OFFICE of
RAIL REGULATION

Policy framework for investments: Guidelines on implementation arrangements & processes

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Contents

Executive Summary

1. We set out our policy framework for investments in our October 2005 document *Policy framework for investments: conclusions* [1]. This framework is aimed at facilitating the efficient delivery of value for money improvements to the railway. These follow-up guidelines, which should be read in conjunction with the October document, are intended to assist current, and potential, funders and promoters of investment schemes. They describe and bring together relevant policies, procedures and processes underpinning the investment framework and provide references to other key documents required to implement the framework.

2. These guidelines should further the key objective of overcoming the barriers to efficient development and delivery of investment schemes In order to assess whether the framework is achieving this key objective, we will monitor the new arrangements being put in place and the efficiency of delivery of investment schemes through the reporting processes described in this document.

3. A consistent approach by Network Rail to investment proposals is important for those wishing to invest so that they can be certain about what they can expect from Network Rail and are clear about the terms on which they can expect to do business with Network Rail. This is addressed through:

   (a) a summary in these guidelines of how the company deals with investment proposals from stakeholders and how it will ensure effective engagement at all stages. A full explanation is contained in Network Rail's document *Investing in the Network;* and

   (b) the template terms and conditions for third party schemes, proposed by Network Rail and approved by us, which provide stakeholders with a clear, balanced set of contracts when buying services from Network Rail. We have now approved the terms for three of the template agreements and expect to approve the terms for the other template agreements shortly.

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[1] Available on our website at http://www.rail-reg.gov.uk/upload/pdf/255.pdf.

4. In this document, we aim to provide clarity on key industry processes for implementing investments. Our detailed criteria setting out the circumstances under which investment expenditure may be added to the Regulatory Asset Base (RAB) are described. Other key processes are outlined in Network Rail's document *Investing in the Network*.

5. Finally, we set out further key policies, not fully covered in our October 2005 policy conclusions, required to incentivise efficient behaviour on the part of all stakeholders. These include our treatment of additional operating and maintenance costs arising from schemes promoted by third parties, and a description of our proposed rebate mechanism to enable third party investors to recover a fair proportion of costs from other beneficiaries.

1. Introduction

Background

1.1 The Office of Rail Regulation (ORR) published its document *Policy framework for investments: conclusions* in October 2005 (our policy conclusions)[2]. That document set out the key activities required to implement and monitor the framework in order to ensure that it is delivering the benefits envisaged, i.e. removing the barriers to investment identified by stakeholders so as to facilitate the delivery of value for money improvements to the railway. These guidelines set out the implementation and monitoring arrangements in more detail.

Purpose and scope of these guidelines

1.2 The purpose is to provide reference guidelines, which bring together the key policies, procedures and processes required to implement and monitor the investment framework. This is an important document for Network Rail and investment promoters, who can use it to understand the process for delivering schemes on the rail network. Our guidelines are intended to have the dual benefits of:

(a) furthering our objective of developing a framework to facilitate appropriate, timely and efficient investment in the rail network; and

(b) helping to overcome barriers to the efficient development and delivery of investment schemes sought by customers and funders, by providing details of:

(i) how Network Rail should meet its obligations under the investment framework, and;

(ii) key industry arrangements and processes.

1.3 We intend to update these guidelines from time to time, to reflect revisions to relevant policies or to the arrangements described. We expect to produce a

[2] This document is available on our website at http://www.rail-reg.gov.uk/upload/pdf/255.pdf.

further version of these guidelines by December 2006, once the arrangements and policies described in this document have been established.

1.4 The key activities necessary to implement and monitor the investment framework are to:

(a) ensure that the policy principles on third party enhancements (set out in chapter 3 of our policy conclusions and in our November 2005 Technical Note[3]) are fully reflected in the template agreements that Network Rail has been developing. Once satisfied, we will approve the agreements under Part G of the Network Code (we have already approved three of the agreements[4]);

(b) require Network Rail to produce and publish an appropriate supplementary section to its Code of Practice under Condition 25 of its network licence (the Dependent Persons Licence Condition), to clarify how it will deal with investment proposals from third parties; and

(c) finalise the arrangements for:

(i) the application and reporting of the new Risk Funds for third party schemes: i.e. the Industry Risk Fund (IRF) and Network Rail Fee Fund (NRFF), with assistance where appropriate from the independent rail Reporters;

(ii) governance of major schemes sponsored by Government[5];

(iii) the Network Rail Discretionary Fund (NRDF), the £50 million per annum fund for small schemes promoted by Network Rail, including appropriate reporting and appraisal criteria; and

(iv) self-financing schemes promoted by Network Rail, including station retail schemes.

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3 Available at http://www.rail-reg.gov.uk/upload/pdf/tech_note_3rdparty_investments-231105.pdf.

4 That is: the Asset Protection Agreement (where Network Rail is facilitating a scheme for a third party) and the two Implementation Agreements (fixed price and emerging cost), where Network Rail is delivering a scheme.

5 That is, the Department for Transport (DfT) or Transport Scotland.

1.5 As well as these activities, there are a few related areas where further development was required to finalise our policy approach. These included:

- further details on the treatment of incremental operating, maintenance and renewal (OM & R) costs;
- the proposed rebate mechanism, which allows third party investors partially to recover the costs of schemes from other beneficiaries;
- criteria for the assessment of shared value benefits that arise as a result of developments at stations, or elsewhere; and
- the treatment of accelerated renewals.

1.6 These issues are also addressed in this document, as well as another potential barrier to investment schemes: the issues resulting from the current set of passenger franchise agreements (see paragraph 5.33).

Structure of this document

1.7 The remainder of this document is structured as follows.

(a) Chapter 2 sets out the governance and reporting arrangements for:

(i) major schemes sponsored by Government;

(ii) the NRDF;

(iii) the IRF and the NRFF; and

(iv) self-financing schemes.

(b) Chapter 3 summarises how Network Rail will deal with its customers, through the guidance contained in the supplementary section to the Code of Practice under Condition 25 of the company's network licence, entitled *Investing in the Network*. This is a key document for stakeholders as it sets out comprehensive guidance for dealing with Network Rail and progressing investments.

(c) Chapter 4 provides more details on how we expect to apply our criteria for assessing the efficiency of prices for schemes, including a worked example.

(d) The other policy issues described in paragraph 1.5 are addressed in chapter 5.

1.8 We request views from stakeholders on the arrangements, processes and policies set out in this document, particularly on:

(a) the guidance contained in *Investing in the Network*, in terms of whether it:

(i) adequately explains what you can expect from Network Rail; and

(ii) meets Network Rail's obligations as set out in chapter 2 of our policy conclusions; and

(b) the policies set out in chapter 5 of these guidelines.

