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OFFICE OF RAIL REGULATION

2 March 2007

To: see attached list

Dear Stakeholder

Policy framework for investments – update on implementation guidelines

1. In October 2005 we published our conclusions on a new policy framework for investments[1], which aims to facilitate investment in the railway by addressing a number of barriers to the delivery of efficient investment. The framework establishes clear roles and responsibilities and, where appropriate, new approaches to enable these barriers to be overcome. These are set out in our investment guidelines, published in March 2006[2].

2. In our investment guidelines we requested views from stakeholders on the arrangements, processes and policies, particularly in relation to:

(a) the guidance contained in Network Rail's draft document "Investing in the Network", in terms of whether it:

   (i) adequately explains what stakeholders 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 our investment guidelines .

3. We received 10 responses to our investment guidelines[3]. We have discussed many of the issues with stakeholders through the Investment Forum, chaired by the Department

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

[2] Available at http://www.rail-reg.gov.uk/upload/pdf/277.pdf

[3] Respondents are listed in Annex A. Responses are available at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8268

for Transport (DfT). We have also held bilateral meetings with stakeholders on particular issues where appropriate. Following the consultation process, the paper attached to this letter provides an update on some of the issues covered in the investment guidelines.

4. The attached paper should be read in conjunction with other key publications relating to the investment framework, all of which are available on our website under the heading "Investments in the network"[4] - in particular:

(a) the March 2006 investment guidelines;

(b) Network Rail's document "Investing in the Network"[5], the final version of which was published in November 2006;

(c) our December 2006 letter to Ron Henderson of Network Rail on our Annual review of investment activity by Network Rail[6]; and

(d) our December 2006 draft conclusions letter on the proposed Rebate mechanism[7].

5. We would welcome your views on any of the issues raised in the attached paper and, in particular, on:

(a) whether or not the templates for third party schemes help to facilitate investment and how the templates could be improved, and whether the accompanying explanatory notes drafted by Network Rail are sufficiently clear and comprehensive (see paragraphs 8 to 13 of the paper);

(b) proposals for using the RAB to finance small-scale schemes promoted by TOCs or other third parties, particularly self-financing schemes (see paragraphs 23 to 30 of the paper);

(c) treatment of development gains, set out in the section on shared value and hypothecated gains (see paragraphs 61 to 66 of the paper); and

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4 See http://www.rail-reg.gov.uk/server/show/nav.190

5 Available at http://www.networkrail.co.uk/documents/3802_Section13AccompanyingMaterial.pdf

6 Available at http://www.rail-reg.gov.uk/upload/pdf/inv-nr-letter141206.pdf

7 Available at http://www.rail-reg.gov.uk/upload/pdf/Rebat001.PDF

(d) our approach to monitoring the framework and our proposal to keep certain elements of the framework under review by producing regular updates to these guidelines.

6. Comments should be sent in electronic format (or, if not possible, in hard-copy format) by ***Friday 27 April 2007*** to:

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London WC2B 4AN

E-mail: Jon.Clyne@orr.gsi.gov.uk

7. We will make your response available in our library, publish it on our website and may quote from it. If you wish all or part of your response to remain confidential to us then please indicate this clearly. We may also publish the names of respondents unless a respondent indicates that they wish their name to be withheld.

8. Copies of this document can be found in the ORR library and on the ORR website (www.rail-reg.gov.uk).

Yours sincerely

Jon Clyne

Head of Investment Policy & Analysis

Policy framework for investments – update on implementation guidelines (investment guidelines)

Background

1. If rail services are to develop so that the needs of users are better met, it is essential that there is an effective framework for delivering infrastructure investment, including schemes sponsored by third parties (i.e. non-government funders).

2. In October 2005 we published our conclusions on a policy framework for investments, which aims to facilitate investment in the railway by addressing a number of barriers to the delivery of efficient investment. We have implemented the framework by establishing clear roles and responsibilities and, where appropriate, new approaches to enable these barriers to be overcome. These are set out in our investment guidelines, published in March 2006.

3. The purpose of our investment guidelines was to provide reference guidelines, which bring together the key policies, procedures and processes required to implement and monitor the investment framework. They are intended to have the benefit of helping to overcome barriers to the efficient development and delivery of investment schemes sought by customers and funders, by providing details of:

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

(b) key industry arrangements and processes.

