

## **Policy framework for investments – obstacles to investment conclusions**

### **Introduction**

1. Third party investment represents a significant and growing proportion of investment in the railway, with a doubling of schemes in implementation from 2006-07 to 2007-08 and a large number of projects in development.
2. In support of this growth we have for some time been seeking to facilitate improvements to the efficient delivery of third party investment through our investment framework guidelines, and through improvement to the template investment agreements. In March 2009 we published our guidance on changes to station charges to reflect the cost of station enhancements, and we expect this guidance to make the process of investing at stations clearer and more straightforward. In May 2008, and, on the specific issue of liability provisions, in March 2009, we published our conclusions on the changes necessary to Network Rail's template investment agreements (the asset protection agreement, implementation agreement, etc.). Network Rail will be consulting on the consequent changes to the template agreements from 23 April 2009, and we will work with Network Rail and stakeholders to approve revised template agreements this year. We expect these to provide a more appropriate balance of risks between Network Rail and investors and so to encourage further investment.
3. While the growth in third party investment has been encouraging, there continue to be concerns expressed by investors and potential investors, and requests for ORR to intervene where specific problems arise.
4. One of the concerns relates to the difficulties investors had faced in trying to use alternative service providers to Network Rail. We therefore conducted a desk-based market study into contestable services (i.e. those services, such as construction of schemes, where customers should have the choice of alternative suppliers to Network Rail) in order to ascertain whether Network Rail was using its monopoly position to require third parties to buy contestable services from it. At that stage of our assessment, we found insufficient evidence either to give the area a clean bill of health, or of market failings.
5. As a result of the on-going concerns expressed by investors and the inconclusive results from our market study, we decided to consult stakeholders with a view to gathering more information about obstacles to investments. The aim of the consultation was to help us to understand to what extent there remain issues that cannot be addressed by the industry alone and will therefore require some intervention by ORR.

6. The consultation sought stakeholders views on the effectiveness of:

- the processes for third party investment;
- Network Rail's attitude to encouraging investment;
- the organisational structure of Network Rail; and
- the procurement of contestable services, for example, in terms of the impact, if any, of Network Rail's planning processes on the choice of service provider.

7. We asked stakeholders to use specific project examples in their responses to us and requested information on what went well and what went less well. We also asked how any perceived weaknesses/failures in project delivery could be addressed, including any role that ORR should play in facilitating/ensuring delivery of efficient investment in the railways for the future.

### **Responses to consultation**

8. We received 19 responses to the consultation, including responses from train operators (TOCs), developers, representatives of the freight industry, PTEs and Network Rail. Several of the responses were confidential, but were reflective of the issues raised in the non-confidential submissions; in any case our summaries of the issues are based on all of the responses. We have categorised the issues raised into six broad themes:

- processes and timescales;
- structure and culture within Network Rail;
- payments sought for grants of access to or over Network Rail's land – so called 'shared value';
- costs and charges for services provided by Network Rail;
- Network Rail's template investment contracts; and
- contestable services.

9. We sent all the non-confidential responses to Network Rail to understand whether it recognised the issues that consultees had raised, what plans it had for dealing with them, how it will monitor and evaluate the impact of its initiatives and what remedial action it will take where any on-going/residual problems are identified. We set out Network Rail's

initiatives in these conclusions and how we will monitor their effectiveness in addressing current weaknesses.

10. As described in the introduction, we have also required improvements to the risk allocation and liability provisions in the template investment contracts and updated our guidance on changes to station charges following enhancements at stations. We believe that our conclusions on those issues should address some of the obstacles to investments identified by consultees. We have delayed issuing these conclusions on obstacles to investments until after publishing our conclusions on the template investment contracts and guidance on changes to stations charges.

11. The issues raised by consultees and, where applicable, Network Rail's response to them, are summarised below using the categories in paragraph 8 as headings. We then set out our conclusions in the final section.

### **Processes/timescales**

12. While some respondents noted some improvements in project delivery by Network Rail, the issues raised in relation to its processes highlight concerns about delivery, particularly in relation to delays and consistency of service levels.