Views on these guidelines should be sent in hard copy and electronic format, no later than 19 May 2006 to:

Jon Clyne
Head of Investment Policy & Analysis
Office of Rail Regulation
1 Kemble Street
London
WC2B 4AN

Email: jon.clyne@orr.gsi.gov.uk

1.9 Copies of these guidelines may be seen on ORR's website (www.rail-reg.gov.uk) and in its library.

2. Governance and reporting arrangements for schemes

Introduction

2.1 Our policy conclusions set out how we expect Network Rail to carry out its role in investments, including the governance arrangements we expect to be established for schemes. We identified two broad governance models:

(a) through Network Rail's network licence, which should be used for most projects sponsored by Government (whether or not these are included in periodic review determinations); or

(b) through contracts. For third party sponsored schemes, contractual mechanisms will be put in place through template agreements to be approved by us under Part G of the Network Code.

2.2 We also noted that, in certain exceptional cases, schemes promoted and funded by Government (such as the Southern Region New Trains Programme - SRNTP) may benefit from bespoke arrangements through a "protocol" or similar document, which would set out the customer's or funder's reasonable requirements under Condition 7 of Network Rail's network licence. The nature of such bespoke governance arrangements for major schemes, through the network licence model, is described in more detail below.

2.3 The chapter then sets out the governance arrangements and reporting processes for NRDF schemes, through the network licence model, and for schemes promoted by third parties accessing the new Risk Funds i.e. the NRFF and the IRF. The governance arrangements for schemes using the new Risk Funds are contractualised using the model terms for third party schemes approved by us. We address the criteria for using the Funds, and our role in the framework for third party schemes, including reporting arrangements. Finally, this chapter describes arrangements for self-financing schemes promoted by Network Rail, including station retail schemes.

2.4 The monitoring arrangements set out below are designed to provide us with sufficient information to understand whether the new arrangements are resulting in an increase in the volume of schemes being delivered, and whether or not Network Rail is delivering on the obligations set out in our policy conclusions. Also, comprehensive information on investments has not been available in the past and the new approaches we have established will need, at least initially, careful scrutiny to ensure they are delivering benefits to all stakeholders.

2.5 However, in future, assuming the results of our monitoring suggest that the barriers to delivering investment are being overcome and that Network Rail is meeting its obligations, we will expect to take a ‘lighter touch’ approach to monitoring. In particular, we will consider whether or not our initial information requirements for quarterly reporting are still appropriate.

Governance arrangements for major schemes

2.6 In certain cases, large schemes promoted and funded by Government may require bespoke governance arrangements, for example to reflect unusual circumstances (such as risk allocation which differs significantly from the default allocation set out in chapter 4 of our policy conclusions document), which would be embodied in a protocol (or similar document) to set out the customer’s or funder’s reasonable requirements under Condition 7.

2.7 A typical protocol[6] would generally comprise the following elements:

(a) a description of the scheme, including the scope of the works required, the outputs to be delivered and the expected timescale for the works and delivery of outputs;

(b) the funding mechanism(s) for the scheme, explaining how Network Rail will recover its costs;

(c) risk allocation, and a description of the roles and responsibilities of the stakeholders involved;

(d) cost control, monitoring and management processes, including the process for approving variations to the scope or cost of the scheme; and

(e) the dispute resolution processes.

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[6] Government may wish to use a protocol for any large scheme it sponsors under the network licence governance model.

2.8 We have discussed with the Department for Transport (DfT) the governance arrangements going forward for schemes it sponsors. The DfT has put in place the following processes with Network Rail:

(a) regular meetings with Network Rail, including:

(i) the Joint Programme Board (JPB), covering strategic issues and portfolio management of major schemes; and

(ii) Project Development Groups (PDG) for individual schemes, to discuss project development and delivery issues as necessary;

(b) the use of contractual provisions (based, for example, on the EFA[7]) to govern the development stage of schemes, with any efficient written-off development costs paid in cash or added to the RAB; and

(c) the use of protocols (or similar documents) to set out arrangements for major schemes, such as the Access for All programme of investments at stations, with bespoke arrangements as appropriate. Once we were satisfied, these protocols would be recognised by us as documenting the DfT's reasonable requirements under Condition 7.

2.9 We are content with these arrangements for any new major schemes sponsored by the DfT. Before making any addition to the RAB in respect of expenditure on new schemes sponsored by Government, we would have regard to the criteria set out in chapter 4 of this document.

2.10 For schemes sponsored by other public sector or Governmental bodies in England or Wales, such as Transport for London (TfL), we would generally expect the contractual governance model to be used.

2.11 Transport Scotland has thus far followed the contractual model for major schemes, such as the upgrade of Edinburgh Waverley station, for which Network Rail has now entered into an implementation agreement with Transport Scotland. We continue to discuss with Transport Scotland and Network Rail appropriate arrangements for major schemes, given the transfer

[7] The Enhancement Facilitation Agreement put in place between the Strategic Rail Authority (SRA) and Network Rail at the time of the acquisition of Railtrack PLC by Network Rail.

of responsibility to Scottish Ministers for specifying and funding railway outputs in Scotland.

Arrangements for the NRDF

2.12 The arrangements for the NRDF were described in Annex B to our policy conclusions and are set out again here for ease of reference, with appropriate updates to reflect recent developments.

Scope of the NRDF

2.13 The NRDF was established to fund schemes to be designed and delivered by Network Rail which meet the following criteria:

(a) estimated cost of less than £5 million per scheme, (although larger schemes may be approved by Government on a case-by-case basis) net of any third party contribution

(b) the scheme has been identified by Network Rail itself or as part of discussions with customers, usually through the relevant Route Investment Review Group (RIRG), and reviewed by Network Rail's own Route Strategy Planning Group (RSPG); and

(c) the scheme has a strong whole-industry business case (see below for discussion of the relevant appraisal criteria), either as a stand-alone scheme or as an addition to an existing major renewal planned by Network Rail.

2.14 The DfT has confirmed that it supports the financial commitment for the NRDF, and therefore that £200 million should be made available over the four years beginning in 2005-06, with flexibility to carry forward over- or underspends against an assumed £50 million annual spend. As part of the financial settlement between the DfT and Transport Scotland, it has been agreed that around £20 million (i.e. around 10%) of the fund will be spent in Scotland, and the remainder in England and Wales.

2.15 Network Rail had suggested that any additional short-term (i.e. until the next periodic review) OM & R costs associated with NRDF schemes should also be funded through the overall funding allowance and added to the RAB. However, additional operating and maintenance costs should not be capitalised by including them in the RAB, and should instead be carried by

Network Rail until the next periodic review. To the extent that these enhancements will result in increased operating and maintenance costs (which is far from certain), these are likely to be small. The treatment of additional OM & R costs associated with third party funded schemes is discussed in chapter 5.

2.16 We have assessed five pilot NRDF schemes which the DfT has committed to fund as part of the overall NRDF funding, and are satisfied that these schemes should deliver value for money outputs for the benefit of the industry. The following pilot schemes have been used to develop the appraisal and monitoring framework for the NRDF:

- Peterborough-Werrington bi-directional signalling (estimated cost £3.4 million);
- Tyseley North junction (estimated cost £4.9 million);
- a new turnback at Tunbridge Wells (estimated cost £1.1 million);
- Basingstoke loop (estimated cost £3.1 million); and
- Coventry-Kenilworth (estimated cost £4.9 million). This scheme was not listed in Annex B of our policy conclusions but has since been included within the list of pilot schemes.