4. Our investment guidelines covered the following key areas:

(a) the governance and reporting arrangements for:

- (i) major schemes sponsored by Government (i.e. DfT and Transport Scotland);
- (ii) the Network Rail Discretionary Fund (NRDF);
- (iii) the new risk funds for schemes promoted by third parties - the Industry Risk Fund (IRF) and the Network Rail Fee Fund (NRFF); and
- (iv) self-financing schemes.

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

(d) 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.

5. The policies and processes set out in our investment guidelines have received general support from the industry. Since then, we have also published:

(a) three letters approving nine template agreements for third party investment[8]. The final batch of template agreements was approved on 5 September 2006;

(b) a letter to Ron Henderson of Network Rail in December 2006 on our Annual review of investment activity by Network Rail; and

(c) a letter setting out our draft conclusions on the proposed Rebate mechanism, in December 2006.

6. Feedback from stakeholders combined with an increasing volume of investment by third parties and Government suggests that some of the original barriers to investment (as set out in our October 2005 policy conclusions) have been overcome. However, there are several key issues needing resolution in order to address the remaining barriers to investment.

Update on key issues

7. We intend to continue to implement the investment framework broadly in accordance with our March 2006 proposals. However, the consultation process and subsequent bilateral discussions, have resulted in a number of proposed amendments and the development of our thinking on the detailed application of the framework. These are elaborated throughout this paper, but include:

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[8] Available at http://www.rail-reg.gov.uk/upload/pdf/netcode_partg-3rdptyinvest.pdf

(a) the approach to schemes promoted by third parties;

(b) "Self-financing" schemes and use of the RAB to finance small-scale third party schemes;

(c) arrangements for major schemes promoted by Government and the NRDF;

(d) Network Rail's document "Investing in the Network"; and

(e) other policy issues, including the treatment of development gains.

Approach to schemes promoted by third parties

Arrangements for the new risk funds (IRF and NRFF)

8. In our investment guidelines, we summarised the treatment of third party schemes with reference to the two new risk funds, the NRFF and the IRF, established in order to address issues of risk aversion holding up schemes.

9. The new risk funds can be utilised by Network Rail or third party promoters[9] for schemes which meet the following criteria:

(a) the scheme sponsor is not Government;

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

(c) 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 which uses land from a station car park.

10. Our approval of the template agreements, under Part G of the Network Code, has effectively activated the use of the risk funds for all schemes which meet the criteria above.

11. In the course of our detailed review of the draft templates, we aimed to resolve the issues discussed in our November 2005 Technical Note[10]. Through a series of meetings with Network Rail we addressed all the key issues, including:

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[9] Once liability for cost overruns is exhausted

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

(a) achieving consistency between the various agreements in a number of areas, such as the calculation of contributions to the risk funds and a consistent framework for limitation of liability;

(b) clarification of risk allocation across all templates, including a clear description of which risks were covered by fixed prices offered by Network Rail;

(c) an increase in Network Rail's liability caps, based on the level of liability caps used for the model contracts for passenger track access agreements; and

(d) binding commitments by Network Rail to provide services by particular end-dates, agreed up-front with the customer, with liquidated damages payable if timescales are not met.

12. Network Rail's document "Investing in the Network" (see also paragraphs 44 to 48 below) 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. Also, Network Rail has now produced detailed explanatory notes[11], which should clarify the purpose and interpretation of the template agreements. These explanatory notes also describe the relationship between key clauses in the various agreements relating to the development stage of a scheme (i.e. the Basic Services Agreement (BSA), the Development Services Agreement (DSA) and the Framework Development Agreement (FDA)).

13. Although we will not formally approve the explanatory notes, we believe it is important that the notes aid customers' understanding and facilitate agreement to progress schemes. We recognise that Network Rail's Route Enhancement Managers also have a key role for all proposals in responding to customers' requirements and explaining Network Rail's responsibilities.

14. We would welcome views from stakeholders on the detailed explanatory notes, in particular on whether or not the notes are sufficiently clear and comprehensive. Based on these views, we will consider whether or not we should carry out a full review of the explanatory notes. We expect Network Rail, in consultation with its customers, to keep the explanatory notes under review going forward.

[11] Available at http://www.networkrail.co.uk/documents/3869_Explanatory%20Note%20Overview.pdf

Reporting on third party schemes

15. Our investment guidelines set out reporting arrangements on the use of the risk funds, including a template annual summary report and the requirement for quarterly reporting on all schemes with access to the risk funds.

