a simple specification, a competitively-bid, fixed price contract might be appropriate. For larger, more complex deals, a more sophisticated contractual arrangement may be called for e.g. target cost
- For all multi year contracts, thought is given to the balance of risk borne by the supplier and NR when choosing a suitable inflation mechanism (fixed price, RPI/ CPI indexed, sub inflation index, multiple indices). There appears to be disconnect between business planning and procurement in the use of input price indices – too much detail in business planning and not enough use of input pricing in procurement

c.£5.2bn of expenditure linked to RPI/ CPI or other indices

In the employed cost base, NR pursues a ‘labour peace’ strategy to achieve cost reduction targets

- For 23,500 of the workforce of c.34,000 staff, pay is linked to RPI+0.5% to secure industrial relations peace and enable headcount reductions; changes to working practices; and the introduction of new technologies
 - The cost of labour peace (c.£17m over the life of CP4, a NR estimate based on 0.5% premium over RPI) is viewed by NR as relatively modest versus annual cost savings of c.£100m p.a. by the end of CP5
- For the non-unionised workforce of c.100 staff, pay increases are discretionary and not linked to an index. NR retains the flexibility to move with market conditions e.g. apply pay freezes during recession

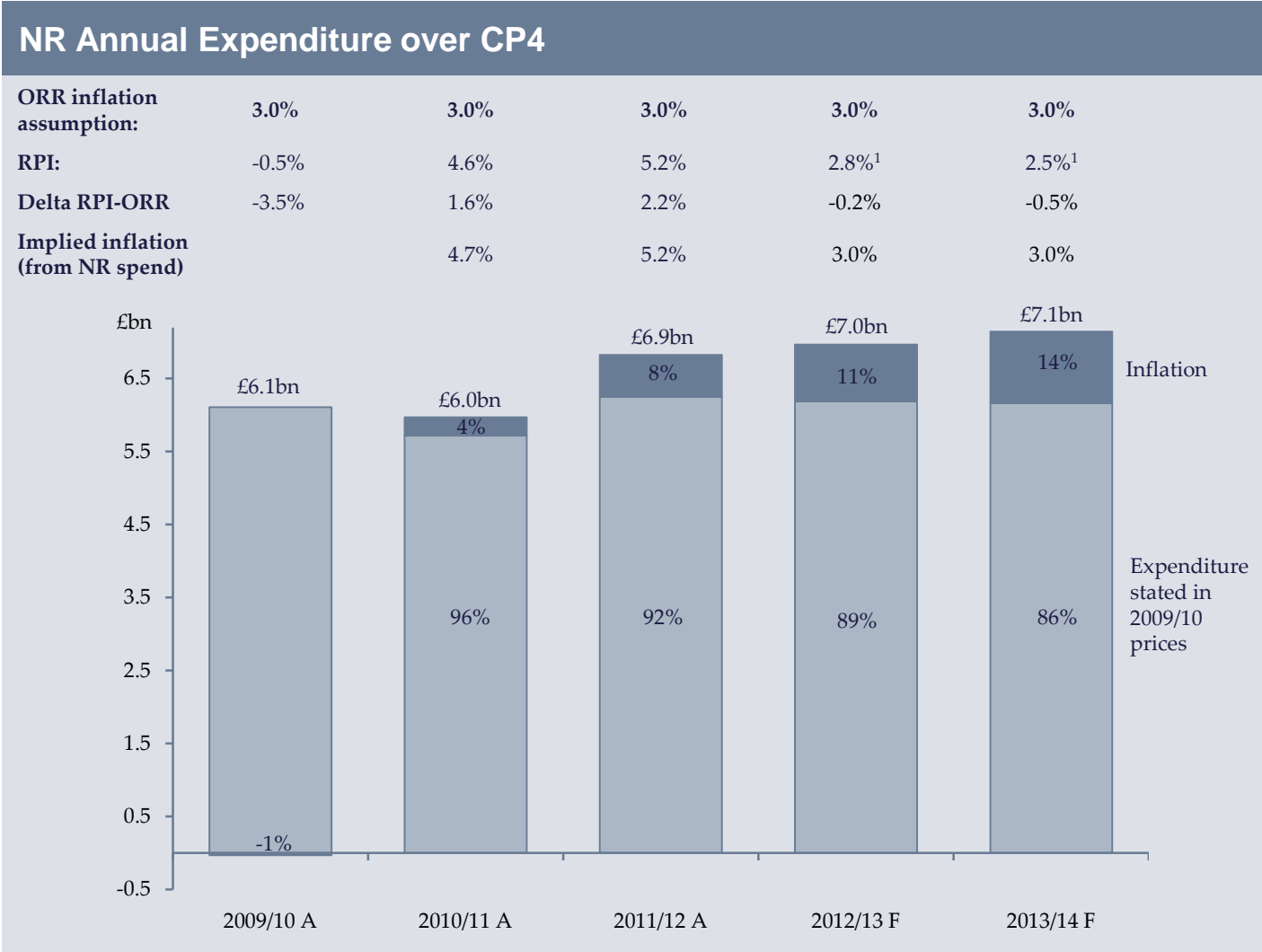
c.£1.2bn of opex (two-thirds linked to RPI+0.5%)

Property income is partly market-driven, partly indexed to RPI+X%

- Rents from the 17 NR-operated stations, are driven by a typical retail model based on a percentage of shop turnover (the exact % determined by retail margins), with a floor of a guaranteed minimum rent. Service charges are based on emerging costs (a pass through charge of reasonable, actual costs)
- Other property income (under the arches and land), rents are either reviewed against market levels every 5 years or, for sub £25k leases indexed to RPI+1 %
- Income from advertising hoardings is based on a percentage of revenue generated from advertisers

Property income exposed to some inflation risk

The inflation component of expenditure is a material factor - inflation accounts for 14% of total costs by 2013/14 (the current Control Period)