2.17 Over the last few months Network Rail has identified and appraised potential NRDF schemes, and currently has a short list of 105 schemes across Great Britain with a total estimated cost in this control period of £223 million. Of these schemes, 56 schemes with an estimated value of £119 million have been selected for 'fast track' development.

Process for bringing forward NRDF schemes

2.18 The DfT and Transport Scotland, in discussion with us and Network Rail, have now produced appraisal criteria consistent with best practice which Network Rail has used to prioritise schemes it has identified, taking account of wider benefits (such as decongestion on the road network) and allowing for any third party contributions. These criteria will be published with Network Rail's business planning criteria and are now available on the DfT's website[8].

2.19 Network Rail will also set out the incremental enhancements (or at least a possible list of enhancements) it expects to deliver through the NRDF annually in its business plans, starting with the March 2006 Business Plan.

2.20 The arrangements for identifying and delivering NRDF schemes, and our monitoring of them, will be as follows:

- Network Rail identifies and prioritises potential schemes using appraisal criteria agreed with Government;
- Network Rail develops the schemes it has prioritised and produces estimated prices for delivery, expected outputs and (if appropriate) the estimated split between renewal and enhancement elements for each of these schemes. Network Rail informs us and Government of this information for schemes under development;
- Network Rail delivers the schemes and maintains a file of all relevant information on each scheme;
- Network Rail reports on the progress on all NRDF schemes to us and Government, on a quarterly (initially) and annual basis;
- each year, the independent Reporters (Halcrow) audit a representative sample of schemes, using the information on Network Rail's files, to confirm delivery of outputs and that the renewal/enhancement split of costs is appropriate;
- at year-end, Network Rail should include details in its regulatory accounts of all NRDF schemes, using the standard reporting template[9]; and
- we will confirm the efficient net additional costs to be added to the RAB.

[8] See http://www.dft.gov.uk/stellent/groups/dft_railways/documents/page/dft_railways_611192.hcsp

[9] This was set out in the *Regulatory Accounting Guidelines*, published by ORR in May 2005.

Reporting on NRDF schemes

2.21 As noted above, Network Rail will provide details to us of all schemes under development or in implementation on an annual basis, starting from April 2006. For each scheme, the report provided will contain broadly the same type of information we already receive through the standard template for reporting enhancements and hence should not impose a significant additional burden on Network Rail.

2.22 In addition, the following summary report will be provided to us quarterly and reviewed by the independent Reporters. The same summary table will be used to report on the NRDF schemes on an annual basis, and will be included in our annual assessment of Network Rail.

Template annual/quarterly summary report on NRDF schemes

	Number of schemes completed (in total)	Number of schemes in implementation	Year-to-date: Forecast spend (£m)	Year-to-date: Actual spend (£m)	Variance (£m)
Stand-alone schemes					
Schemes linked to major renewals					
Total NRDF					

2.23 We require annual information from Network Rail in order to obtain information on the overall volume of activity and expenditure for this new Fund, to ensure that the NRDF arrangements are leading to an increased volume of investment and to understand where incremental outputs are being provided. We do not generally expect to ask the Reporters to carry out detailed analysis of the quarterly data, unless specific issues have been highlighted.

Arrangements for the new Risk Funds (IRF and NRFF)

2.24 The arrangements for the new Risk Funds were summarised in chapter 3 of our policy conclusions. Since then, we have met with Network Rail to discuss appropriate arrangements.

2.25 In summary, Network Rail proposed that two new risk funds are established order to address issues of risk aversion holding up projects:

(a) the NRFF: a ring-fenced fund, where payments from customers to cover Network Rail's own additional costs and liabilities (over and above its direct costs[10]) are put into the Fund and it is drawn on as necessary by Network Rail. Any surplus Network Rail derives from its charges to customers will be held within the Fund. Network Rail has also proposed contributing £10 million to top up this Fund to ensure it has incentives to manage effectively liabilities that may arise[11]; and

(b) the IRF, funded by customers' contributions based on a proportion of scheme costs, which will provide insurance for both parties against the low-probability, high-impact industry risks[12].

2.26 If liability caps are breached and the NRFF and IRF are both exhausted, Network Rail would finance any additional costs until the next periodic review, at which time there would be an addition to the RAB. Given that this may lead to an increased funding requirement for Government (through financial support of potentially higher access charges in future control periods), a necessary pre-requisite for our approval of the model terms and conditions is Government support for these arrangements. We expect that Network Rail will manage risks within its control and manage these Funds so as to ensure as far as possible that they are not exhausted. We would need to be satisfied that this was the case before considering making any addition to the RAB, by reference to the monitoring arrangements described below.

[10] These are estimated up-front and paid by the customer.

[11] This £10 million 'top up' contribution would be drawn on if contributions from customers to the NRFF were to be exhausted.

[12] Although it would also be drawn on in certain circumstances to fund Network Rail liabilities if the NRFF was exhausted, and also to fund customer liabilities if liability caps had been breached.

Scope of the new Risk Funds

2.27 The new Risk Funds are designed to be utilised by investment schemes which meet the following criteria:

(a) scheme value (estimated cost) generally less than £50 million, although larger schemes may be eligible subject to agreement from Government;

(b) the scheme should enhance the rail network i.e. schemes encroaching on the network without delivering improved outputs are not included, for example, a new development by a stakeholder[13] using land from a station car park;

(c) the scheme sponsor is not Government, although we note that Transport Scotland has chosen to put in place a framework agreement with Network Rail for the provision of investment services, to cover the transition period prior to full transfer of funds and responsibilities from the DfT to Transport Scotland. We would not expect Transport Scotland to access the new Risk Funds for schemes it sponsors in future, as it will be supporting the Funds rather than benefiting from them as a customer; and

(d) NRDF schemes (whether or not the scheme is identified by a third party) are excluded.

2.28 We have now received a letter from the DfT confirming its support for the financial exposure it faces arising from the approach to third party schemes, and understand from Transport Scotland that it supports the financial exposure relating to the use of the new risk funds in Scotland. Transport Scotland will write to us shortly confirming this position. We have now given approvals for the key template agreements: the Asset Protection Agreement (APA) and Implementation Agreements – both fixed price and emerging cost. These approvals, set out in a letter to Network Rail dated 9 March 2006 and available on our website[14], effectively activate the use of the risk funds.

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13 Often referred to as an "Outside Party" - to differentiate it from a third party investing in the network.

14 Available under http://www.rail-reg.gov.uk/server/show/nav.190

2.29 The supplementary section to the Dependent Persons Licence Condition (DPLC) Code of Practice explains the process a third party should follow and what it can expect from Network Rail when bringing forward a scheme to access the new risk funds. Our November 2005 Technical note on third party investments[15] also sets out in more detail how our policy conclusions are applied to the operation of the new risk funds.