13. The responses highlighted the following key concerns.

- The time taken by Network Rail to progress proposals is generally too long.
- Bureaucracy is excessive, with documents required by the process that are subsequently not referred to.
- Network Rail fails to have a single accountable person for a project, and too many people involved in decision-making or problem-solving.
- The GRIP process is logical but, depending on the individual responsible in Network Rail, it can be too slow. The process is not appropriate for all projects. The new (fast track) GRIP process is an improvement, moving much more quickly.
- Obtaining Network Rail consents is difficult (depending on the individual leading), and the process is unclear.
- Network Rail should commit to minimum service levels, with more flexibility and more customer focus.

14. Network Rail has confirmed to us that it has projects in place to address a number of these concerns through its 'service culture' initiative which is part of its overall transformation programme. These are set out in Table 1 which is summarised from Network Rail's response to us<sup>1</sup>.

### **Structure and culture**

15. Consultation responses highlighted that customer experience is inconsistent across Network Rail. The underlying issue appears to be that the ease of engaging constructively with Network Rail can be dependent upon the individuals concerned.

16. While some responses commented on positive engagement with the organisation (for instance there were comments on the positive impact of Network Rail's Route Enhancement Manager on one route) others felt things had gone less well. These negative comments are summarised below.

- There is a lack of a 'can-do' approach from Network Rail staff.
- Customers experience a lack of responsiveness.
- There is a risk-averse culture within Network Rail.
- Some respondents said that Network Rail was not adequately incentivised to deliver third party investments.
- There is a lack of transparency surrounding Network Rail's organisational structure, and a lack of clarity of the roles and relationships between its departments.

17. Network Rail said that it had work in hand to address these concerns, focusing on resourcing and skills improvements for enhancement teams and initiatives to deliver behavioural change and a focus on the customer. The initiatives described by Network Rail are set out in Table 2.

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<sup>1</sup> Published on our website at <http://www.rail-reg.gov.uk/server/show/nav>

## Shared value

### *Background*

18. Shared value is the term used where a land owner seeks a share of the increase in value created when it grants property rights in respect of its own land, to a developer, and this increases the value of the developer's land.

19. For example, a developer owns a piece of land to which access is difficult because of intervening land (e.g. a railway). If the owner of the intervening land grants access rights to the developer's site over its land, then the value of the developer's site will rise. The land owner would then normally seek a share of this increase.

20. The principle behind seeking a share of any valuation uplift as a result of granting such rights is part of property valuation practice, established in the case of Stokes v Cambridge<sup>2</sup>.

21. Since this case, the principle has become established in valuation practice<sup>3</sup> and is used by local authorities, private landowners and developers alike. 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.

### *Response to consultation*

22. The responses to our consultation, and other feedback from stakeholders, have raised concerns about Network Rail's approach to shared value, both in relation to the appropriateness of Network Rail applying shared value principles in certain circumstances (in particular in relation to bridges across the railway) and in relation to the effect that the level of value sought by Network Rail might have on development projects.

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<sup>2</sup> Stokes v Cambridge Corporation (1961) 13 P & CR 77

<sup>3</sup> For example, see Law Commission, Compulsory Purchase and Compensation: Disregarding "The Scheme", A Discussion Paper, p.34, [www.lawcom.gov.uk/docs/cpo2.pdf](http://www.lawcom.gov.uk/docs/cpo2.pdf), "The Lands Tribunal decision of Stokes v Cambridge Corporation [1961] 13 P&CR 77 has long been taken as establishing that the owner of the sole access to a development site is entitled to a share in the enhanced development value of the site because it is his access which unlocks the development value in the site. This is a principle of valuation and not a rule of law."

23. A detailed submission from the law firm White and Case on behalf of its clients Hammerson, Stanhope, Hines UK, Ballymore and Westfield argued that Network Rail's practice of charging shared value for bridges over the railway:

“ (a) breaches European (and therefore domestic) competition law against the abuse of a dominant position and the imposition of excessive prices;

(b) should be discontinued because adjoining landowners do not need Network Rail's consent to build bridges over the railway, under section 71 of the Railways Clauses Consolidation Act 1845; and

(c) is an unnecessary and appreciable barrier to investment in and around the railway, causing companies to regard the railway as a hostile, expensive and complex environment which is best avoided if possible”.

