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Policy framework for investments: conclusions

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Contents

Foreword

1. Improving performance and increasing the capability of the rail network to meet the needs of rail passengers and freight users will often depend on investment. Large schemes will generally be the subject of specific discussion with the major funders: the Secretary of State and Scottish Ministers. But smaller schemes are also important: these can be funded through increased revenue or with contributions from Passenger Transport Executives (PTEs), Transport for London (TfL), train operators, local authorities or similar bodies. Often, these schemes will involve improvements to station facilities. Network Rail needs to deal effectively with such proposals, both in the planning stage and when facilitating or delivering agreed projects at an efficient cost.

2. The arrangements for smaller schemes have not always worked well in the past. We have received a number of complaints about the way Network Rail handles proposals, and about their costs. The framework set out in this document is designed to address these and other issues. The framework follows a consultation earlier in the year and has been developed with the full cooperation of Network Rail and other industry stakeholders. Promoters of schemes will now be clear about Network Rail's role and obligations and the process they need to follow, and they will have greater certainty on both timescales and costs.

3. The test of the new arrangements will, of course, be whether they result in more schemes being taken forward, and delivery of better value for money. The onus is now on Network Rail to make sure this is achieved. We will be keeping the framework under review, and will look to make changes in the light of experience if further improvements are needed.

4. The framework clarifies that third party promoters have the option to carry out schemes themselves, either to own and operate (as has happened in the past with some new stations) or to transfer to Network Rail on completion. Competition is a more effective spur to improved performance than regulation alone, and the ability for promoters to choose between alternative approaches will help to ensure that Network Rail delivers effectively those schemes it is taking forward.

Executive Summary

1. Efficient investment in rail will provide value for money improvements to the capacity, capability, and/or quality of the network for the benefit of fare payers, freight customers and taxpayers. Such investment is crucial if the railway is to accommodate expected future demand at an affordable cost. The scale and type of investments include connections to private freight facilities, construction of new maintenance depots, small and large-scale station improvements (ranging from new facilities at minor stations to the proposed Kings Cross redevelopment) and major route upgrades (such as the West Coast route modernisation project).

2. Our work, and many responses to our February 2005 consultation document, identified a number of barriers to efficient investment, which have resulted in delays to schemes, inflated costs or missed opportunities to improve services for the benefit of rail users. These barriers need to be overcome. Many of the barriers relate to how Network Rail engages with promoters and other stakeholders in taking investment schemes forward.

3. Network Rail has a central role in facilitating, developing, delivering and financing many schemes. It is essential that the company ensures that its customers' and funders' reasonable investment requirements are satisfied in a fair, timely, transparent and consistent manner. Network Rail's Network Licence obligations to develop and enhance the network in an efficient and timely manner are on a par with those to operate, maintain and renew the network.

4. Our role in facilitating efficient investment is three-fold:

   - at periodic reviews, to establish appropriate incentives for Network Rail to deliver the required outputs from investment schemes at an efficient cost;

   - for proposals not included in a periodic review determination, to establish an appropriate framework to enable efficient development and delivery of schemes; and

- to monitor Network Rail's performance and hold it to account for systemic failures which are hindering efficient investment, with the option of taking formal enforcement action where necessary.

5. The framework set out here focuses mainly on the second and third of these issues. We set out a clear framework, within which the various parties to investments are able to work to deliver schemes efficiently, including:

- Network Rail's role and obligations and how these will be secured;
- default terms (including principles for risk allocation) for carrying out investments;
- specific proposals in relation to third party investments to overcome barriers caused by the impact of low-probability, high-impact risks which cannot be efficiently managed or insured; and
- the remedies available when things go wrong.