16. Network Rail provided us with an annual summary table for the year 2005-06 in August 2006, which is presented below[12]:

Network Rail involvement in third party schemes in 2005-06[13] (excluding schemes sponsored by the Scottish Executive)

	Total numbers of agreements	Total value of projects (rail-related) £m	Total forecast NR spend £m	Numbers of template agreements	Ratio of projects on schedule
Projects in development	151	£1,390	£31	33	77.5% right time 20% customer requested delay 2.5% NR delay.
Projects in implementation - NR facilitating	50	£372	£36	2	100%
Projects in implementation - NR implementing	11	£82	£65	3	100%
Total third party projects	212	£1,844	£132	38	0

17. The key points arising from this table and our analysis of activity on schemes sponsored by third parties in 2005-06 (excluding the Scottish Executive, who sponsored 11 major schemes with a rail-related value of £1,600 million) were that:

(a) Network Rail provided services to 212 schemes in 2005-06, of which 38 used the new templates;

(b) in total there were 61 projects in implementation during 2005-06, the majority (50 schemes or 82% of the total) being delivered directly by third parties. The total rail-

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[12] Excluding schemes sponsored by the Scottish Executive

[13] The values in this table reflect the total value of the investment or spend on completion of an activity. This table is not a statement on project expenditure in 2005-06.

related value of these projects once completed, is estimated at £454 million (£372 million for schemes that Network Rail facilitates + £82 million for schemes the company is implementing itself); and

(c) the value of the services and works that Network Rail has been contracted to provide in developing, facilitating and implementing schemes in 2005-06 was £132 million[14].

18. Further analysis of this activity in 2005-06 is set out in our December 2006 letter to Ron Henderson of Network Rail.

19. We are now using the template summary report above to monitor the overall level of activity and Network Rail's involvement in third party schemes on a quarterly basis.

Review of the arrangements for third party schemes

20. We will carry out a comprehensive review of the arrangements for the risk funds once they have been in existence for a full financial year, i.e. around September 2007, so that the arrangements have had time to 'bed down' and sufficient information is available to enable a meaningful review. As part of this review, we will consider whether or not the current structure is an efficient approach to managing financial risk. We would also expect to carry out a full review of the levels and arrangements for the funds as part of the periodic review 2008. We will discuss detailed information requirements for this review with Network Rail.

21. In advance of our review, now that the templates have been in use for several months, we would also welcome comments from stakeholders on:

(a) whether or not the use of the templates has presented any practical difficulties and how the templates could be improved to better meet stakeholders' requirements;

(b) whether or not the templates, along with recent organisational changes by Network Rail, designed to improve the services it offers to customers, have helped to facilitate investment; and

(c) the way in which Network Rail deals with customers when discussing third party proposals before entering into a contract, including whether you believe that Network Rail's behaviour is consistent with its document "Investing in the Network"?

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[14] For contracts already in place or entered into in the year

22. We intend to convene a meeting of the stakeholder working group on third party investments in April 2007 to discuss these issues.

“Self-financing” schemes and use of the RAB to finance small-scale third party schemes

23. The term “self-financing” is applied to schemes which do not have an impact on Government’s budget. That is, schemes that do not:

(a) require Government’s financial support; or

(b) otherwise generate liabilities for Government[15].

24. We discussed the treatment of self-financing schemes promoted by Network Rail, such as commercial property investments, in our investment guidelines: the treatment of these schemes is set out later in this section. We first consider self-financing schemes promoted by third parties, particularly small-scale schemes promoted by franchisees, regardless of whether these schemes payback within the term of the franchisee’s current agreement.

25. Since publication of our investment guidelines, we have discussed with Network Rail and DfT possible ways of facilitating self-financing third party schemes which meet certain criteria. The approach resulting from these discussions has the following key elements:

(a) Network Rail provides finance to the third party promoter for construction: the promoter may also require Network Rail to deliver the scheme, or use an alternative delivery agent;

(b) in return Network Rail receives a corresponding RAB addition; and

(c) the return on the RAB (and any relevant depreciation or financing costs) is funded by the third party[16] through amortised payments.

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[15] With the exception of certain remote risks such as franchisee insolvency or support for Network Rail’s FIM

[16] And, in many cases where franchisees are promoting schemes, successor franchisees – see below

26. The rest of this section summarises:

- the benefits expected from this approach;
- the eligibility criteria; and
- the process for developing and progressing such schemes.

27. This approach aims to overcome barriers to investment by third parties and has been agreed with Network Rail and DfT. The approach should produce the following benefits:

(a) incentivise investment by third parties without calling on public funds;

(b) promote efficient financing of such schemes through use of the RAB;

(c) address the issues discussed in Chapter 5 of our investment guidelines relating to current franchise terms and residual value risk; and

(d) produce a “fast track” approval process for such schemes, where explicit approval from Government is generally not required for smaller schemes, and our approval of proposed RAB additions is generally with reference to templated information.