24. It has also been suggested that our statement on shared value, set out in our '*Policy framework for investments: Guidelines on implementation arrangements & processes*'<sup>4</sup>, could be interpreted as a blanket 'endorsement' of the application of the Stokes v Cambridge principle by Network Rail in its negotiations with developers. White and Case, on behalf of its clients, requested us to:

- clarify or revise our statement on shared value, to make it clear that it does not apply to bridges; and
- confirm that we will not assume that Network Rail will receive any income in the next control period in respect of shared value payments for bridges.

### **Charges/costs**

25. Specific reference was made to the high level of Network Rail's labour rates, fees and charges as well as to the appropriateness of Network Rail seeking to off-charge its peoples' time to projects in the manner they currently do. Issues were also raised in relation to the calculation of stations long-term charges (LTCs).

### **Template contracts**

26. The template contracts are a suite of template agreements for delivery of third party schemes which we approved under part G of the network code.

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<sup>4</sup> March 2006, <http://www.rail-reg.gov.uk/upload/pdf/277.pdf>

27. Stakeholder responses to this consultation included criticisms of the balance of risk in the template agreements, of the caps on liability and consequent incentives on Network Rail to perform its obligations, and of the level of compensation available to customers for losses incurred because of breach of contract.

28. After investors had accrued some experience of using the template agreements for investments we consulted on what changes should be made to the original template agreements in order to improve their efficacy for investment with Network Rail. We concluded on the changes necessary generally in May 2008, and following specific concerns expressed by stakeholders on the issues of liability caps and liquidated damages, we published further conclusions in March 2009. Network Rail is now amending the templates to reflect those conclusions, and will consult with stakeholders before submitting the revised agreements to ORR for approval later this year.

29. Since our review of the templates was ongoing during this consultation into obstacles to investment, we have considered the concerns expressed by stakeholders in their responses to this consultation in reaching our conclusions on the changes necessary to the templates.

### **Contestable services**

30. One of the aims of this consultation was to draw out any evidence to support claims that Network Rail is using its monopoly position to require third parties to buy contestable services from it.

31. While one of the respondents said that Network Rail should make it easier to use outside contractors, others noted that contestable services had been carried out either by themselves or their contractors. These responses went on to say that Network Rail had not corporately hindered decisions to undertake contestable services themselves, and welcomed Network Rail's willingness to undertake contestable services as this provided a degree of competition in deciding which provider is most appropriate to deliver on an individual project. Network Rail has said that it is in favour of others undertaking small scale enhancements so that it can focus its attention on the larger, more complex schemes.

32. We therefore have no evidence that Network Rail has systematically limited the use of third party contractors, although we are aware from some investors that Network Rail, at a local level, can make it difficult to use other service providers. We welcome Network Rail's commitment to see others undertake small scale investments but Network Rail needs to ensure that this is followed through consistently at a local level. In this regard, as outlined in our conclusions below, we will be looking closely at how such projects are implemented.

## Our conclusions

33. Many of the consultation responses reflected concerns with areas of the investment process that we were reviewing in parallel workstreams: through our requirements for changes to the template investment contracts; in our updated guidance for investment at stations; or in our review of incentives more generally as part of the 2008 periodic review. We have now reached conclusions in these areas. Our conclusions on changes to the template investment agreements<sup>5</sup>, and our revised guidance for investment at stations<sup>6</sup> are published on our website.

34. Concerns were expressed in relation to costs: both charges made for services under the template contracts, and in relation to the calculation of long term charges at stations. In relation to the template contracts for contestable services, Network Rail faces competition, and therefore if investors are unhappy with the price offered by Network Rail, they should have the option of using alternative suppliers. But this does rely on Network Rail not making it difficult to use alternative service providers (see below on how we will monitor this). For charges incorporated into the contracts themselves (for instance contributions to the fee funds) we considered these in coming to our conclusions on the changes Network Rail needs to make to the contracts in its current revision of them. In relation to the station long term charge, this was considered as part of the 2008 periodic review and in our updated guidance on changes to station charges to reflect enhancements funded outside periodic reviews.