6. This document also sets out how we propose to monitor whether the framework is delivering the objective of facilitating efficient and appropriate investment in the rail network. There are a number of key factors which will underpin the success of this framework:

- Network Rail pro-actively identifying value for money investments, either through the route utilisation strategy (RUS) process or through incremental improvements in capacity and/or capability, usually on the back of major renewals programmes (for which the Department for Transport (DfT) has agreed to fund £200 million over the period 2005 - 2009). This should include seeking self-financing investments, for example by leveraging in private sector development funding on the back of station improvements;
- Network Rail fostering a culture throughout its organisation to respond positively and consistently to investment proposals identified by others. It has started to do this by appointing a number of Route Enhancement Managers;
- Network Rail establishing a code of practice (enforceable by us) setting out the terms of its engagement with its customers and funders, including who to contact, the timescales for responses to proposals, the steps in the

process of delivering investments and the framework for contracting with Network Rail;

- all parties striving for continuous improvements in efficiency, thus reducing year by year the cost of improvements to the rail network;
- for third party investments, clarity of legal, economic and financial obligations set out in templated contracts, including who bears what risks, the prices of provision of different services, and the remedies following any breach of contract;
- our monitoring of the framework and acting swiftly but proportionately on any failings; and
- effective streamlining of other industry processes related to investment, in particular the reform of Part G (network change) of the Network Code.

7. Given this framework, we believe that there is every reason now for Network Rail to facilitate and deliver necessary, efficient and sustained improvements to the railway network to benefit both current and future rail users. However, if the framework set out in this document fails to address the barriers to efficient investment, we will consider what further action is necessary including the possibility of imposing requirements on Network Rail to grant access to third parties wishing to carry out schemes on its network on non-discriminatory terms.

1. Introduction

Background

1.1 In February 2005, we published a consultation document (the February document)[1] proposing a policy framework for investments (i.e. enhancements and other major projects[2]), aiming to address the barriers to efficient delivery of improvements to the network. The framework clarifies Network Rail's role in investments and the terms on which it engages with its customers and funders in facilitating and delivering them.

1.2 Since then we have:

- received and analysed 44 responses to the February document;
- held five workshops with groups of stakeholders in London, Leeds and Edinburgh;
- met a range of interested parties to discuss the framework; and
- developed policy across several aspects of the framework, primarily through the Investment Working Group (IWG), led by the Department for Transport (DfT), and the IWG sub-group chaired by us to discuss Network Rail's proposed approach to third party enhancements.

1.3 These final policy conclusions on the investment framework have benefited significantly from the extensive and constructive engagement of all stakeholders and their knowledge of the barriers that have hindered the efficient delivery of schemes in the past. There are a number of elements of the framework where further work is required to finalise detailed arrangements (such as Network Rail's proposed templates for third party investments) or to

[1] *Policy framework for investments: an initial consultation*, Office of Rail Regulation, London, February 2005 may be downloaded from http://www.rail-reg.gov.uk/upload/pdf/223.pdf.

[2] See the Glossary in Annex C for a full definition.

develop specific aspects of related policy. In particular, we intend to finalise our detailed *Guidelines for investment*[3] before the end of 2005.

Need for a policy framework for investments

1.4 Our objective in developing a framework is to facilitate appropriate, efficient investment in the rail network, which will lead to value for money improvements in the quality, capability and/or capacity of the railway (including stations and depots as well as the core rail infrastructure: track, structures, signals, telecoms, etc.) to the benefit of current and future users of rail services.

1.5 The main reasons why a framework for investments is required are to facilitate efficient delivery of:

- enhancements that arise between periodic reviews and which require decisions on funding in advance of the next scheduled periodic review; and
- schemes on, or connected to, the rail network and promoted by third parties which are not funded through a periodic review.

1.6 Discussions with industry parties suggested that there appear to be a number of barriers to developing and delivering the investment schemes required by customers and funders which the investment framework needs to address. These are primarily:

- a lack of clarity over Network Rail's role in investments, its obligations under Condition 7 of its Network Licence, and its fees for providing services to scheme promoters or customers;
- the complexity of industry processes for implementing investments, such as the network change process in Part G of the Network Code[4];

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[3] These will contain details of: how Network Rail will deal with investment proposals, the governance arrangements for different categories of scheme, and key industry processes.

[4] Phase one of Network Code reform placed a general obligation on Network Rail to facilitate Network Change, including specific obligations to provide and publish information and produce standard forms and model terms and conditions.

- inconsistency in the approach to proposals across the network and between industry parties, particularly on the part of Network Rail;
- the impact of low-probability, high-impact risks, which cannot be efficiently managed or insured, such as the impact on a scheme of an operational emergency on the network; and
- the approach to risk allocation and risk avoidance.

1.7 The Railway Industry Association (RIA) suggested that there were a number of other barriers, such as changes in scope, applicable standards and in the required specification of projects.