2.30 As of December 2005, there were 179 schemes promoted by third parties in development or implementation. The majority of these (120 schemes) have an estimated cost of less than £5 million, and around 80 are promoted by Passenger Transport Executives (PTEs) or local authorities. The estimated value of the activity contracted to Network Rail from the schemes is £224 million, and the total rail-related value of the investment schemes in implementation is around £800 million. Of these schemes, 15 are using the revised template agreements, with a total rail-related value of £488 million: these 15 schemes have access to the risk fund mechanisms.

Payments into the funds

2.31 Payments into the funds are governed by the terms of the draft templates. The fees that customers will pay were originally set out in Network Rail's March 2005 submission to ORR[16], and the final level of customer contributions are set out in the table below.

[15] Available at http://www.rail-reg.gov.uk/upload/pdf/tech_note_3rdparty_investments-231105.pdf

[16] Available at http://www.networkrail.co.uk/Documents/ORRSubmission2005.pdf

Table of Fees payable by customers

Service/agreement	Metric on which contribution based	NRFF contribution	IRF contribution
Feasibility Costs (BSA)	Total cost (of feasibility stage)	15%	-
Development	Total cost (of development stage)	10% (maximum[17])	2%
NR Asset Protection	Total NR costs (NRFF) / Implementation cost (IRF contribution)	10%	2%
Emerging Cost Implementation	Implementation cost	5%	2%
Fixed price Implementation	Implementation cost	13%	2%

Reporting on the use of the IRF and NRFF

2.32 Network Rail will provide us with annual reports on all schemes with access to the funds. We will carry out a comprehensive review of the arrangements for the funds once they have been in existence for a full financial year, i.e. around May 2007, so that the arrangements have had time to 'bed down' and sufficient information is available to enable a meaningful review. This review would not be expected to lead to an automatic adjustment to contributions to the funds, as we will need to analyse the reasons for the levels of the funds at the time. We would also expect to carry out a full review of the levels and arrangements for the funds at the next periodic review.

2.33 In the meantime, Network Rail will provide us with a quarterly summary table of all schemes with access to the funds, and also an annual summary table that we will publish. We will ask the independent Reporters to monitor this summary quarterly information and to review the annual information to help us assess whether an appropriate balance exists between customer contributions and drawdowns from the funds.

2.34 We expect the summary table to take the following format.

[17] We are discussing with Network Rail how this contribution should vary if services are provided on a fixed price basis rather than an emerging cost basis.

Template annual summary report on third party schemes

	Number of schemes	Value of schemes	Forecast NR spend	Actual NR spend	NR spend variance	Ratio of schemes "on programme"[18]
Schemes in development						
Schemes in implementation - NR facilitating						
Schemes in implementation - NR implementing						
Total third party schemes						

2.35 We are also considering what form of reporting is appropriate on Network Rail's transaction costs for schemes, and we are continuing to discuss this with Network Rail and other key stakeholders.

[18] i.e. schemes whose estimated completion date is within 10% of the agreed timescale.

Arrangements for self-financing schemes

2.36 As noted in our policy conclusions document[19], we would expect Network Rail to identify and pursue opportunities to:

(a) increase its property revenue, for example through retail schemes at major stations; and

(b) improve its operational performance and/or reduce its costs through appropriate investment.

We have discussed with Network Rail the potential treatment of station retail schemes and other self-financing schemes, including cost saving schemes, promoted by the company.

2.37 Some of these schemes are self-financing through the incremental revenue from the scheme within a control period, in which case no RAB addition is necessary. Other such schemes are self-financing over a relatively short period but not within a control period, and may generate additional revenue (including property income and/or access charges) and/or cost savings.

2.38 In general, provided such schemes generate sufficient revenue in total to cover the associated return on the RAB, we are content in principle to add capital expenditure on such schemes to the RAB without the need for specific approval from Government, as there should be no additional call on Government funds[20]. Any schemes promoted by Network Rail which generate sufficient incremental income and/or cost savings to produce a payback in less than 20 years are eligible for inclusion under this category of scheme.

2.39 These schemes should be depreciated over a suitable period, relating to the average payback period of such schemes. Network Rail estimated the average payback period for the schemes within this category in 2004-05, and proposed a payback period of ten years, based on a sample of seven schemes. We are content with this depreciation period as an initial

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[19] See, for example, paragraph 2.20 of that document.

[20] Although in cases where Government is exposed to future risks we would expect to seek an appropriate letter from Government confirming that it has no objection to the scheme.

assumption, which we will keep under review as other schemes are brought forward.

2.40 Network Rail has also provided a forecast of expected revenue or cost savings for this sample of schemes, which will be audited by the independent Reporters. Once we are content with the information provided by Network Rail, this forecast revenue stream will be fixed and included within the single till income figures, as part of future periodic review determinations.

2.41 These schemes will need to be reported and monitored as a separate category in Network Rail's annual regulatory accounts, as they will be depreciated over a shorter period than other schemes added to the RAB.

Template analysis for self-financing schemes

2.42 In order to obtain a consistent approach to analysis of these schemes, we have asked Network Rail to propose a form of templated analysis for self-financing investment schemes. It has proposed (and we are content with) a template based on its standard format for submissions to its Investment Board, extended for self-financing schemes and containing information which includes a description of the scheme, key risks and mitigating measures and a business case summary including the project Net Present Value (NPV), the internal rate of return (IRR) and the discounted payback period.

3. How Network Rail deals with its stakeholders

Introduction

3.1 Chapter 2 of our policy conclusions set out Network Rail's obligations in respect of investments, clarifying what its customers and other stakeholders can expect from the company.

3.2 The key document setting out how Network Rail should deal with customers (and other stakeholders) is the supplementary section to the DPLC Code of Practice, under Condition 25 of its network licence. In this context, "dependent persons" includes all bodies who do not (yet) have a contract with Network Rail, but who have expressed an interest in undertaking a scheme. This definition therefore includes all third party promoters or funders who have not yet contracted with Network Rail for the provision of services.

3.3 Network Rail needs further to improve its customer focus, including being pro-active and responding positively to customers who wish to undertake investment schemes, and to identify innovative approaches to facilitate investment in the network. It is now making significant changes to enhance customer focus, including the continuing process of recruiting new route enhancement managers to liase directly with customers, and other steps to improve these relationships, including:

(a) staff training programmes;

(b) holding a workshop with local authority promoters in mid-December;

(c) establishing a Route Investment Review Group (RIRG), which meets quarterly and whose membership consists of Network Rail and all operators who have access rights on the relevant route; and

(d) drafting a short document entitled "*Doing Business with Network Rail*" for its customers. This covers the improved means of communication with customers that the company is developing. The document, which will be published shortly, includes a short pamphlet and refers to a new section of Network Rail's website on investment processes to:

(i) explain the guiding principles;

(ii) explain how Network Rail is improving its processes; and

(iii) refer to sources of further information such as the Code of Practice under the DPLC and the template agreements.