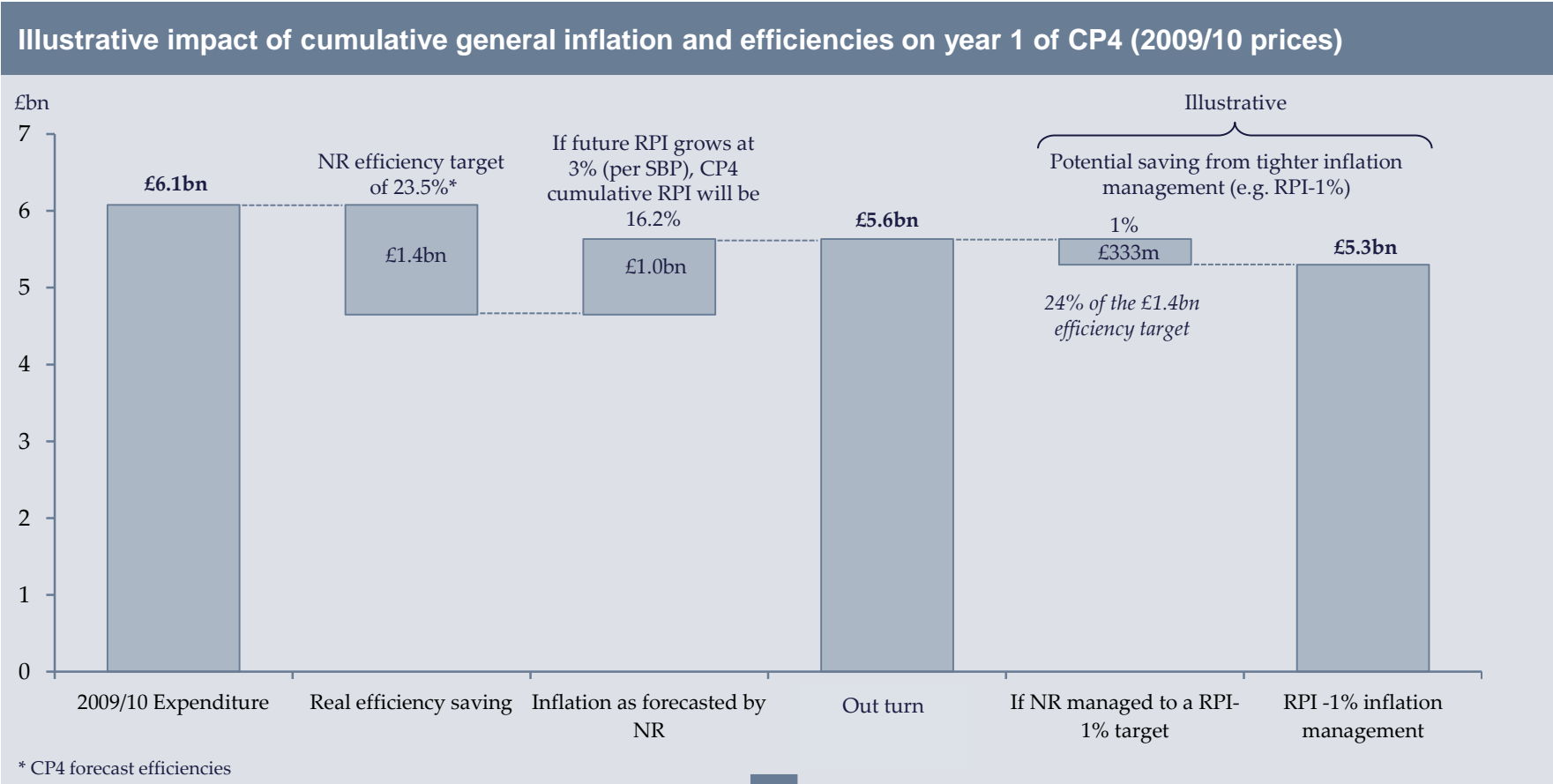
- NR regulatory accounts imply that actual expenditure has increased in line with RPI
- RPI has seen a marked variance relative to the ORR’s inflation assumption of 3% p.a. during CP4: from -3.5% to +2.2%
 - In year 1 of CP4, NR has experienced inflation below the ORR assumptions, in years 2-3 it has experienced higher inflation.
- The compounded effect of general inflation over the control period accounts for a significant proportion of overall costs:
 - 14% of the total cost base of £7.1bn by 2013/14



In the first 3 yrs of CP4, the variance between the ORR assumptions and RPI, equates to £13m net additional spend²

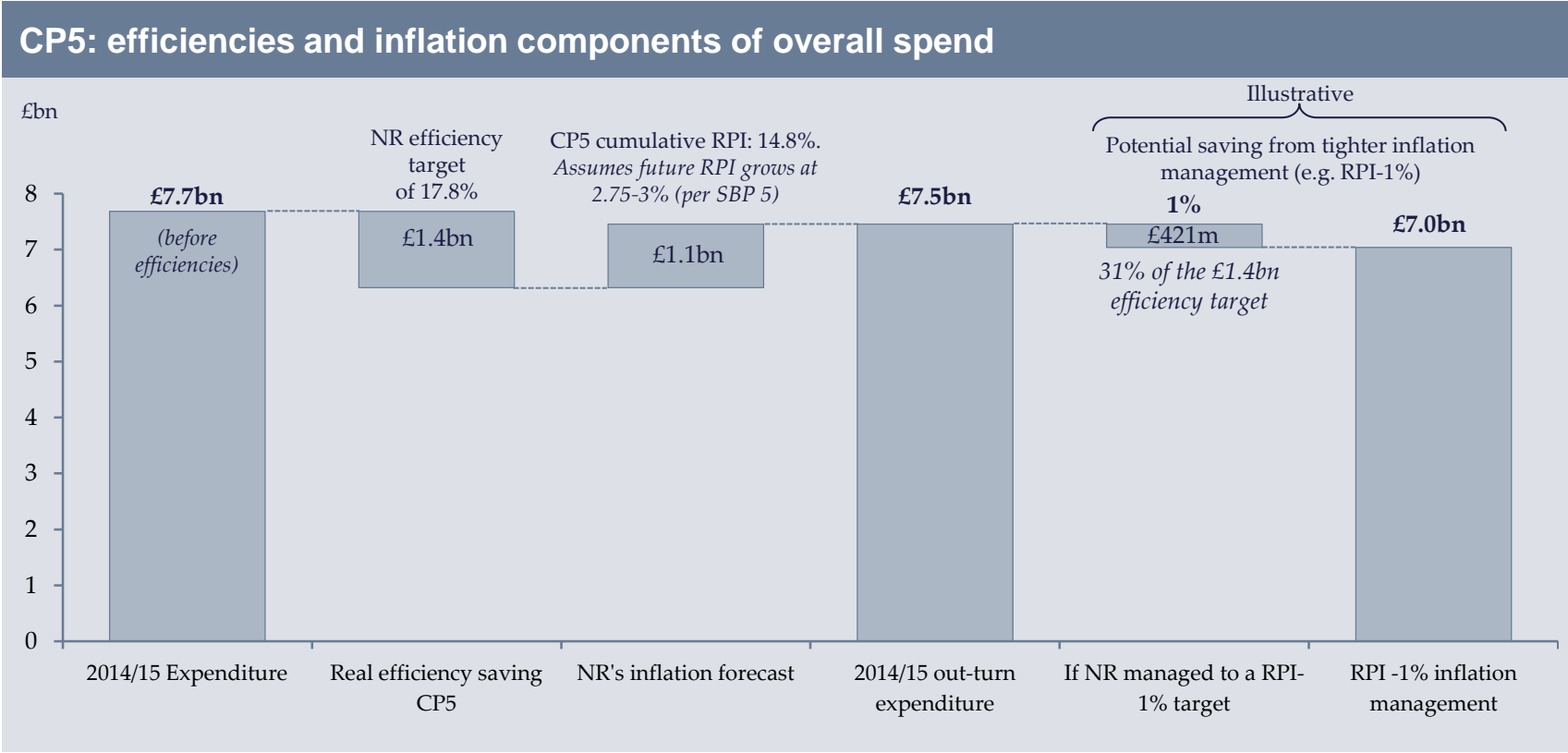
Notes: ¹Average forecasts from independent sources as published by HM Treasury, ²Calculated from the cumulative variance over 3 years multiplied by the annual expenditure in 2009/10