28. The schemes which are eligible for application of the approach should meet the following criteria/conditions:

(a) the value (estimated cost) is generally less than £10 million, although schemes above this value can be included on a case-by-case basis (see below);

(b) the scheme is promoted by a third party, who prepares the business case and must pay for the costs resulting from the scheme (including any relevant incremental OM & R costs) for an agreed period. For franchisees this will generally be the remaining term of the franchise agreement, which should have at least two years remaining;

(c) Network Rail must support the scheme and confirm that the scheme is consistent with other relevant policies (particularly its Business Planning Criteria) and strategies (including its Business Plan and relevant route utilisation strategies);

(d) the scheme must satisfy our criteria for adding investment expenditure to the RAB[17] i.e. only efficient expenditure on the scheme that enhances the economic value of the network will be eligible for addition to the RAB;

(e) the third party promoter should confirm that the scheme is not already financed through some other means e.g. through a financial facility agreed as part of a franchise agreement; and

(f) Network Rail and the third party promoter must inform Government of the proposal and then confirm that the scheme does not require Government's financial support or generate future liabilities for Government.

29. Provided the scheme meets the criteria above, the promoter and, where appropriate, Network Rail will develop and progress the scheme through the following process:

(a) with support from Network Rail as required, the promoter will prepare its business case and a short submission for us, explaining how the scheme meets the criteria above and also setting out the arrangements and estimated price for delivery of the scheme outputs. This submission should include brief details of:

   (i) a description of the scheme, the required outputs and the project timescale and any other relevant background. The promoter should confirm that it has a strong business case for the scheme;

   (ii) the proposed structure for delivery of the scheme, including contractual arrangements and the project management approach;

   (iii) risk allocation and roles and responsibilities of stakeholders;

   (iv) cost management/control arrangements, and how an efficient outcome will be achieved; and

   (v) financial arrangements, including the method of remunerating costs, the financing strategy, the agreed transfer price (if Network Rail is buying back the assets on completion), and the calculation of the proposed RAB addition.

[17] Set out in detail in Chapter 4 of our investment guidelines

(b) Network Rail will provide finance for the scheme for construction and enter into appropriate agreements with the promoter (for example, an Implementation Agreement if Network Rail is delivering the scheme);

(c) if Network Rail is not delivering the scheme, it will usually buy back the enhanced assets for the agreed price on completion of the scheme i.e. delivery of the required outputs;

(d) at this point, provided all costs have been efficiently incurred in accordance with the submission[18], Network Rail can log up the efficient costs of delivery to the RAB (based on the agreed price for delivery). The promoter also starts to pay an amortised charge to Network Rail, usually through an increase in relevant supplemental access charges, based on an annual amount set out in the submission. The charge will be calculated to allow recovery of all capital costs, financing costs (based on Network Rail's allowed return), any relevant depreciation costs and incremental OM & R costs for a maximum period of 15 years[19];

(e) for franchisees, the charges are paid until the end of its franchise agreement at which point either the charges are novated to the next franchisee (through the franchise bidding process) or Government[20] agrees to spread the charges across other franchises;

(f) the additional income Network Rail receives through these charges is included in its single till income and therefore netted off Network Rail's total revenue requirement at the next relevant periodic review. There is therefore no additional call on Government's budget. The total additional income, and relevant RAB additions for these schemes are reported separately in Network Rail's regulatory accounts each year.

30. This approach has already been applied to several schemes, such as enhancements to stations and depots. Indicative calculations of charges are attached at Annex C. Also, customers are encouraged to use the template for submissions to us drafted by Network Rail and used for the submission for recent schemes, as this template

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[18] We may wish to audit the costs at this stage - on a sample basis

[19] The period may be shorter depending on the life of the enhanced assets. Also, the charge should be net of any reductions in cost

[20] DfT in this case, as Transport Scotland is the franchising authority for one franchise only

covers all the issues listed in paragraph 29(a) above. This template will shortly be available on NR's website[21].

Schemes promoted by Network Rail

31. We set out a proposed treatment of self-financing schemes promoted by Network Rail in our investment guidelines, whereby schemes which pay back within 20 years can be added to the RAB provided such schemes generate sufficient revenue in total to cover the return on the RAB. If these conditions are satisfied, there would be no call on Government funds.