Investing in the Network: the supplementary section to the DPLC

3.4 Network Rail has now drafted a document entitled *Investing in the Network*, which represents the supplementary section to its DPLC Code of Practice, to clarify how it will deal with investment proposals from third parties. The draft supplementary section covers:

(a) a schedule of services Network Rail can provide;

(b) how Network Rail will deal with prospective customers who approach it with a proposal;

(c) the timescale for responding to these customers;

(d) points of contact (including who to contact if escalation is required);

(e) the process for contracting with Network Rail should the scheme progress, including brief explanatory notes for prospective customers on the use of the template agreements;

(f) remedies available to customers if things go wrong; and

(g) details of key industry processes relevant to investments, including network change, station and depot change, and Network Rail's approval processes.

3.5 The draft supplementary section is available on Network Rail's website[21].

Feedback on the supplementary section and next steps

3.6 We are broadly content that the supplementary section covers all the key areas discussed in chapter 4 of our policy conclusions. However, we would

[21] See http://www.networkrail.co.uk.

welcome the views of stakeholders on the draft supplementary section, in particular with regard to the following questions:

(a) Does the supplementary section adequately explain what you can expect from Network Rail?

(b) Does it meet Network Rail's obligations as set out in chapter 2 of our policy conclusions?

3.7 We expect Network Rail to have regard to your responses when finalising the supplementary section by the end of May 2006.

4. Criteria for assessing efficient outcomes

Introduction and background

4.1 In our policy conclusions, we set out criteria for adding investment expenditure to the RAB. We also said we would provide more details on our methodology for the assessment of efficient outcomes, including a worked example. This chapter explains our methodology and sets out a detailed worked example.

4.2 In summary, the following criteria should be met before we consider making a RAB addition.

(a) Is the expenditure incurred as a result of a reasonable requirement of Government (or another funder directly supported by Government), and is Government therefore content to support the financial commitment arising from the associated RAB addition?

(b) Have the outputs required by the scheme promoter or customer been delivered?

(c) Has the expenditure been incurred efficiently?

(d) Does the expenditure add to the economic value of the rail network? In cases where the expenditure does not add to the economic value of Network Rail's assets, the scheme funder or promoter and Network Rail should explain, with reference to Network Rail's appraisal criteria:

(i) why the proposed RAB addition represents an efficient whole industry solution, including why it is more efficient for Network Rail to finance the scheme; and

(ii) how the proposal will add economic value to the rail network.

4.3 We also explained how we would judge what constitutes an efficient outcome by reference to recent proposed RAB additions for investments. We will expect to conclude that proposed scheme arrangements should produce an efficient outcome if the following conditions are met:

(a) the proposed risk allocation is appropriate and either is consistent with the default risk allocation, or clear justification is provided for differences from the default allocation;

(b) the procurement and governance arrangements, including management and cost control arrangements, are clearly specified and provide appropriate incentives on all stakeholders. Design and implementation services should usually be procured through a transparent, competitive process to ensure market-tested prices are obtained;

(c) outputs and acceptance criteria are clearly specified, so that it is clear when the scheme is complete and under what terms Network Rail will be remunerated; and

(d) cost estimates put forward by Network Rail represent efficient prices.

4.4 When assessing the robustness of a cost estimate prepared by Network Rail, we have regard to appropriate market-tested values for each element of cost included in the estimate. Cost estimates submitted to us should show costs according to the following categories:

(a) development costs (showing any sunk costs);

(b) estimated construction costs, showing unit costs and quantities assumed, any insurance costs due to the construction phase and any Schedule 4 or Schedule 8 costs expected to be incurred;

(c) management costs incurred by Network Rail;

(d) the allowance for identified, quantified risk usually estimated through a Quantified Risk Analysis (QRA) or similar process; and

(e) the contingency or allowance assumed for unidentified risks.

Which schemes do we assess and when?

4.5 We intend to continue to assess the arrangements (including cost estimates) for major schemes in advance (*ex ante*), with assistance where appropriate from the independent Reporters. Our approach is in line with the practice of other regulators, for example Ofgem and the Civil Aviation Authority (CAA)[22], who often assess major capital expenditure schemes arising between price reviews on a case-by-case basis.

4.6 We would generally expect to carry out an assessment for any schemes with a value above £5 million where the expenditure is to be added to the RAB. For such schemes with a value below £50 million we would generally expect this assessment to be relatively high-level. We will keep these threshold levels under review and consider whether or not in future the lower threshold should be increased, with reference to whether Network Rail continues to improve its scheme development, cost estimation and other associated processes.

4.7 We will generally carry out an assessment of relevant schemes when scheme development has reached GRIP[23] Stage 4 or 5 in Network Rail's development process, i.e. when detailed design is complete (or nearly complete) but before Network Rail (or another delivery agent) has gone out to tender. It is at this stage that the detailed information required for our assessment should be available in an advanced form but before Network Rail has entered into contractual commitments. If we receive information later in the process of scheme development (or implementation), this may delay the assessment process and ultimately could result in an *ex post* adjustment to any RAB addition.

4.8 For larger-scale schemes (costing above £50 million), we would generally expect to receive a summary of the arrangements for any proposed RAB addition in advance of the final submission for the scheme, to enable us to provide initial views on whether or not the scheme is consistent with our criteria. In recent practice, for major schemes Government and Network Rail have sought an early agreement "in principle" from us (at around the GRIP Stage 3) that capital expenditure on schemes can be added to the RAB.

4.9 As described in chapter 2 of this document, in order to monitor minor schemes effectively and ensure that Network Rail is promoting efficient outcomes for these schemes, we will also assess a sample of NRDF schemes on an *ex post* basis. We may also choose to assess the efficiency of a small

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[22] For more details see the December 2004 NERA report, available on our website at http://www.rail-reg.gov.uk/upload/pdf/nera_final_report-investments.pdf.

[23] GRIP is Network Rail's *Guide to Rail Investment Projects.*

sample of third party schemes delivered by Network Rail on an *ex post* basis as part of our monitoring arrangements. If this sample analysis highlights particular concerns, or results in any adjustments to prices for these schemes, then we would expect to examine whether or not there was a systemic problem and seek further information from Network Rail.

A worked example: additional works on the Southern Region New Trains Programme (SRNTP)

Background

4.10 In June 2004 the Strategic Rail Authority (SRA) wrote to us proposing that expenditure on certain works forming part of the SRNTP should be added to the RAB. Expenditure on these works was not included within the allowance for the SRNTP in the 2003 access charges review (ACR2003) settlement.

4.11 The SRA was seeking an incremental RAB addition of up to £44 million (2002/03 prices) for certain works to be delivered by train operating companies (TOCs), primarily at depots, not forming part of the core power supply upgrade (non-PSU works). The estimated cost included a contingency of £3 million, equivalent to around 7% of the base price.