NR's efficiency target in CP4 is 23.5%* of the cost base, which is comparable in magnitude to cumulative general inflation at 16%



NR's over-riding focus on efficiencies drives significant value. But its lack of attention to managing general inflation may underplay the importance of this financial risk

During CP5, cumulative inflation (15%) increases relative to efficiencies (18%), the gap between the two shrinks to 3% in CP5, from 8% in CP4



During CP5, NR should take a more explicit stance in managing its inflation risk, especially if actual inflation exceeds the SBP estimates

Summary – supplier contract review

Index-linked contracts prevail, observed evidence for fixed price or target cost contracts was limited

- NR balance competing requirements in the management of its supply chain – it must ensure it realises efficiencies whilst maintaining a sustainable supply chain . This means that the ‘correct’ allocation of inflation risk to the supplier will become a judgement call with no definitive ‘right answer’
- Contract structures allow a buyer to share inflation risk with a supplier. For example, a fixed price contract transfers all risk to the supplier; this may be appropriate in a market that is highly competitive, relatively low complexity and where the product is well-defined. The other extreme would be an index-linked contract where the buyer takes some or most of the inflation risk. In a target cost contract, inflation risk is shared and managed by the party best-placed to manage that risk .We reviewed 56 contracts of which:
 - 33 were index-linked; 15 were fixed price; 4 target cost; and 4 negotiated (inflation assumptions were subject to negotiation in-contract)

CPI and RPI indexation is most common; steel and fuel were the only examples of input price indexation

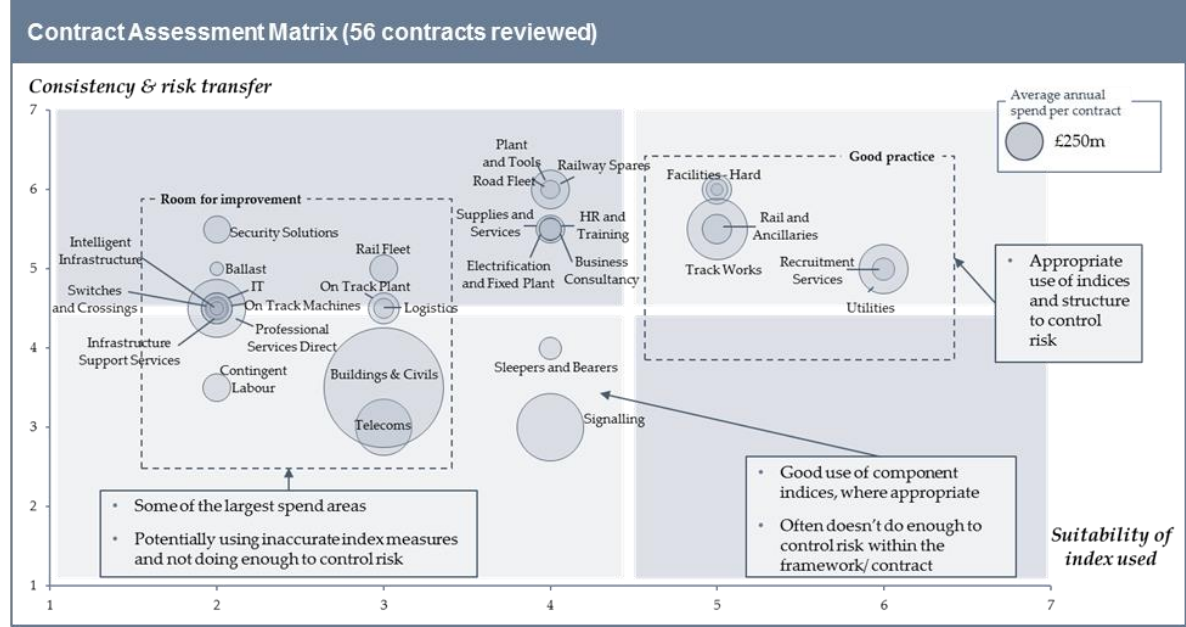
- The most common form of indexation was to RPI or CPI, and to a lesser extent, bespoke indices comprised of a combination of general inflation indices and input price indices, namely for fuel and steel
- The mismatch between RPI/ CPI and input prices can be costly for NR in instances where input prices have grown less than general inflation e.g. IT hardware (see next page). Equally, in instances where RPI indexation has been used but input prices have risen above general inflation, this may cause issues for a supplier who may find the extra cost they have to bear as unfairly high e.g. switches & crossings (where steel prices are not indexed separately). We have not been able to assess how base prices may have been agreed to reflect apparent generous indexation

An assesment of the 56 contracts indicates that 7/29 categories are following good practice but most categories would benefit from a review of the indexation used

- Therefore to assess the appropriateness of the index used, risk transfer to the supplier and consistency of approach across a category, we scored and positioned all 29 categories of spend (see chart right). 7/29 categories (approx. £1bn of spend) follow good practice; spend in other categories (£3.8bn spend) have room for improvement

Inflation risk can also be mitigated through hedging - NR does not hedge commodities today; this may be an option for volatile materials

- NR uses hedging to mitigate exposure to currency and interest rates (debt risk)
- Commodity hedging (buying futures contracts) e.g. for electricity, steel, copper may also be considered