32. DfT suggested in its response to our investment guidelines that costs and revenues for these schemes should be ring-fenced outside the single till. However, following discussions with DfT and Network Rail we believe that DfT is now content with our proposed approach as it protects Government's financial position while providing incentives on Network Rail to pursue such schemes. We therefore have asked Network Rail to develop and progress such schemes on the basis of the approach set out in our investment guidelines.

33. We have established a template for analysis of such schemes, following discussion with Network Rail, which Network Rail is now using for all such proposals. For the period April 2004 to April 2006, Network Rail has invested £45 million in such schemes, and has received incremental income of £22 million from them to date.

34. The independent Reporter has reviewed the information provided by Network Rail on these schemes[22] and recommends that Network Rail's Commercial Property team should:

(a) implement periodic reporting of baselined output KPIs, CPI/ SPI and unit costs to improve the measurement, and consequently the management, of the work;

(b) assess commercial property activities to identify those that might usefully be captured using the Network Rail Cost Analysis Framework (CAF) so that efficiency can be monitored and future cost estimation can be improved.

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[21] See http://www.networkrail.co.uk/aspx/1606.aspx

[22] For further details see the report by the Independent Reporter Halcrow, "Project Monitoring 2005/06 - Final Report"

35. Network Rail has informed us that it has now begun implementing these recommendations.

Arrangements for major schemes promoted by Government

36. In our investment guidelines we explained the governance arrangements typically put in place by Government for major schemes it promotes, including the coverage of a typical Protocol setting out how Network Rail will deliver a major scheme.

37. DfT has confirmed it intends to follow the arrangements set out in our investment guidelines and to use Protocols extensively. We have also discussed the use of Protocols with Transport Scotland, particularly in relation to the Airdrie-Bathgate scheme. We have held several useful meetings with both Governments on a draft Protocol for the Access for All Programme and are in the process of establishing a clear structure for this Protocol, which we believe can act as a starting point for a model structure for other major schemes.

38. We therefore expect Network Rail to work with Government to implement the arrangements set out in our investment guidelines, particularly in relation to drawing up Protocols to meet Governments' requirements on major schemes.

Network Rail Discretionary Fund (NRDF) arrangements

39. The NRDF was established to fund schemes with a strong industry business case, to be designed and delivered by Network Rail, with an estimated cost of less than £5 million per scheme. In our investment guidelines we set out the scope of the NRDF, the process for bringing forward NRDF schemes and the reporting arrangements.

40. Since then, Network Rail provided us with information at the end of 2005-06 on the schemes in development and has collected the information required to populate the reporting template set out in our investment guidelines.

41. We also noted in our recent national rail review[23] that Network Rail had made a slow start in delivering NRDF schemes, and had lagged behind both its own plans and industry expectations.

42. In May 2006 Network Rail reported that, for 2005-06, it had not delivered any outputs from the NRDF and only £4m of the NRDF funding had been spent. We

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[23] For Q2 2006/07, available at http://www.rail-reg.gov.uk/upload/pdf/305.pdf

understand that since then, two schemes have been successfully completed[24] and that a significant further tranche of schemes have recently been authorised by its investment panel. We also recognise and support its objective of speeding up the overall industry processes (including the GRIP process) in this area to facilitate progressing small-scale enhancement schemes more promptly. We expect Network Rail to demonstrate real progress over the coming months such that the industry has confidence in its ability to deliver these small schemes (and other minor and medium-sized schemes) in a timely manner. In this context, we welcomed Network Rail's suggestion to publish details of NRDF schemes on its website: these are now available[25]. Network Rail has also now provided us with a forward programme with expected delivery dates for NRDF schemes.

43. We will monitor Network Rail's development and delivery of NRDF schemes on a quarterly basis using the template set out in our investment guidelines, and report on progress in our quarterly national rail review.

Investing in the Network

44. Network Rail's document "Investing in the Network" sets out how Network Rail will deal with customers (and other stakeholders). This document is supplementary material to section 13 of the Code of Practice on Network Rail's dealings with Dependent Persons, under Condition 25 of its network licence (the DPLC)[26].

45. The document 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;

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[24] The schemes are: Peterborough Werrington Bi-Directional signalling and GE rectifier replacement

[25] See http://www.networkrail.co.uk/aspx/3822.aspx

[26] 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.

(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.

46. In our investment guidelines we asked stakeholders for views on the draft document, in particular:

(a) does the document adequately explain what they can expect from Network Rail?