Information provision

4.12 We asked for and received from the SRA, as promoter and funder, the following information:

(a) a full description of the scope of the scheme, including the detailed outputs to be delivered for each sub-project, and the overall work programme;

(b) full details of cost estimates for the scheme, identifying all sunk costs and a reconciliation of cost estimates provided for the SRNTP as a whole;

(c) details of the funding arrangements, including any comfort letters between the parties; and

(d) the governance arrangements for the scheme, including cost monitoring and change control processes, and the proposed risk allocation.

4.13 We assessed the information received (and associated documents) with regard to the criteria in paragraphs 4.2 and 4.3 above, and sent a decision letter to the SRA in November 2004.

Our assessment of the proposal

4.14 With regard to each of the criteria in paragraph 4.2:

(a) we received a letter from the SRA (as the Government funder) indicating that it required the outputs from the scheme and that it supported the financial commitment arising from the RAB addition;

(b) in our decision letter, we required the SRA and Network Rail to provide us with confirmation that the outputs set out in the submission had been delivered before making any RAB addition; and

(c) we also received confirmation from the SRA that the outputs were required in order to deliver the (infrastructure elements of) SRNTP. We therefore concluded that the enhanced assets should add to the economic value of Network Rail's assets.

4.15 Turning to the criteria in paragraph 4.3, we assessed the allocation of risk set out in the SRA's submission and the draft protocol it had drawn up with Network Rail, against good practice. The guiding principle (as we said in our policy conclusions) is that risks should be borne by the stakeholder best able to manage and mitigate them. We felt that some elements of the risk allocation could have been sub-optimal but we also felt that requiring amendments to the arrangements at that stage could result in further inefficiencies. Importantly, we believed that the capped price set for delivery of the required outputs should provide appropriate incentives to enable and promote efficient delivery of the works.

4.16 We reviewed the draft protocol agreed between the SRA and Network Rail for the scheme and concluded that the cost control, scope control and monitoring arrangements it contained were reasonable and should help to promote an efficient outcome. These included a Project Development Group (which covered the entire SRNTP including the TOC-delivered works) to address strategic issues including stakeholder liaison, and a Works Authorisation Committee (WAC)[24], consisting of members from all stakeholders, which met

[24] A separate WAC was set up specifically to deal with the TOC-funded works.

regularly to discuss and (if appropriate) authorise new works and any changes in scope or cost. For schemes with several stakeholders we would generally expect to see evidence that all affected stakeholders were consulted on any material changes in its scope or costs.

4.17 The SRA provided a clear, detailed output specification through its submission, which specified when individual sub-projects were complete and what criteria were in place for assessing overall completion of the scheme.

4.18 We carried out a detailed analysis of the cost estimates provided by the SRA. We noted that the proposed contingency for the scheme of 7% was within the range of contingencies we would expect for schemes of this type, i.e. less than 10% of the "base price"[25]. We assessed the cost estimates for a sample of individual sub-projects (there were around 80 in all) and compared unit costs provided by the SRA with benchmark unit costs, particularly those for platform works. We examined the estimation methodology and the overall technical solution through a series of meetings with the technical team (a joint SRA/Network Rail team), as well as the "value engineering" processes put in place to manage and reduce costs where appropriate. We concluded that good practice had generally been followed and therefore we were broadly content with the approach. We also recognised that the SRA and Network Rail had followed a reasonably robust, comprehensive process to planning and implementing the scheme.

Our decision

4.19 Following this assessment against our criteria, we said that we would expect to make an addition to the RAB for all costs properly incurred on the scheme of up to £44 million provided that we receive:

(a) confirmation from the SRA and Network Rail that the required works have been delivered as set out in the submissions;

(b) details of the actual outputs delivered by the scheme, along with an explanation (if this is required) of why the actual outputs delivered differ from the outputs set out in the submissions;

[25] See Chapter 3 of our policy conclusions.

(c) assurances from Network Rail that its costs were legitimately incurred in accordance with the arrangements described in the submissions; and

(d) confirmation from the SRA that all costs relating to the works have been properly incurred in accordance with the arrangements set out in the submissions.

5. Other policy issues

Treatment of additional operating, maintenance and renewal costs

Background

5.1 We described in our policy conclusions the proposed treatment of additional operating and maintenance (O & M) costs[26] arising from schemes promoted by third parties where Network Rail takes on the operational and maintenance responsibility following completion of the scheme.

5.2 In summary, we said that:

(a) between completion (and acceptance) of the enhanced assets and the next periodic review, efficient additional O & M costs should be funded by the relevant third party promoter or funder, to the extent Network Rail cannot recover these costs directly from another beneficiary; and

(b) after the next periodic review, additional O & M costs should be included in Network Rail's cost submissions/business plans and efficient costs allowed by us in the revenue requirement assessment for the next control period.

5.3 We said that we would discuss this approach further with stakeholders. Also, Network Rail has noted that our policy conclusions did not explicitly address the issue of additional renewal costs. Since publication we have had further discussion with stakeholders (particularly Network Rail) on the appropriate treatment of these additional costs.

5.4 Network Rail has expressed concern that our proposed treatment could discourage investment (at least at the margins) because third party investors, particularly franchisees, may be unwilling to fund the additional costs after completion. Network Rail said that it believes that Government should fund the additional costs until the next periodic review in order to encourage investment. However, the DfT has indicated that it is not willing in general to

[26] In this context, "additional" refers to the O & M costs over and above those that would be recovered through the variable charges that may arise from any increase in traffic resulting from the enhancement.

support these additional costs due to affordability constraints, and we understand that if it was to support any such costs it would wish to cap these and fund them through a RAB addition. However, we would not generally expect to approve the capitalisation of operating or maintenance costs through a RAB addition.

Developing the approach proposed in our policy conclusions

5.5 Our policy conclusions did not provide any detail on how OM & R costs associated with an enhancement should be recovered following a periodic review, to the extent that they are not fully recovered from beneficiaries of the enhancement through access charges.

5.6 We consider that our approach needs to recognise the fundamental principle that the scheme promoter should allow for all costs and benefits associated with a scheme in its business case, in line with best practice in investment appraisal. The corollary of this principle is that the third party customer[27] should bear any additional OM & R costs associated with the enhancement for the life of the asset, net of those costs which Network Rail recovers directly from beneficiaries through access charges.

5.7 We would expect Network Rail to enter into an appropriate contract with the third party customer to remunerate any ongoing additional OM & R costs, to give both sides certainty going forward[28]. Where an access beneficiary (e.g. a TOC) is funding the scheme, we would expect this contract to be a supplemental access agreement.

5.8 The expected income to Network Rail from these additional OM & R costs should be identified separately within Network Rail's single till income forecasts (with reference to an appropriate materiality threshold[29]), and reported separately within the regulatory accounts. For transparency, any RAB additions that relate to these additional OM & R costs should also be separately identified.