Summary – employee cost base review and property income

NR employs 34,200 staff at a cost of £1.24bn p.a. nearly all of whom are unionised

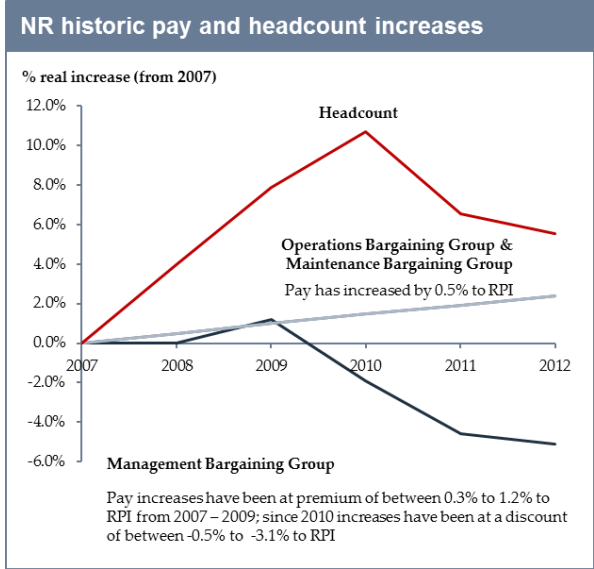
44% of staff are on an RPI+0.5% pay deal; other staff are on sub-inflation pay deals at the moment

NR's above inflation pay increases set a precedent in the industry that affects TOCs and TfL

NR receives c.£270m p.a. from property related income

Half of this income is not directly protected for inflationary rises

- Of the 34,200 staff, all but 100 senior managers are subject to collective pay bargaining:
 - c.10,600 form the Management Bargaining Group where pay is negotiated with the TSSA – salaries have increased below RPI since 2009
 - c.23,500 staff are part of either the Operations or Maintenance Bargaining Groups where pay is negotiated with the RMT – salaries have increased by 0.5% above RPI, see chart right
- The above inflation pay strategy for the maintenance bargaining group seeks to “minimise the risk of disruption and opposition to the introduction of new technologies and working practices that will allow headcount reductions”. The aim is to reduce headcount by 3,300 staff between Dec 2012 and the end of CP5, this forms a significant proportion of efficiencies in CP5
- Considered on its own, the cost-benefit argument for increasing unionised pay by RPI+0.5% seems credible. However, we note that NR has paid a premium to RPI even while headcount was increasing during CP3 and at the beginning of CP4. Further, the IDS (2013) and Inbucon (2008) reports suggest that NR pays significantly above the market rate for some roles e.g. maintenance
- We note that the RMT’s apparently strong bargaining position is restricted to the parts of the industry where its members can affect network closures (NR, TfL and the TOCs). Whereas NR’s tier 1 suppliers have negotiated sub-inflation pay deals with the RMT. Any changes to pay increases in the RMT-unionised workforce should be considered as part of an industry-wide exercise



- NR derives c.£270m p.a. of income from its managed stations (40%); under the arches’ property rentals (30%); the remainder from advertising, telecoms and car park concessions and other
- Whereas expenditure is inflated by RPI and NR is incentivised to outperform the Regulator’s assumptions for RPI, property income is more exposed to inflationary rises
- We estimate that half of property income is determined by market forces (e.g. commercial rent reviews, consumer demand) and therefore not explicitly protected for inflationary rises, though the turnover rent model does offer some protection against price rises. 40% of income is protected either through RPI+x% indexation or a dynamic mechanism, see table right. The mix of the contracts used suggest that NR is no better or worse than comparable industry players at managing inflation risk through property rents

← Rent increase determinant →

Area	Turnover rent	RPI + x%	Market driven	Other (unknown)
Managed Stations Retail	22%	-	18%	-
Advertising	-	-	10%	-
Property (under the arches)	-	12%	18%	-
Telecoms	-	5%	-	-
MS concessions (car parks)	-	-	4%	-
Other income	-	-	-	11%
Total (as a percentage of all property income, £272m)	22%	17%	50%	11%

↓

c.40% of NR rental income is protected for inflationary rises either through indexation to RPI + x% or through a dynamic mechanism (turnover rent)

↓

50% of income is determined by market forces and therefore not protected for inflationary rises

Summary – input price analysis

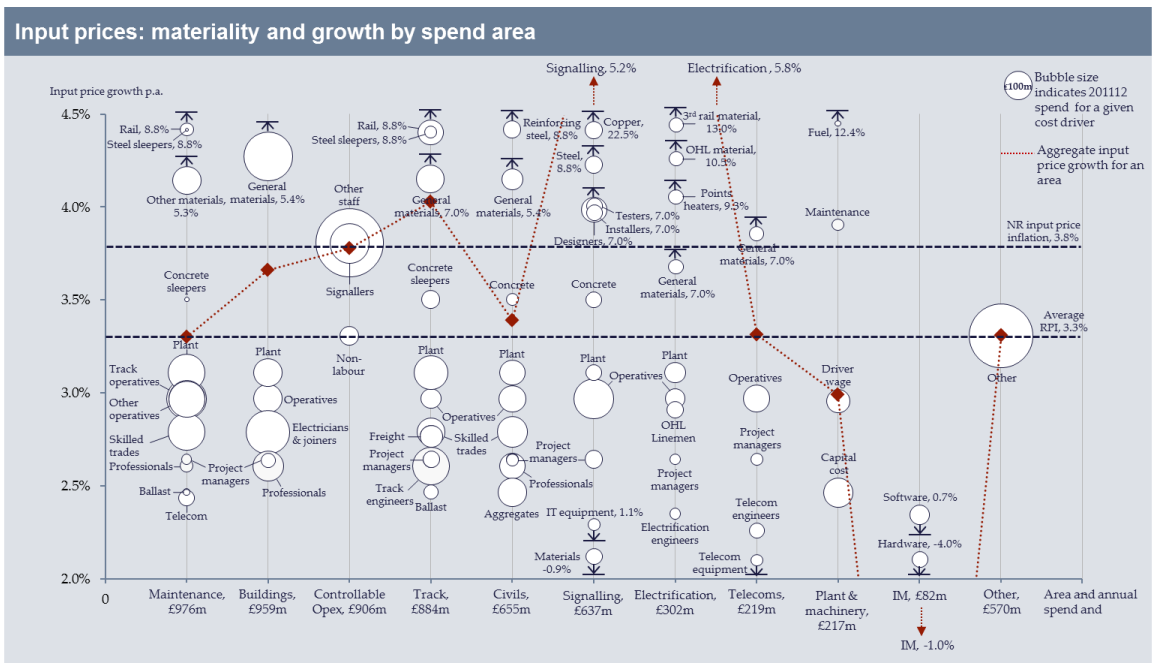
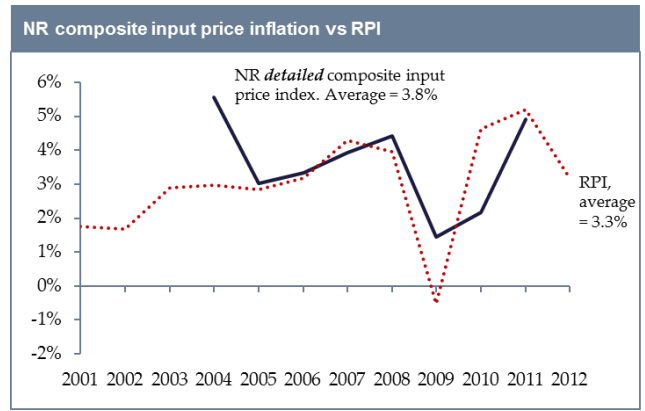
Input prices track at a premium to RPI – around 0.36% to 0.5%