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

47. Stakeholders were broadly happy with the structure and coverage of the guidance provided in the draft document. The key issues that were raised on the draft document were the following:

(a) respondents asked for greater emphasis in the final document on the contestability of some of the services provided by Network Rail and further clarification on how the contestability of these services and their delivery by third parties would work in practice, also in relation to Network Rail's role in relevant industry processes (including the RUS process);

(b) respondents also asked for greater clarity on Network Rail's processes for internal approval of the proposed schemes. Further information was also required on how stakeholders would be involved by Network Rail's Route Strategy Planning Group in its decisions on prioritisation of schemes and what appeal mechanisms would be available to promoters; and

(c) more generally, respondents asked for a simplification of the content of the document whenever possible given the complexity of the topic.

48. Taking account of these comments, and building on our own detailed review of the document over the period between March 2006 and its final publication in November 2006, we recommended a number of changes to Network Rail, accepted by the company, that have improved the clarity of the document, including:

(a) providing more clarity on Network Rail's processes, its role in reviewing and prioritising investment proposals and the appeal mechanisms available to promoters;

(b) providing further information on contestable services and Network Rail's facilitative role in schemes developed and/or implemented by third parties; and

(c) explaining more clearly Network Rail's role and responsibilities at different stages in the investment process and under different delivery arrangements.

Rebate mechanism

49. In December 2005 we published a letter consulting on proposals for a rebate mechanism for investors in large-scale track infrastructure enhancements. This proposed mechanism should help to address one of the barriers to investment by enabling investors to recover a fair proportion of the costs incurred in funding an investment scheme where competitors benefit from the use of the enhancement, or where funding constraints prevent public sector funders from progressing a scheme without such a mechanism.

50. Our proposals have received general support amongst consultees. Our draft conclusions on the proposed mechanism are now set out in a letter published on 21 December 2006. We asked stakeholders for views on the issues raised in our letter and, in particular, on:

(a) whether they still believe there is merit in implementing the proposed mechanism, given its inherent complexity;

and, if so:

(b) the revised scope of the mechanism;

(c) the methodology for calculating the rebate, and in particular our proposals for simplification;

(d) our proposals for dealing with enhancements that create additional capacity or an alternative route;

(e) our proposal to implement the mechanism through applications under Section 22 (or Section 22A) of the Railways Act 1993, rather than the Network Code; and

(f) our proposal to keep the mechanism under review.

51. Following a workshop on 15 February 2007 to discuss issues arising from our draft conclusions letter, stakeholders have now provided responses to our letter which will inform our final conclusions on this issue, due to be published before the end of June 2007.

Other policy issues

Incremental OM &R

52. In our investment guidelines we proposed a treatment of incremental OM & R costs arising from investments promoted by third parties. In summary, the third party customer should bear any additional OM & R costs for the life of the enhanced asset, net of those costs which:

(a) Network Rail has already recovered directly from beneficiaries; or

(b) the customer has recovered from beneficiaries through the proposed rebate mechanism.

53. We also proposed applying an annual scheme-specific *de minimis* 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. Applying this threshold should:

(a) reduce transaction costs and in particular avoid long disputes about the robustness of the calculations of minor 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.

54. Responses to our investment guidelines were broadly supportive of this approach, although some respondents raised concerns on the operation of the proposed *de minimis* threshold. Following some analytical work, Network Rail has confirmed that it believes that this level of threshold should ensure that its reporting and monitoring task is not burdensome as incremental OM & R costs for most minor schemes would be caught by the proposed threshold.

55. Therefore we expect Network Rail to implement the approach described in our investment guidelines, and to report these costs in its Regulatory Accounts on this basis.

Accelerated renewals

56. In our investment guidelines we proposed a treatment of accelerated renewals costs incurred by Network Rail – i.e. renewals brought forward from future years as a result of the requirements of a customer or funder, usually because of a link to a particular investment scheme. In summary:

(a) 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; and

(b) if the renewals are brought forward from a later control period, Network Rail is not funded for the renewal. The funder should pay for the additional financing costs until the renewal costs are added to the RAB and 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.

57. Responses to our investment guidelines were broadly supportive of this approach, although Network Rail noted that any accelerated renewals works should fit within its overall approach to efficient whole-life asset management. TfL noted that in general, accelerated renewals are likely to reduce maintenance costs and that these reductions should be taken into account in calculating the net effect of any accelerated renewal.

58. We agree with both these comments: we would expect Network Rail to work with scheme promoters/funders to ensure that all investment proposals (including those involving accelerated renewals) fit within its overall asset management strategy. It should also inform scheme promoters/funders of the effect on maintenance costs, and any changes to maintenance costs should be allowed for in calculating charges (or other payments) relating to the scheme.