[27] The party contracting with Network Rail, usually the scheme promoter.

[28] The costs recovered are net of any income from charges so the contractual arrangements should allow for changes to charges as a result of future periodic reviews.

[29] For example, only costs above a pre-defined threshold of £100,000 per annum from a single scheme would be reported separately, other costs could be combined.

5.9 This approach has two key benefits:

(a) it ensures that the treatment of these additional costs is consistent whether or not Network Rail takes on responsibility for the enhanced assets, and whether or not the customer is an access beneficiary. Where the customer assumes operational responsibility for enhanced assets, for example in the case of a new depot, the additional OM & R costs are borne by the customer, to the extent that the costs cannot be recovered from beneficiaries. There is no strong reason why the same allocation of costs should not apply when Network Rail has operational responsibility for schemes, as in general the customer will continue to benefit from the scheme in either case; and

(b) if scheme promoters/beneficiaries did not bear the additional costs for schemes, the costs would still need to be recovered by Network Rail from other sources. It is likely that Government would ultimately bear the majority of them following a periodic review (through the arrangements contained in franchise agreements which protect operators from changes in access charges). We do not consider that such arrangements would necessarily lead to efficient investment. Of course, it is for Government to decide whether it wants explicitly to support third parties in funding schemes.

5.10 Our approach ought not to create a barrier to investment in relation to schemes promoted by local authorities or PTEs, provided the proposed rebate mechanism is implemented so these bodies can recover the additional costs from beneficiaries. The terms of payments by beneficiaries should be agreed up front, to provide certainty for all stakeholders.

5.11 We propose applying an annual scheme-specific de-minimus threshold to additional OM & R costs of £50,000 per scheme, so that all costs below this threshold (and not already recovered) would be borne by Network Rail until the next periodic review, when these costs could be included within the periodic review settlement. This approach should:

(a) reduce transaction costs and in particular avoid long disputes about the robustness of the calculations of marginal increases in OM & R costs;

(b) reduce the reporting and monitoring burden on Network Rail; and

(c) simplify the treatment of these additional costs for minor schemes.

5.12 We would welcome views from stakeholders on the approach to dealing with additional OM & R costs arising from third party investments, including the proposal to apply a de-minimus threshold level of costs and in particular, views on the practicality of these proposals.

Treatment of accelerated renewals

5.13 Accelerated renewals are renewals brought forward from future years, usually because of a link to a particular investment scheme. Any renewals brought forward by Network Rail to produce the outputs (including capability) funded through the ACR2003 would not result in any additional remuneration for the company under the framework put in place at the ACR2003.

5.14 The rest of this section considers the cases where renewals are brought forward as a result of a new investment scheme, differentiating between acceleration within a control period, and from future periods.

5.15 Where renewals are brought forward from later in the same control period, the scheme funder should pay Network Rail for any increased financing costs arising to allow for the timing difference, as these costs would not have arisen without the scheme. Network Rail is already funded for the renewal and so needs no further remuneration. Network Rail should provide details to the funder of the additional costs it incurs.

5.16 If the renewals are brought forward from a later control period, Network Rail is not funded for the renewal. In this case, additional investment expenditure (on renewals) is required as part of the investment scheme. Network Rail should provide the scheme funder (or promoter) with an estimate of the additional financing costs resulting from the accelerated renewal and the funder should pay for these additional costs until the renewal costs are added to the RAB.

5.17 The efficient cost of the renewal works (net of financing costs paid by the scheme funder) should be logged up and remunerated through the RAB at the next periodic review. This is consistent with the treatment of new enhancements.

Recovery of third party investment costs from other beneficiaries

5.18 In our policy conclusions we considered a mechanism to allow recovery of a fair proportion of costs by a scheme funder which might be appropriate in situations where other parties benefit from the use of an enhancement to the network (e.g. provision of additional capacity or higher gauge).

5.19 We said that such a rebate should be paid for all schemes, building on a mechanism (in the freight model clauses) applicable to schemes with a value below £250,000 where, effectively, operators benefiting from the enhancement pay a charge to the investor via Network Rail. The rebate would be paid provided that:

- the beneficiary does actually benefit from the enhancement (for example a freight gauge enhancement may be of no benefit to other operators);
- the rebates are available only for the payback period of the enhancement; and
- the rebate mechanism survives any change in the original investor's access rights.

5.20 We issued a letter consulting on this issue on 16 December 2005. Responses were sought from consultees in relation to:

(a) the practicalities of implementing the proposed rebate mechanism;

(b) how the mechanism should operate under the specific scenarios identified in the letter (i.e. a capacity enhancement and a new link creating an alternative route);

(c) the suggested amendment to the Network Code to implement this policy; and

(d) a possible extension of the mechanism to government funders.

5.21 We are currently reviewing responses to the consultation letter and reflecting on views expressed by stakeholders at a workshop we held on 10 February 2006 to discuss the proposals. After a full consideration of all responses, and further discussions with stakeholders as appropriate, we will issue a policy statement on the use of the rebate mechanism.

Shared value

5.22 Developments which use Network Rail land (but in general do not directly enhance the network) will usually generate financial benefits for the developer, and may also produce wider economic benefits such as regeneration or decongestion. 'Shared value' is the term adopted by Network Rail for the valuation approach where it seeks a share of the uplift in value created as a consequence of it granting property rights to a third party developer (or other stakeholder). These property rights can include:

(a) rights for access to open up land for development; and

(b) rights for new stations or station improvements being promoted by developers to secure or to assist in securing planning consents.

5.23 As an example, in the case of a new settlement that incorporates a new station[30], Network Rail may seek a proportion of the uplift in value that accrues as a result of it granting the property rights, which enable the station to be constructed.

5.24 The principle behind seeking a share of any valuation uplift as a result of granting such rights is part of established valuation practice, commonly called the Stokes v Cambridge principle (following a case settled in the Lands Tribunal in the early 1960s). Since this case, the principles have become established in property valuation and are used by local authorities, private landowners and developers alike[31]. The principle established is that those granting development rights can seek a percentage of the uplift of the value of land caused by the granting of those rights, usually between 25% and 50% of the value added.

5.25 Network Rail should apply the valuation approach described above in its negotiations with developers. In the event that disagreements exist over the uplift in value, an independent valuation should be obtained.

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[30] For example, this could arise as a result of commitment under Section 106 (of the Town Country Planning Act 1990).

[31] These principles have been endorsed by the Compulsory Purchase Order Compensation Code and the Law Commission.

5.26 In general, the uplift in value from a shared value scheme will take the form of additional revenue to Network Rail, and/or a corresponding increase in the value of Network Rail's assets. If there is a demonstrable increase in the value of Network Rail's assets, the value of this increase would be eligible in principle for addition to the RAB, assuming that the additional revenue from the scheme was sufficient to cover the additional return on the RAB and that the increase meets our criteria for efficiency (see chapter 4). If the additional revenue was not sufficient, the scheme could nevertheless meet the criteria for "self-financing" schemes described in chapter 2. The additional property revenue generated should be included within Network Rail's single till income forecasts.