Over time, input prices tend towards RPI though there can be large deviations from this in the short term

The analysis revealed the input cost drivers that were the most significant in value and the most volatile

10 categories of spend were highlighted as areas where NR could potentially benefit from using input price rather than RPI/ CPI indexation

- To analyse the effect of input price inflation on NR’s cost base we disaggregated the £5.2bn of spend into 30 input price ‘buckets’ e.g. track engineers, aggregates, telecoms equipment. This allowed us to:
 - Examine whether input prices (for NR’s work mix) had traded at a discount or premium to RPI – we found that over the past 7 years, it had traded at a premium of 0.36% to RPI. Another estimate based on a simple labour/ plant/ materials index suggests a premium of 0.5%
 - We note that the time period over which an index is tracked can drive whether you conclude input prices trade at a discount or premium to RPI. In general, input prices are more volatile than general inflation but they tend towards RPI over the long term; the shorter the timeframe over which an index is tracked, the more pronounced the delta to RPI
 - Examine, by category, which input price buckets were the most significant by value (see chart right): rail operatives, plant, general materials, skilled trades, electricians / joiners, consulting professionals, signallers; and which were driven by the most volatile inputs (copper, steel, points heaters, OHL material, fuel, signalling testers and installers, rail operatives)
 - Identify where NR could have benefited from using input price indexation over RPI/ CPI (potentially saving money as input prices had risen more slowly than RPI), these included: infrastructure support services; security solutions; IT; contingent labour; intelligent infrastructure; rail fleet; on track machines; ballast; telecoms; track works *



*Note: This analysis shows how NR could have performed over CP4. It does not necessarily translate into savings in CP5 when the relationship between input prices and RPI may alter. A separate econometric analysis of these variables would be required and falls outside the scope of this study

Summary – benchmarking

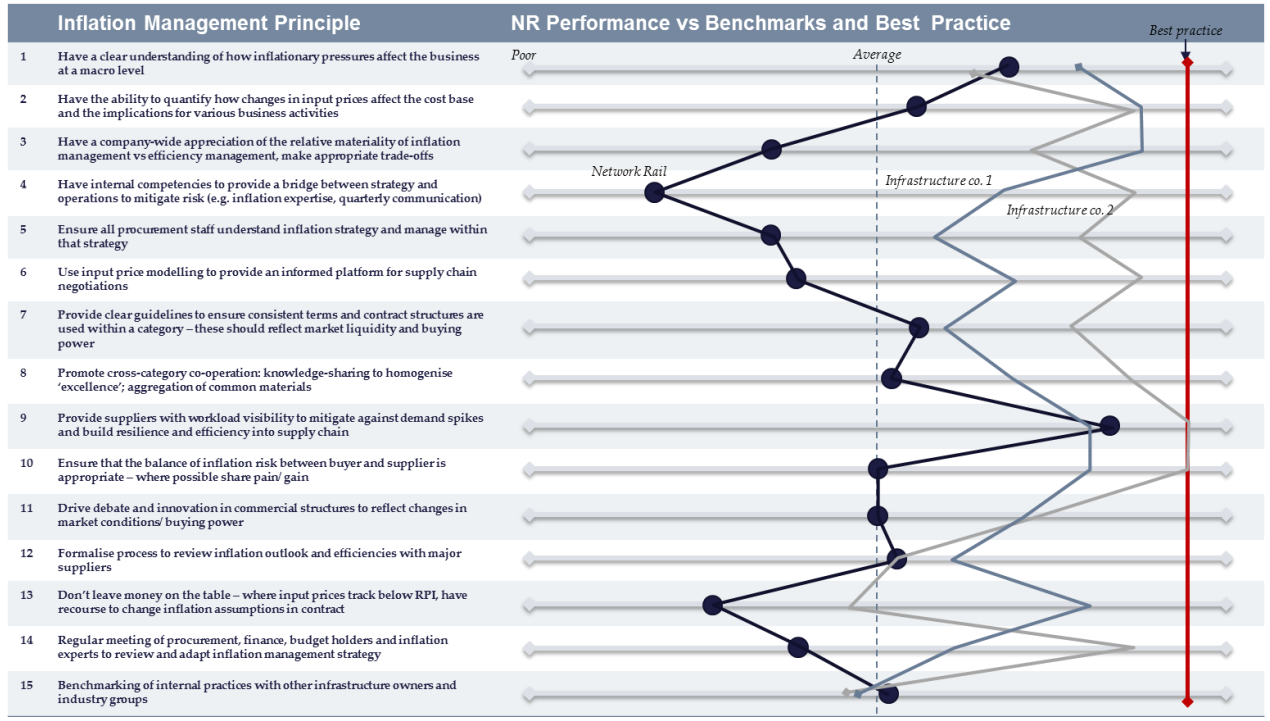
There is greater use of target cost contracts in other sectors compared to rail; to negotiate this type of contract effectively requires commercial maturity and a good grasp of the cost drivers

We define good inflation management against 15 principles

NR performs below average across the 15 principles – 25% below the industry average