35. Further specific concerns were expressed in relation to the issue of the treatment of shared value, and we return to this below. The remaining concerns were of a more general nature, relating not to a specific issue with the experience of investment but more general dissatisfaction with Network Rail's behaviour and processes.

36. It is clear that Network Rail recognises many of these general concerns raised, and has initiatives in place with the aim of addressing the underlying general problems. We will want to monitor whether the initiatives are being implemented and whether they are successful in dealing with the issues raised by stakeholders. In its response to the concerns raised, Network Rail has described the process it has in place to establish KPIs that monitor progress in this area and in improving customer satisfaction generally. We want to work with Network Rail to ensure that the monitoring results are robust, that the monitoring drives continuous improvements in performance, and progress is visible to

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<sup>5</sup> See [http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty\\_templates\\_090508.pdf](http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty_templates_090508.pdf) and [http://www.rail-reg.gov.uk/upload/pdf/inv-tmplte\\_liab\\_cap.pdf](http://www.rail-reg.gov.uk/upload/pdf/inv-tmplte_liab_cap.pdf)

<sup>6</sup> See [http://www.rail-reg.gov.uk/upload/pdf/inv\\_frmwrk\\_stn\\_chrgs\\_conc.pdf](http://www.rail-reg.gov.uk/upload/pdf/inv_frmwrk_stn_chrgs_conc.pdf)

stakeholders. Network Rail has suggested that the established industry steering group (ISG) is used to discuss issues of this type as appropriate. We support this suggestion, and will ask Network Rail to update ISG with a presentation on its service culture initiatives, and its plans to monitor their impact, by July 2009. We will then expect Network Rail to return to ISG every 6 months to report on progress.

37. In parallel we will discuss with Network Rail how reporting on progress in this area can be incorporated into its wider reporting requirements. We will also select a sample of projects for audit, in order to measure Network Rail's progress in implementing its initiatives and assess their effect. The audit will encompass the whole project development process, including Network Rail's response to investors seeking to use an alternative supplier of contestable services. We will provide more details on this audit programme in due course.

#### *Shared value*

38. In the light of the expressions of stakeholder concern on this issue we have reviewed our published guidance as it relates to shared value, with reference to our duties. As a result we are taking this opportunity to clarify our position on Network Rail's approach to shared value.

39. We do not believe that it is appropriate for ORR to stipulate that Network Rail should not seek to share in the benefit of an increase in land value where that increase has been unlocked by providing developers with access to its own land or over its land. Such a position, if adopted by ORR, could in fact be detrimental to railway users and funders if it increases the share of the cost of the railway that they are required to fund. But nor do we believe that it is ORR's role to endorse any particular approach by Network Rail, except to say that:

- Network Rail must of course comply with relevant legislation in this area, and that includes, to the extent applicable, the aspects raised in the White and Case response to our consultation; Network Rail is still reviewing its position in relation to the submission from White and Case. While there may be circumstances in which Network Rail's behaviour might raise competition concerns, it should be noted that the ORR's role in enforcing the Competition Act 1998 only applies to services relating to the railways. It is likely therefore that competition issues relating to developments that are not connected to the railways will fall outside the scope of our powers.
- We would expect Network Rail to be mindful of relevant precedents, and not to frustrate developments from going ahead or significantly delay their implementation by adopting an unreasonable position. Where proposed developments have either direct

or indirect rail-related benefits, we would expect Network Rail to have regard to this when negotiating with developers.

- In order to promote transparency and to provide developers with an early opportunity to understand the basis on which they might expect to do business with Network Rail, the company has said that it will publish guidance on its approach to shared value stakeholders.

40. With these points in mind, it is a matter for the parties concerned to agree between them whether, in particular circumstances, shared value principles apply and, if so, on the appropriate level of shared value.