59. We will apply the approach set out in the investment guidelines on accelerated renewals costs incurred by Network Rail. We also note that a high-level estimate of the likely future renewals costs for a section of route can now be obtained from the Infrastructure Cost Model (ICM).

60. Network Rail has suggested clarifying the treatment of renewals costs avoided as a result of an investment scheme. Applying the same principles as for accelerated renewals, any renewals costs avoided by Network Rail due to a scheme (including any financing benefits resulting from the timing of the works avoided) should be netted off the total cost of the scheme and therefore excluded from charges Network Rail makes to users of the scheme.

Development gain: shared value and hypothecated gains

61. In our investment guidelines we set out a proposed approach to financial gains from developments which use Network Rail land (but in general do not directly enhance the network). Our proposed approach had two elements:

(a) recognition of “shared value”, where Network Rail takes a share of the gains generated by the development which benefits from access rights to its land. 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;

(b) hypothecated gains, which occur where the developer offers to carry out investment in lieu of payments to Network Rail, either in lieu of rent or in lieu of sharing financial benefits with Network Rail. While Network Rail benefits from cash receipts (often through access charges, particularly the station long-term charge), the value of enhancements typically falls to other parties such as TOCs, passengers and funders. Network Rail estimated in its June 2006 Initial Strategic Business Plan (ISBP)[27] that these gains could be worth up to £148m in CP4.

62. Stakeholders who responded to our investment guidelines supported our initial proposals on development gains and welcomed our intention to progress policy in this area. However, one respondent expressed concern that Network Rail should not unfairly use its land portfolio as leverage for development schemes, for example by treating land required for a development as a “ransom strip”. The same respondent also suggested that Network Rail should not be allowed to extract value from development schemes without bearing some risk. DfT also expressed concern over the process for adding hypothecated gains to the RAB, given the implications for Government’s budget.

63. Since then, we have discussed the proposed approach to hypothecated gains with Network Rail and DfT, resulting in a proposal from Network Rail, applying the principles set out in our investment guidelines. The aim of such an approach is to balance the need for an administratively simple process with the need for appropriate incentives on all parties to

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[27] Available at http://www.networkrail.co.uk/aspx/3414.aspx

achieve efficient whole-industry outcomes, while also providing reassurance to funders that only schemes with a strong business case are developed and progressed.

64. Network Rail's proposed approach has four steps: the process is set out in more detail in a paper prepared by Network Rail, which we expect to be available shortly on its website:

I. Feasibility analysis: Network Rail carries out initial project development and business case assessment following a standard template, in consultation with affected stakeholders.

II. Identification of the hypothecated gain element: Network Rail seeks a RAB addition, generating a corresponding single till income stream in lieu of the value of its land that it does not receive through other mechanisms. This RAB addition should therefore be cash-neutral for Government. Network Rail has proposed that the following types of investment should be eligible for treatment as a hypothecated gain:

   a. enhancements to the rail network, such as new platforms;

   b. replacement stations. In the event that a development results in a station that is largely but not completely replaced, 75% of the value would be deemed as hypothecated gain;

   c. new car parks, or enhancements to existing car parks (in terms of improved condition or new car parking spaces).

   Any investment relating to freeing up land for a development or renewal of assets is not eligible.

III. Approval of RAB addition: our approval process will be proportional to the value of the project, in line with our policy for approving RAB additions as set out in Chapter 4 of our investment guidelines. So, minor schemes (with a proposed RAB addition below £5m) would not generally require specific scheme-by-scheme approval by us or Government, whereas larger schemes would generally need approval for each case. Network Rail will need to demonstrate for each scheme that there is a whole-industry business case and that the schemes will generate an NPV > 0 from the point of view of Government. We would expect to approve amendments to single till income streams at this time, often these will be appropriate corresponding increases in station long-term charge.

IV. We monitor the programme of schemes with reference to a quarterly reporting template. This should ensure that only efficient project costs are logged to the RAB. Visibility of project outcomes will also be provided through ongoing reporting to funders and us.

65. We are broadly content with the process outlined above and with the template for quarterly reporting. We will need to confirm that Government is also content with the proposed approach before this can be implemented, with reference to specific case studies. At this stage, we would welcome views from stakeholders on the approach to hypothecated gains outlined above.

66. We anticipate asking one of the independent Reporters to audit a sample of schemes on an annual, *ex post* basis, to confirm that projects are being undertaken in line with the specified process. We would expect that the number of projects reviewed would decline over time as confidence in the operation of the scheme grows.