- We spoke to 18 infrastructure owners and suppliers to understand how they managed inflation risk, principally through contract structures. Compared to the rail industry, other sectors made much greater use of target cost contracts. We recognise this contract type may be more suited to some areas of spend e.g. Infrastructure Projects, than others e.g. Contracts & Procurement
 - In roads (Highways Agency), value for money is ensured through effective target cost negotiation, which includes securing a favourable inflation assumption
 - In airports (BAA, now HAL), target cost mechanisms remain the norm due to the uncertain cost implications of fixed price contracts in a dynamic operational environment. However, the desire to use fixed price contracts is strong
 - In utilities, in depth knowledge of their cost base allows utility infrastructure owners to negotiate accurate target costs. Where costs are less well understood, they transfer risk to the supplier under fixed price deals. National Grid is a good example of this approach, their commercial attitude places them in a strong position as a buyer

- To assess NR’s overall effectiveness in managing inflation risk, we developed a 15 principle framework which defines what good inflation management might look like, see chart right and overleaf
- Overall, NR’s performance is below average against the 15 principles, but notably below par in 6 areas: principles 3,4,5,6,13 and 14
- The ‘performance gap’ to the industry average is estimated at c.25%
- Closing this gap by improving performance against the 15 principles is likely to delivery an efficiency saving but this would need to be considered alongside the wider procurement strategy



To assess how effectively NR managed its exposure to inflation, we considered what 'good' inflation management might look like

- Our view of 'good' inflation management was guided by three things:
 - The day to day practices we observed at the company's we interviewed during the benchmarking exercise
 - Credo's best view of a framework that would help a company through the various stages of planning, implementation, day to day management and improvement of practices related to mitigating inflation risk
- We relied less on the available literature on inflation as the publications tended to focus on...
 - Macroeconomic inflation management;
 - Managing construction risk in general (Infrastructure UK Cost Review)
 - Movement in input price indexes (e.g. Ofgem studies)
- ...rather than pragmatic solutions for managing inflation at the company level



- We have summarised our view of good inflation management in a framework of 15 principles, see over
 - We considered adding a 16th principle which attempted to mitigate inflation by timing projects to coincide with periods of low input prices. This was considered inappropriate for Network Rail given the already limited access to the infrastructure i.e. the need to take advantage of blockades and other designated times to perform works

The management of inflation can be considered against 15 key principles

Inflation Management Governance Model

Strategy	Delivery	Sustainability	Review
<p>1 Have a clear understanding of how inflationary pressures affect the business at a macro level</p>	<p>5 Ensure all procurement staff understand inflation strategy and manage within that strategy</p>	<p>9 Provide suppliers with workload visibility to mitigate against demand spikes and build resilience and efficiency into supply chain</p>	<p>12 Formalise process to review inflation outlook and efficiencies with major suppliers</p>
<p>2 Have the ability to quantify how changes in input prices affect the cost base and the implications for various business activities</p>	<p>6 Use input price modelling to provide an informed platform for supply chain negotiations</p>	<p>10 Ensure that the balance of inflation risk between buyer and supplier is appropriate – where possible share pain/ gain</p>	<p>13 Don't leave money on the table – where input prices track below RPI, have recourse to change inflation assumptions in contract</p>
<p>3 Have a company-wide appreciation of the relative materiality of inflation management vs efficiency management, make appropriate trade-offs</p>	<p>7 Provide clear guidelines to ensure consistent terms and contract structures are used within a category – these should allow flexibility to reflect market liquidity and buying power</p>	<p>11 Drive debate and innovation in commercial structures to reflect changes in market conditions/ buying power</p>	<p>14 Regular meeting of procurement, finance, budget holders and inflation experts to review and adapt inflation management strategy</p>
<p>4 Have internal competencies to provide a bridge between strategy and operations to mitigate risk (e.g. inflation expertise, quarterly communication)</p>	<p>8 Promote cross-category co-operation: knowledge-sharing to homogenise 'excellence'; aggregation of common materials</p>		<p>15 Benchmarking of internal practices with other infrastructure owners and industry groups</p>



Our measure of 'good' inflation management is judged by the extent to which an organisation demonstrates these principles

Through our industry benchmarking exercise, we have developed a view of what 'best practice' looks like which has been validated by two infrastructure owners [1 of 2]