1.8 These barriers have generally added to the timescales and costs of investment schemes and have also resulted in missed opportunities to improve services for the benefit of rail users. We believe that they can be addressed by the investment framework set out in this document and other complementary developments listed in paragraph 1.13.

Scope of the investment framework

1.9 The investment framework set out here is aimed at addressing barriers to progress by providing clarity on:

- Network Rail's obligations and how it should meet its customers' requirements, particularly the requirements of third parties. Network Rail's approach to third party schemes is a key aspect of these obligations, which will be contractualised through model templates requiring our approval under Part G of the Network Code;
- our role in ensuring Network Rail meets these obligations; and
- the appropriate terms on which Network Rail should carry out investment schemes.

1.10 A key principle is that the responsibilities, risks and funding arrangements for all schemes should be clear to all stakeholders as early as possible in scheme development.

1.11 If, following these conclusions, experience in delivering investment schemes suggests that Network Rail's proposals and the wider approach set out here do not address the issues, we will consider what further action we need to take to facilitate investment schemes. Further action could include:

- modifications to the Network Licence to impose further specific obligations on Network Rail in respect of investments[5];
- further modifications to Part G of the Network Code; or
- requirements for Network Rail to grant access to third parties wishing to carry out schemes on its network on non-discriminatory terms. This requirement is similar to that imposed on other regulated infrastructure network operators in respect of third-party connections.

1.12 We will monitor key indicators of Network Rail's investment performance to assess whether or not customers' and funders' reasonable requirements are being met and the desired outcomes are being achieved.

Other issues relevant to this framework

1.13 Since publication of the February document, a number of developments have taken place which will complement this investment framework and help to facilitate the identification, development and delivery of efficient investment. These include:

- modifications made to Network Rail's Network Licence to include obligations relating to whole-industry performance, planning and Route Utilisation Strategies (RUSs);
- publication in July 2005 of our emerging conclusions for Phase 2 of Network Code reform[6] including proposed further changes to Part G;
- the issuing in June 2005 of our operative drafts of the Stations Code package documents, which include, *inter alia*, measures to facilitate

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[5] Network Rail already has obligations in respect of investments through Condition 7 of its Network Licence, which are discussed in Chapter 2.

[6] *Network Code Reform Phase 2: update and emerging conclusions*, Office of Rail Regulation, July 2005, is available at http://www.rail-reg.gov.uk/upload/pdf/241.pdf.

investments at stations through simplifying the contractual regime, and an improved station change process[7];

- publication of our draft conclusions on the Depots Code in July 2005[8], which also included measures designed to facilitate third party investments at depots through streamlined, simplified contractual processes; and
- further work by the industry's system interface committees and the Rail Safety and Standards Board (RSSB) on the issues concerning standards.

Structure of this document

1.14 The remainder of this document is structured as follows:

- Chapter 2 describes Network Rail's obligations and how these are to be secured, and remedies for stakeholders if things go wrong;
- Chapter 3 sets out policy conclusions on the terms on which Network Rail carries out investments, including on Network Rail's proposed approach to third party enhancements; and
- Chapter 4 explains how the framework will be implemented and monitored.

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7 *Operative version of the Stations Code*, Office of Rail Regulation, June 2005, is available at http://www.rail-reg.gov.uk/server/show/ConMediaFile.7222.

8 *Depots Code: Draft Conclusions*, Office of Rail Regulation, July 2005, is available at http://www.rail-reg.gov.uk/upload/pdf/243.pdf.

2. Network Rail's role in investments

Introduction

2.1 Network Rail has a key role in all investment schemes on, or connected to, its network, either in delivering schemes or in facilitating schemes delivered by others. It provides certain non-contestable services (known as network operator services[9]), such as booking and providing possessions, for all schemes.

2.2 This Chapter sets out our policy conclusions on:

- what we expect Network Rail to do to facilitate and deliver network investments;
- how we expect Network Rail to carry out its role in network investments; and
- how Network Rail is incentivised and held accountable for carrying out this role, and the remedies available to customers when things go wrong.