67. For scheme involving development gains, we would also expect to have early visibility of the financial arrangements Network Rail negotiates with developers, especially where the arrangements are expected to result in increases in the RAB and/or access charges.

Outperformance fund

68. As a result of its outperformance against our ACR2003 price control, Network Rail has allocated £200m towards an outperformance fund for enhancements. It is currently developing criteria for use of this fund, which will need to be consistent with its overarching Business Planning Criteria. We understand that Network Rail is currently developing around 30 schemes which may take advantage of the outperformance fund, including the “Platform Y” scheme at Kings Cross station as well as several schemes which may require third party funding or further funding in CP4.

69. We have asked Network Rail to set out in more detail:

(a) how it intends to select and prioritise schemes which use the outperformance fund; and

(b) how it will ensure that schemes brought forward through this fund are integrated within its overall delivery programme for enhancements in CP3 and beyond.

Station charges guidance

70. To complement our investment guidelines, we have been updating our guidance covering the regulatory treatment of changes to charges due to investment at stations, previously set out in our document "A Fair Deal for Stations". The guidance, which will be published shortly as a separate document, has been informed by our policy framework for investment and other policy evolution since publication of our investment guidelines, for example in relation to the structure of station long-term charges.

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

71. Under the amendments made to the Railways Act 1993 by the Transport Act 2000, which were commenced relatively recently, we have powers to direct Network Rail (or another "appropriate person") to either build a new railway facility or enhance an existing facility. 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.

72. We published a draft Code of Practice setting out how we intend to apply these powers on 2 August 2006, and received three consultation responses[28]. We then published a final Code of Practice on 29 November 2006, having taken due account of consultation responses[29]. We will keep this Code of Practice under review.

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28 Available on our website at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8291

29 The final Code of Practice is available at http://www.rail-reg.gov.uk/upload/pdf/309.pdf

Annex A: Respondents to March 2006 investment guidelines

We received 10 responses to our investment guidelines, which are available on our website at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8268.

1. Department for Transport
2. First Group
3. Laing Rail
4. Merseytravel
5. Network Rail
6. Rail Freight Group
7. Transport for London - London Rail
8. Transport for London - London Underground
9. Transport Scotland
10. Warwickshire County Council

Annex B: Address list for letter

Association of Train Operating Companies

Department for Transport

Freight Operating Companies

HM Treasury

National Assembly of Wales

Passenger Focus

Passenger Transport Executives

Rail Freight Group Members

Rail Industry Association

ROSCOs

Train Operating Companies

Transport for London

Transport Scotland

Annex C: Indicative calculations for self-financing schemes promoted by third parties

Calculation of Facility Charge to Reimburse Network Rail for Financing a TOC Enhancement

Assumptions - can be varied in the table below

1. Assume construction cost of project is paid by Network Rail
2. Depreciation over 30 years straight line basis as per Chapter 12 of interim review final conclusions.
3. Rate of return of 6.5% as per interim review final conclusions (Chapter 13).
4. Facility charge is paid by funder to NR from point of project completion

Year of commencement, 1 April…	**2006**
Rate of return (currently 6.5%, tbd CP4	**6.5%**
Period of agreement (max 30 years)	**15**
Construction price to completion (incl.	**0.5**

Financial year beginning 1 April….		**2006**	2007	2008	2009	2010	2011	2012	2013	2014	2015
Construction price	**0.5**										
Annual depreciation	0.033										
Opening value		0.5	0.47	0.43	0.40	0.37	0.33	0.30	0.27	0.23	0.20
Closing value		0.47	0.43	0.40	0.37	0.33	0.30	0.27	0.23	0.20	0.17
Average value		0.48	0.45	0.42	0.38	0.35	0.32	0.28	0.25	0.22	0.18
Rate of return		6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
Return charge		0.031	0.029	0.027	0.025	0.023	0.021	0.018	0.016	0.014	0.012
Amortisation charge		0.033	0.033	0.033	0.033	0.033	0.033	0.033	0.033	0.033	0.033
Total facility charge (constant current prices)		**0.065**	**0.063**	**0.060**	**0.058**	**0.056**	**0.054**	**0.052**	**0.050**	**0.047**	**0.045**

Note that the facility charge would then be inflated by RPI as per track access charges for each year it is billed.

Note that facility charge would be included in Network Rail's single till income forecast at the next periodic review;
for consistency the construction price would be added to the RAB (inc financing costs between payment and actual RAB additic