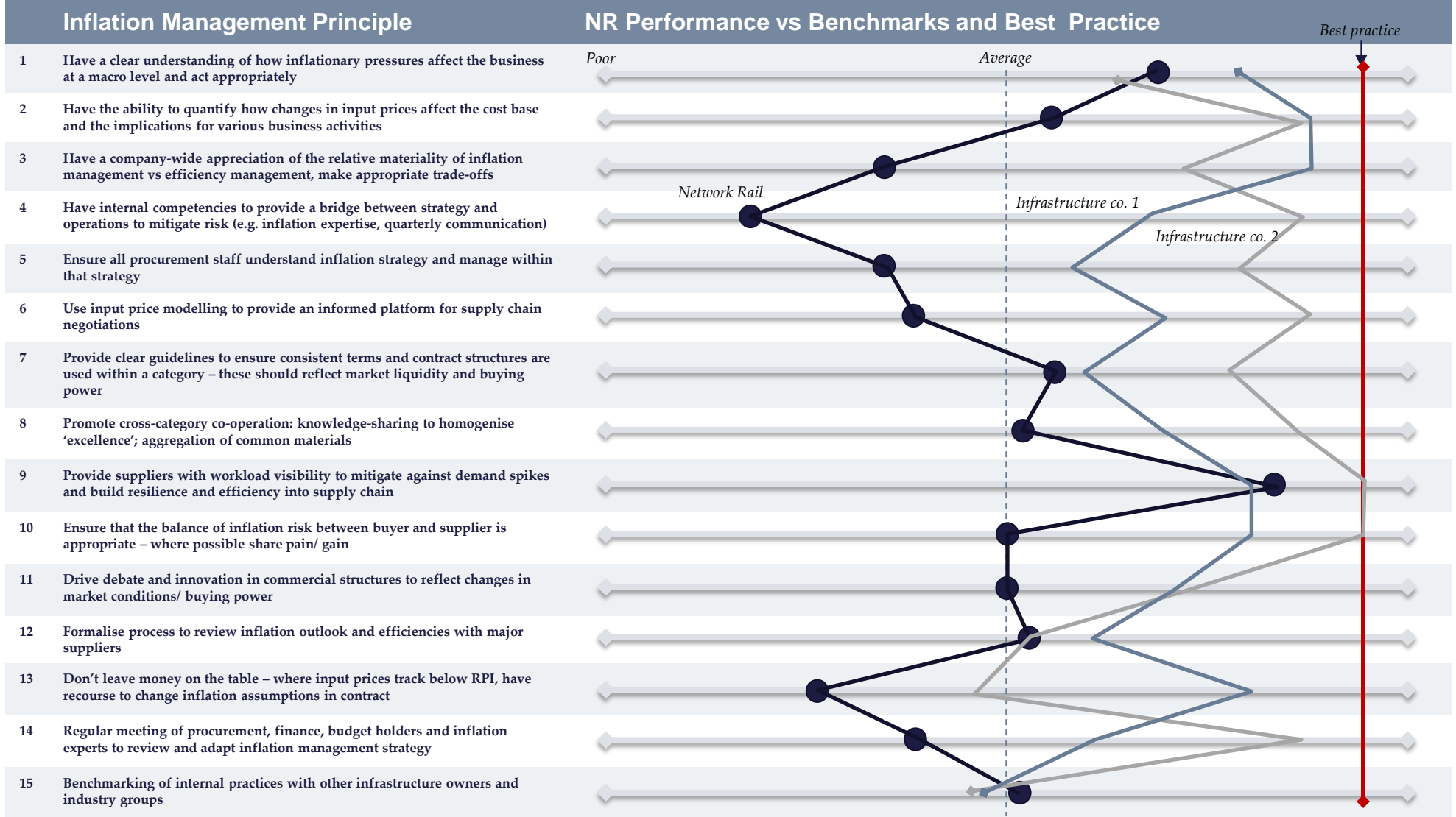
	Principle	Best Practice	Examples
Strategy	1 Have a clear understanding of how inflationary pressures affect the business at a macro level	Open frequent dialogue between finance, strategy, procurement and budget holders tracking inflation impact against company's financial goals	[redacted]
	2 Have the ability to quantify how changes in input prices affect the cost base and the implications for various business activities	Quantify impact of input price changes on the cost base on a quarterly basis, feed this into engineering planning to optimise work let to the supply base	[redacted]
	3 Have a company-wide appreciation of the relative materiality of inflation management vs efficiency management, make appropriate trade-offs	Quantify impact of inflation on the cost base relative to real efficiencies; cascade this knowledge to budget holders/ procurement to incentivise them using a mix of efficiency (£) and inflation goals (possibly qualitative)	[redacted]
	4 Have internal competencies to provide a bridge between strategy and operations to mitigate risk (e.g. inflation expertise, quarterly communication)	Have an inflation expert who is actively involved in procurement and contract negotiations; provides advice to procurement managers and challenges contracts where the buyer's risk is high	[redacted]
Delivery	5 Ensure all procurement staff understand inflation strategy and manage within that strategy	Communicate the <i>internal view</i> on inflation forecasts and provide guidance through memos, workshops, tools; ensure compliance through peer-level performance comparisons	[redacted]
	6 Use input price modelling to provide an informed platform for supply chain negotiations	For the largest contracts, use up to 5 indices per category covering the most material input costs (>5 becomes too complex). Develop cost model ahead of negotiation and use to quantify inflation risk borne by each party	[redacted]
	7 Provide clear guidelines to ensure consistent terms and contract structures are used within a category – these should reflect market liquidity and buying power	By category, have a decision tree on how to incorporate inflation risk into contracts, which indices to use and supply trend data on those indices (forecast and historic)	[redacted]
	8 Promote cross-category co-operation: knowledge-sharing to homogenise 'excellence'; aggregation of common materials	Up-skill weak areas with formal training/ hire new procurement talent to drive calibre of skill/ commercial smarts. Encourage collaboration through secondments, recognition awards and personal objectives. Identify opportunities for aggregating materials under one contract and consider hedging (using financial instruments or stockpiling)	[redacted]

Through our industry benchmarking exercise, we have developed a view of what 'best practice' looks like which has been validated by 2 infrastructure owners [2 of 2]

	Principle	Best Practice	Examples
Sustainability	9 Provide suppliers with workload visibility and stability to mitigate against demand spikes and build resilience and efficiency into supply chain	Share workbank with suppliers and ensure punctual project starts. Security of workflow gives suppliers confidence to invest in resources to avoid price spikes (in plant skills especially)	[redacted]
	10 Ensure that the balance of inflation risk between buyer and supplier is appropriate – where possible share pain/ gain	Use appropriate contract structures e.g. for large projects, target price incorporates best understanding of risks from both parties. Buyer needs to be informed of inflation sensitivities going in and be an equal to his counterpart to drive a fair deal	[redacted]
	11 Drive debate and innovation in commercial structures to reflect changes in market conditions/ buying power	Consider relevance of out-of-industry commercial mechanisms e.g. use of auctions, annually benchmarked pricing, performance-contingent volume increase	[redacted]
Review	12 Formalise process to review inflation outlook and efficiencies with major suppliers	Monitor supplier assumptions for efficiency and inflation and review budgets against both cost drivers	[redacted]
	13 Don't leave money on the table – where input prices track below RPI, have recourse to change inflation assumptions in contract	Design long term contracts with benchmarking/ market testing provisions – allows buyer to rebase prices in deflationary markets	[redacted]
	14 Regular meeting of procurement, finance, budget holders and inflation experts to review and adapt inflation management strategy	Challenge internal view of inflation forecasts given latest economic outlook. Review contract inflation assumptions across the portfolio and assess inflation exposure; make tactical adjustments	[redacted]
	15 Benchmarking of internal practices with other infrastructure owners and industry groups	Annual meeting with other infrastructure owners sharing best practices followed by an internal review of practices and implementation of ideas as part of a continuous improvement programme	[redacted]

* NR has attracted a good rating against principle 9 at the mid point in CP4 when our study was conducted. However, the first 2 years of a control period are typically marked by very poor workbank visibility, something that should be avoidable given the ample planning horizon

Overall, NR's performance is below average against the 15 principles (but below par in 6 of the 15 principles). There are many areas that would benefit from improvement compared to best practice



Note: Some of the above principles will have a greater bearing on commercial outcomes than others, for example: principles 2, 3, 4, 6, 7, 9, 10, 13

Summary - recommendations

Our recommendations for improvement are based around 12 themes. Some directly refer to the principles in the Inflation Management framework, others transcend the specific nature of the principles, for example, the call for a change in mind-set and culture

Shift culture:

1. **A pound is a pound:** instil a change of mind-set to *'inflation is a cash cost, a pound is pound'*
2. **Introduce incentives:** cascade incentives down to personal objectives and incorporate in the Balanced Scorecard dashboard
3. **Joined up working:** closer cohesion between, planning, finance, procurement and budget holders