What Network Rail has to do

2.3 Network Rail's role in investment projects can be categorised as follows:

- deliver network investment requirements established by and funded at periodic reviews;
- identify, promote and deliver network investment schemes over and above those funded at periodic reviews, using objective, transparent appraisal criteria. These schemes can then be 'logged up' for inclusion in the Regulatory Asset Base (RAB) at the next periodic review;
- facilitate development of, and deliver specific schemes which have been, or are in future, established as reasonable requirements of Government;
- facilitate development of, and where appropriate deliver, schemes proposed by third parties; and

[9] See the Glossary in Annex C for a full description of these.

- prioritise between these different activities in accordance with appropriate appraisal criteria.

2.4 Consultees generally supported our description of Network Rail's obligations with regard to different categories of investment schemes. Our policy conclusions on each of these obligations are set out in the next sections.

Investment requirement from periodic reviews

2.5 In advance of future periodic reviews, the Secretary of State and Scottish Ministers will set out high-level output specifications (HLOS) describing the extent and quality of the railway activities that they want to buy, and the funds that they have available. We will translate the HLOS into Network Rail output requirements. Network Rail will produce a cost submission, including detailed route plans, setting out the investment (renewal and enhancement) necessary to deliver the output requirements. We will review and challenge this submission to determine the reasonable costs necessary to deliver the HLOS, to be funded through access charges, and set out an appropriate incentive framework to encourage efficient delivery. We monitor delivery of outputs and hold Network Rail to account.

2.6 The next periodic review will take effect from April 2009. Network Rail's current funding and baseline outputs are those established in the Access Charges Review 2003 (ACR2003). In essence, Network Rail was required to deliver a number of performance and asset condition targets over the period, and to maintain network capability for broadly existing use at April 2001 levels (unless adjusted through the contractual mechanisms in the Network Code). In the ACR2003, £2.2 billion (in 2002-03 prices) was allowed over the period from 2004 to 2009 for anticipated enhancement schemes. In addition Network Rail was given financial incentives (for example, through the operational performance regime) to invest in further improving outputs.

Additional investment schemes not funded at periodic reviews

2.7 Our February document set out:

- the process for 'logging up' investments that generate economic value for the rail industry and arise between periodic reviews;

- our proposed criteria for adding expenditure on investment schemes to the RAB; and

- arrangements proposed by Network Rail and DfT for the Network Rail Discretionary Fund (NRDF), a mechanism for funding minor schemes (of value less than £5 million) identified by Network Rail which are either linked to major renewals or other schemes which have a positive whole-industry business case.

2.8 Most consultees welcomed the proposals for logging up investment expenditure to the RAB, and for setting up the NRDF.

2.9 Network Rail should log up investments (which satisfy the criteria set out in Chapter 3) that generate economic value for the rail industry, but which were not funded by the ACR2003 settlement. Network Rail bears the financing costs of such schemes until the next periodic review when the cost of the schemes (including accrued financing costs) is added to the RAB, and thus paid for through access charges.

2.10 Under the current arrangements, whereby franchised passenger train operators are in effect insulated from changes to access charges at periodic reviews through provisions in franchise agreements, the cost of remunerating these investments falls on Government (i.e. the Secretary of State or Scottish Ministers)[10].

2.11 With respect to the NRDF, consultees said that they would welcome some clarification on the process of identifying suitable schemes, and on how we plan to:

- monitor the fund;
- ensure Network Rail appraises these schemes using suitable criteria;
- determine their enhancement element where this is being 'piggybacked' on a major renewal; and
- guarantee "equal opportunities" between freight and passenger schemes.

[10] To the extent that additional investments generate additional revenue for franchised operators, revenue sharing (or similar) provisions in new franchise agreements could ensure that Government receives some of the financial benefits from investments it funds. However, under current arrangements, Government would not capture the full financial benefits of the investment until franchise renewal.

2.12 Proposed arrangements for the NRDF are set out in Annex B. In summary, the arrangements for identifying and delivering NRDF schemes are expected to be:

- 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 on a regular basis (at least quarterly) 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 progress on all NRDF schemes to us and Government, on a quarterly and annual basis;
- the independent regulatory Reporters audit a sample of schemes at year-end, using the information on Network Rail's scheme files; and
- we will confirm the efficient net additional costs to be added to the RAB.

2.13 Detailed arrangements for the NRDF will be established and published by Network Rail before the end of 2005, and will be included in our *Guidelines for investment*. We expect that in future, NRDF schemes (or at least potential schemes) will be included, and identified separately, in Network Rail's annual business plans.