Hypothecated gains

5.27 In some cases the developer may also offer to carry out investment in lieu of payments to Network Rail, either rent or shared financial benefits. Network Rail has previously argued that the value of such "benefits in kind" or hypothecated gains should be added to the RAB, in recognition of the additional economic value added to its network.

5.28 We consider that an amount representing the total industry benefits from any enhanced assets transferred to Network Rail should be eligible for addition to the RAB. Before making any addition to the RAB, we would need to be satisfied that the proposed addition represented efficient expenditure on delivering the enhanced assets, in line with the criteria described in chapter 4 of this document. The calculation of economic value added should exclude any direct financial benefits to Network Rail (such as opex savings) or any grant contributions received (e.g. in respect of the social benefit of the development).

5.29 We will discuss the regulatory treatment of shared value and hypothecated gains further with stakeholders and would welcome stakeholders' views on the principles outlined in this section.

Rolling incentive mechanism for investment expenditure

5.30 We stated in our policy conclusions that we are also considering a potential rolling incentive mechanism for sharing with customers and funders any benefits arising from Network Rail's outperformance against regulatory assumptions, for schemes funded through the RAB. Currently if Network Rail outperforms, by delivering such a scheme for a cost lower than the estimated price, the company retains the benefit until the scheme is fully depreciated (by amortisation of the RAB).

5.31 Drawing on practice from other regulated sectors, one option could be for Network Rail to retain any surplus and the associated financing savings from such outperformance for five years. After this time, a downwards adjustment could be made to the RAB to remove this surplus and thus ensure that Network Rail shared the benefits from its outperformance with customers and funders.

5.32 We intend to consider this issue as part of the overall incentives framework for the next periodic review. In the meantime, we would welcome stakeholders' views on the principle of this proposal.

Franchises and residual value risk

5.33 Discussions with stakeholders have identified a potential further barrier to investment that affects franchised train operators. The current franchise model is generally for relatively short-term franchise agreements, i.e. less than ten years. There are two typical funding scenarios for schemes required by franchisees, which often create barriers to investment. These are:

(a) where franchisees fund and finance schemes themselves, thereby incurring all the capital costs, for example building and owning a new station. Franchisees are often reluctant to invest in such schemes that do not pay back within the term of their franchise agreements without assurance that they will be able to receive revenue to repay their investment, or other benefits, beyond the end of the franchise term. Under the current franchise model franchisees generally have little incentive to invest in the final few years of their franchise term as they will have limited opportunity to realise the benefits; or

(b) where Network Rail is financing and delivering the investment on behalf of a franchisee, and is remunerated by that franchisee through increased access charges, usually through a supplemental access agreement. Unless we approve a RAB addition for the residual value of the scheme, which requires support from Government, Network Rail is exposed to the risk that it will not be able to recover its costs beyond the end of the franchise term. This issue arose on the Virgin Cross-Country upgrade scheme.

5.34 Many investment schemes do not pay back within the life of the franchise, so without any other mechanism in place to address the issues above, the funder (i.e. the franchisee) would be left bearing the residual value risk[32], or Network Rail would bear the risk of not being able to recover its costs in full[33].

5.35 There are several possible models for addressing these risks including the following.

(a) Where the franchisee has financed the scheme itself, the proposed rebate mechanism could be used to allow the franchisee to recover its costs beyond the term of a franchise, for example through a long-term access option relating to the enhanced assets where appropriate. However, we would need to consider further the appropriate contractual mechanisms, and any related policy issues, in implementing such a model.

(b) Where the franchisee has financed the scheme itself, and a new asset is created which does not form part of Network Rail's network (such as a new station or depot) the franchisee can take an interest in the relevant land or property through a long-term lease and so retains a right to any income stream generated by the investment through the lease. This funding route has been used successfully for several new stations and depots although it is not easily transferable to track investments as in practice, the terms required in a lease to give the franchisee sufficient assurance of its rights to future income can create a conflict with Network Rail's obligations under its network licence (e.g. rights for any lending bank to take possession of the enhanced assets).

(c) In general, the franchisee (where it has financed the scheme) and Network Rail (if it has financed the scheme) will seek some form of underwriting or guarantee from Government in respect of the residual value of the enhanced assets remaining at the end of a franchise. Under the current framework, this would need to be given on a case-

[32] i.e. the risk that the value remaining in the enhanced asset cannot be realised.

[33] This is often referred to as "counterparty risk".

by-case basis. The DfT has indicated it would often be willing to provide such assurance, and to make the corresponding financial commitment through support for the RAB, provided it was content that the investment represented value for money in the long term. Such assurance could potentially be given through the following methods:

(i) where Network Rail has financed the scheme and is remunerated through increased access charges, Government can agree to support the residual value of the scheme through support for the financial commitment arising from an appropriate RAB addition. In general, the return on the RAB resulting from this support would be balanced (and often outweighed) by additional revenue from the scheme;

(ii) where the franchisee has financed the scheme itself, Government could designate the enhanced assets as primary franchise assets, to be transferred to future franchisees as part of the bidding process; or

(iii) where the franchisee has financed the scheme itself through a company which will continue to exist beyond the franchise term, Government could enter into section 54 undertakings[34] with the company. These have already been put in place for the contracts between franchisees and rolling stock companies (ROSCOs), or train maintenance companies, for long-term leases.

5.36 ORR would welcome stakeholders' views on the potential models for addressing this residual value risk set out above, and will discuss these models further with Government and other stakeholders.

Investments at stations: guidance

5.37 To complement these guidelines, we are in the process of updating our guidance covering the regulatory treatment of investment at stations, previously set out in our document *A Fair Deal for Stations*[35]. We are currently

[34] Undertakings under section 54 of the Railways Act 2005, in the form of a commitment by Government to exercise its functions for the purposes of encouraging railway investment e.g. to provide a guarantee for this kind of investment.

[35] Available at www.rail-reg.gov.uk/upload/pdf/76.pdf.

considering what form this guidance for stakeholders should take. The guidance will be informed by our policy framework for investment, in a form applicable to the calculation of appropriate station long-term charges. We expect to publish this guidance in the next few months.

Sections 16A-I of the Railways Act 1993 (as amended)

5.38 Under the amendments made to the Railways Act 1993 by the Railways Act 2005, we now have powers to direct Network Rail (or another “appropriate person”) to either build a new railway facility or enhance an existing facility, now that sections 16A-I of the Act have been commenced. Such a direction can be made following an application to us by the Secretary of State for Transport, or Scottish Ministers, or with Government consent to an application made by a third party.

5.39 We are continuing to work up a draft Code of Practice for consultation, focused on our process for considering applications and the process for issuing directions.

5.40 In general, we would not expect stakeholders to have to use these legislative provisions unless other forms of remedy (for example, under the relevant contract) were not available, or where the relevant processes had been exhausted.