Build:

4. **A principles led approach:** simple tenets that underlie an effective Inflation Management (IM) strategy
5. **A central Inflation Management Unit:** the 'go to' experts for all matters related to inflation
6. **Input price modelling tools:** introduce simple support tools for procurement to inform supplier negotiations

Educate:

7. **A consistent house view on inflation levels:** guidance and regular communication on the company's outlook for input price and general inflation
8. **Training:** up-skill procurement staff, encourage and reward knowledge sharing
9. **Innovation:** use of relevant non-rail industry commercial mechanisms

Commercial challenge:

10. **Appropriate contract structures:** assess existing contracts and use of indices
11. **Don't leave money on the table:** various checks to ensure inflation risk is mitigated
12. **Monitor and evaluate:** process and metrics for monitoring and evaluation of input cost inflation

Recommendation details (1 of 3)

A pound is a pound

- Drive a change in mind-set from ‘inflation is a factor that is layered on top of budgets’ to ‘inflation is a cash cost, a pound is pound, and there are things that I can do to mitigate it’
- The change in mindset would also see inflation assuming a greater priority relative to driving efficiencies (they are almost equivalent in value during CP5)

Incentives

- There should be ‘buy in’ to the need for explicit management of inflation across finance, planning and procurement
- Incentives help priorities to stick. Inflation incentives imposed by the regulator should be aligned to management’s personal incentives throughout the organisation
 - Include specific inflation management targets in the Balanced Scorecard dashboard for relevant procurement staff, splitting the existing real cost reduction targets into nominal cost efficiency and inflation management
 - As part of a “balanced” dashboard of targets to avoid detracting from other key areas of the business e.g. safety

A principles led approach

- Develop a principles led approach, simple tenets that underlie an effective Inflation Management (IM) strategy
- The 15 principles laid out in the preceding pages could be a start point

A central inflation management unit

- Set-up a central Inflation Management Unit
 - Appoint a small dedicated team to be the ‘go to’ experts for all matters related to Inflation Management
 - Responsible for the IM strategy and actively involved in procurement e.g can be called upon to support key contract negotiations; the expert will have a remit to challenge contracts where the buyer’s risk is high
 - Their remit should include detailed analysis of input costs and inflation drivers, benchmarking latest best practice and supporting IM strategy development
 - The team would work with Category Managers to monitor existing contracts and ensure contract structures and indexation are appropriate and in line with the NR IM strategy

Input price modelling tools

- Make available modelling tools (using consistent indices for different work types) to budget holders and commissioning agents
- Develop input price models for each procurement category (e.g. signalling, track etc). The default settings should reflect the input price mix for a typical project, we suggest using up to 5 indices
- Tailor the cost model ahead of negotiation (using tender assumptions for inflation) and use the model to compare the inflation risk borne by each party and therefore a suitable balance of cost/risk for the buyer

Recommendation details (2 of 3)

Regular guidance – a house view

- Quarterly communication, covering input price trends and the company’s outlook for general inflation
- Plus particular guidance on the implications for the supply base and procurement strategies through memos and workshops
- An IM section on the NR intranet with policy documents and guidance notes on inflation management

Joined up working

- Regular meeting of procurement, finance, budget holders and inflation experts to review and adapt inflation management strategy
 - Workshops chaired and run by the central IM team and attended by representatives from Business Planning, Treasury, Procurement (both senior management and category managers) and Budget Holders
 - Monitor inflation risk (quantified where possible)
 - Challenge internal view of inflation forecasts given latest economic outlook
 - Review contract inflation assumptions across the portfolio and assess inflation exposure; make tactical adjustments

Training

- Provide specific inflation management training for relevant procurement staff, e.g. Category Managers
 - Perform an audit of procurement staff and their approach to managing contract and inflation risk (we believe it is done better in some categories but regional procurement might show culturally differences towards risk). The aim would be to train up the weaker areas identified by the audit
 - Up-skill weak areas/ hire new procurement talent to drive calibre of skill/ commercial smarts
 - Encourage collaboration through secondments, recognition awards and personal objectives

Innovation

- Several interviewees have remarked that the rail industry lags other sectors (road, utilities) with respect to commercial innovation; our suggestion would be to place greater emphasis on innovation, in particular:
- Consider the relevance of non-rail industry commercial mechanisms e.g. use of auctions, annually benchmarked pricing, performance-contingent volume increase

Appropriate contract structures

- For each procurement category, have a decision tree on how to incorporate inflation risk into contracts, which indices to use and supply trend data on those indices (forecast and historic)
- Assess appropriateness of all existing contracts, especially, the apportionment of risk between NR and the supplier
 - Potential improvement strategies include: more prevalent use of Fixed Price mechanisms within contracts, where the supplier is best placed to manage inflation risk; increased use of Target Cost contracts on complex, multi-disciplinary projects where a risk share is most appropriate; avoid annually “negotiated” contracts where the rules of the negotiation are broad and vague. These contract structures contain uncertainty for suppliers and NR and create an additional administrative burden

Recommendation details (3 of 3)

Don't leave money on the table

- Use input price modelling to assess how prices track against RPI and use this to decide on the most appropriate index for a contract
- Design long term contracts with benchmarking/ market testing provisions – allowing the buyer to rebase prices in deflationary markets
- Identify opportunities for aggregating materials under one contract and consider hedging (using financial instruments or stockpiling)
- Particular suggestions for contract indexation:
 - Move away from RPI / CPI model. For most contracts, this does not accurately reflect the actual input costs involved and appears to be based on historic practices
 - Consider moving to an RPI-X model for some categories of spend where input costs have historically tracked at a discount to RPI, for example, IT hardware and software . The RPI-X approach has the advantage of avoiding highly volatile indices and reducing complexity where contracts have >5 input cost elements to be indexed
 - Consider moving to more bespoke multiple indices to reflect the cost structure of more complex multi input contracts. Using RPI or CPI to track these input costs is inefficient in terms of inflation risk management, for both NR and suppliers

Monitor and evaluate

- Establish a process and metrics for monitoring and evaluation of input cost inflation
 - Inflation reviewed as part of budget reporting
 - Formalise the ad hoc analysis and monitoring conducted by some Category Managers, to cover all spend categories with a requirement to share intelligence and internal best practice across the procurement function
 - Monitoring should include “In-contract” reviews which monitor indexed contract or framework costs against the market and...
 - ...“Post contact” reviews to assess the structure and indexation for each contract, and compare to actual inflation for the key input costs