Other schemes funded by Government

2.14 Certain schemes required by Government (usually those funded through an addition to the RAB) may warrant bespoke arrangements, primarily:

- major schemes arising between periodic reviews or other schemes with unusual circumstances, such as the Southern Region New Trains Programme (SRNTP) which involves unusual risk allocation and control mechanisms (see paragraph 2.37); and

- schemes that impose additional obligations on Network Rail, such as new safety-related schemes. Such schemes should also generally be funded through the logging-up process, but may in exceptional circumstances[11] require additional short-term funding through an adjustment to access charges in advance of the next relevant periodic review. There are two possible routes for achieving this short-term adjustment:

  (i) if the additional obligations arise as a result of a change of law through the direction of a competent authority[12], there is a mechanism within the template track access contracts to adjust access charges; or

  (ii) if the additional obligations result in a significant additional financial burden on Network Rail, there are re-opener provisions in the ACR2003 settlement for adjustments to access charges, subject to the conditions set out in the December 2003 final conclusions being satisfied[13].

Facilitation of schemes delivered by third parties

2.15 Network Rail should facilitate schemes promoted and delivered by third parties, such as station improvements, by providing network operator and other services on fair and reasonable terms, ensuring that it recovers only its additional efficient costs when it is taking a facilitative role[14].

2.16 In many cases, third parties will also want Network Rail to design, develop, finance and deliver schemes, whether or not the enhanced assets are owned by the third party or transferred to Network Rail following completion. However, in other cases the third party may wish to seek a price from other suppliers for the provision of contestable services, for example design and delivery services. Competition for the provision of such services should:

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11 For example, if the additional obligation has a significant impact on Network Rail's financial position.

12 As defined in the Railways Act 1993, as amended.

13 See Chapter 16 of the *Final conclusions*, available at http://www.rail-reg.gov.uk/upload/pdf/184.pdf.

14 The terms under which Network Rail should provide services to third party customers are discussed in Chapter 3 in more detail.

- provide benchmark prices for comparative purposes;
- drive efficient behaviour; and
- create additional capacity in the market for delivery of schemes.

2.17 In order that benefits from competition can be realised, Network Rail should not use its monopoly position to require third party promoters to buy contestable services from it. We will monitor Network Rail's behaviour in this area[15] and also seek regular feedback from customers and their representatives (such as the Association of Train Operating Companies (ATOC) and the Rail Freight Group (RFG)). If there is evidence that Network Rail is using its monopoly position in this way, we will consider what further measures are appropriate to facilitate competition for contestable services, such as further modifications to the Network Code or the Network Licence.

2.18 The treatment of third-party schemes within the investment framework and in particular, the terms on which Network Rail proposes to provide services to these schemes under template contracts, with model terms to be approved by us under Part G of the Network Code, is discussed in more detail in Chapter 3.

Prioritisation of schemes

2.19 Network Rail's business plans need to include business planning criteria which set out clearly how Network Rail makes investment decisions and prioritises investment schemes. Network Rail included proposed appraisal criteria for investments in its March 2005 *Business Planning Criteria* document. Following discussion with stakeholders and us, Network Rail is revising this document and will publish an updated version by the end of this year, including more detail on:

(a) economic criteria for appraising schemes;

(b) how its decisions reflect wider industry considerations, such as whole industry outputs and efficiency;

(c) the company's safety investment criteria; and

[15] See Chapter 4 of this document.

(d) the principles for the company's possessions strategy.

Self-financing schemes promoted by Network Rail

2.20 We have discussed with Network Rail the potential treatment of station retail schemes and other 'self-financing' schemes promoted by Network Rail, an issue that was not covered explicitly in the February document.

2.21 Network Rail should identify and pursue opportunities to increase its property revenue, for example through retail schemes at major stations. 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.

2.22 In general, provided such schemes[16] generate sufficient revenue in total to cover the associated return on the RAB, we are content in principle to add 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 (there is expected to be a reduction). These schemes should be depreciated over a suitable period, to be established with reference to Network Rail's estimates of the average payback period for the schemes. Network Rail should provide a forecast of expected revenue from these schemes, which we propose is audited by the independent regulatory 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.

2.23 These schemes will need to be reported separately and monitored through Network Rail's annual regulatory accounts, showing details of expenditure and income generated for each scheme.