41. We do include an estimate of the income Network Rail is likely to generate from its property portfolio when we conduct periodic reviews of the company's access charges. This income is netted off Network Rail's gross revenue requirement and hence reduces a combination of the access charges paid by train operators and direct grant paid by governments. In the 2008 period review, we took Network Rail's estimates (which included a small element of proceeds from shared value) and made adjustments where appropriate. However, we had no reason to adjust Network Rail's estimate of income from shared value. Consistent with our statement in paragraph 40, we do not believe it would have been appropriate for us to make an explicit assumption that Network Rail would receive no benefit in relation to bridges (as White and Case had requested) and then to instruct Network Rail not to extract any value.

42. If a developer thinks that Network Rail is unreasonably frustrating developments from proceeding, there needs to be available swift and effective dispute resolution mechanisms. Developers are able to take their case to the Lands Tribunal but Network Rail has also offered alternative avenues in order to resolve disputes, including mediation. Network Rail has also confirmed that it is willing to discuss other possible dispute resolution mechanisms with investors.

**Table 1: Network Rail initiatives to address process and timescale issues**

Issue raised	Relevant Network Rail initiatives
Network Rail generally slow in progressing proposals	<ul style="list-style-type: none"> <li>• Introduction of GRIP fast-track process. Further standardisation of project specification will shorten time spent on developing and agreeing proposals.</li> <li>• Streamlining of processes to increase speed of production and approval of engineering deliverables.</li> </ul>
Excessive bureaucracy (documents required but not used)	Greater consistency through templating forms and processes to provide more uniform and responsive customer services.
Network Rail fails to have a single point of accountability	Established Route Enhancement teams specifically to provide a single point of contact and accountability.
GRIP process – inconsistency of application, not appropriate for all schemes	<ul style="list-style-type: none"> <li>• Introduction of GRIP fast track process.</li> <li>• Better alignment of GRIP with company standards (some GRIP documents will become instructions referenced from a revised standard).</li> <li>• GRIP will become ‘governance’ rather than ‘guidance’ for railway investment projects.</li> </ul>
Network Rail consent difficult to achieve	<ul style="list-style-type: none"> <li>• Landlords consent: web-based application for management of process being rolled out following successful pilot.</li> <li>• Engineering approvals under asset protection arrangements: improved joint working with customers in order that information requirements of the programme and customer design requirements are clear.</li> </ul>
Transparency / understanding required of how third party schemes interface with existing rail projects / investment plans	<ul style="list-style-type: none"> <li>• Joint stations board initiative to develop integrated station plans. Local delivery groups will be responsible for developing an overall plan for stations.</li> <li>• Network Rail is considering operating local authority conferences at a more regional level.</li> </ul>

**Table 2: Network Rail initiatives to address structure and culture issues**

<b>Issue raised</b>	<b>Relevant Network Rail initiatives</b>
<p>Lack of can-do approach <i>and</i> Lack of responsiveness and inconsistency</p>	<ul style="list-style-type: none"> <li>• Training courses being rolled out to improve skill-level and consistency and improve customer experience.</li> <li>• Increased resourcing for enhancement teams.</li> <li>• Cross-route groups and intranet used to disseminate lessons learnt and best-practice.</li> <li>• Streamlining of processes to increase speed of production and approval of engineering deliverables.</li> <li>• Improved communication with stakeholders.</li> </ul>
<p>Risk-averse culture</p>	<ul style="list-style-type: none"> <li>• Improving understanding of customers' commercial position.</li> <li>• Revising third party investment template agreements accompanied by sponsor training.</li> <li>• Implementing more robust estimating process, in order that the appropriate party is managing the appropriate risks.</li> <li>• Production of a guidance note for the development process of the template agreements and the key decision points in their use.</li> </ul>
<p>Network Rail not incentivised to deliver investments</p>	<ul style="list-style-type: none"> <li>• Network Rail approaching stakeholders who made these statements to understand concerns in detail.</li> <li>• Investigating how to increase internal awareness of the benefits of the volume incentive for Network Rail, and to incorporate it into decision making at a local level.</li> </ul>
<p>Lack of transparency in organisational structure / lack of clarity around roles between departments</p>	<ul style="list-style-type: none"> <li>• Clarified roles and responsibilities including those of sponsors, project managers, engineering.</li> <li>• Effort to communicate these clearly through Network Rail and to stakeholders.</li> </ul>