How we expect Network Rail to carry out its role

2.24 Our February document identified five key activities for Network Rail in carrying out its role in relation to investments:

[16] Or other "self-financing" schemes, which may include performance- improving schemes.

- planning/project development;
- delivery;
- financing;
- provision of network operator services[17]; and
- monitoring/change control/governance.

2.25 Consultees generally welcomed our description of how Network Rail should carry out its role in planning, developing, delivering and financing investment schemes and the way it should provide network operator services and effective project governance arrangements. Consultees also agreed with us on the central importance of Network Rail improving both its asset knowledge and the accuracy of the information it provides to other parties (in particular, information on network capability) in order to facilitate the effective planning and development of investment schemes.

Planning and project development

2.26 The planning and development of investment schemes are underpinned by Network Rail's:

- business plans, and particularly its route plans and RUSs; and
- knowledge of its assets.

2.27 Development of these is therefore a high priority for Network Rail. In particular:

- the RUS and route planning process should enable identification of value for money improvements to the railway, and these processes should ensure that investment schemes are consistent with emerging market needs;
- better route plans should clarify what Network Rail is funded to do already and hence clarify any interfaces between investments and the maintenance of existing capability;

[17] See the Glossary in Annex C for more information.

- better asset knowledge should reduce the investment risks associated with unexpected asset condition and also reduce the need for large contingencies to be included in scheme cost estimates. We also expect Network Rail to provide information to stakeholders on existing assets during scheme development, which is subject to binding commitments; and

- clarity on the definition of the network's baseline capability will allow customers to establish exactly what capability is available on all routes to operate services, and thus to assess whether or not any enhancement is needed to realise the outputs they require. Network Rail is currently funded through the ACR2003 to provide the level of capability consistent with broadly existing use at April 2001 levels on all routes[18], and must meet its contractual obligations to provide the published capability[19] to its customers.

Delivery

2.28 Network Rail is obliged to deliver the requirements for investments emanating from outputs established at periodic reviews. Network Rail is strongly incentivised to deliver schemes efficiently through the "fixed price" funding arrangements put in place for most schemes at periodic reviews. We monitor Network Rail's delivery of outputs through the annual regulatory accounts process, and more frequent monitoring arrangements.

2.29 For other schemes (e.g. those funded through the logging up mechanism or third-party schemes), it is likely that under current arrangements Network Rail will generally be the delivery agent. We expect Network Rail to put in place efficient delivery arrangements for all schemes it is required to deliver, and to take on those risks which it is in the best position to manage.

Financing

2.30 Network Rail should be prepared to finance schemes which add economic value to the rail network on appropriate terms[20], allowing for any financeability

[18] This is subject to any Network Changes made under the processes in Part G of the Network Code.

[19] As at April 2001

[20] In practice, these would usually not be major schemes.

constraints, and be remunerated by an income stream over time. Under current arrangements this income stream would generally be contractualised through a supplemental access agreement, and similar arrangements could be put in place for third parties without access agreements.

2.31 One respondent to our February document mentioned two potential issues arising from remunerating Network Rail through income streams contractualised through access agreements:

- the treatment of the unremunerated balance of enhancement expenditure on expiry of the relevant access agreements; and
- the difficulty in specifying the scheme outputs with a sufficient degree of contractual precision to allow us to approve the access contract.

2.32 We recognise the need to put in place appropriate arrangements to remunerate any residual value relating to enhanced assets remaining at the end of an access agreement. Generally, franchised operators will need to seek support from Government for the residual value. Other arrangements for recovering the unremunerated costs of an enhancement, which are particularly relevant to non-access beneficiaries, are discussed in more detail in Chapter 3.

2.33 We consider there to be adequate mechanisms in place to allow parties to an access agreement to specify enhancement outputs without requiring excessive precision. For example, using an access option to specify expected outputs and allowing a testing period following completion of physical works to establish what outputs are actually available at that time.

Provision of network operator services

2.34 Network Rail, as owner and operator of the network, is generally the only practicable supplier of certain “network operator services”, such as:

- providing information on existing assets;
- facilitating the process for obtaining approvals under the Network Code and similar processes under the station and depot access conditions;
- booking and providing possessions;

- managing any operational disruption; and
- approving/accepting schemes.

2.35 Network Rail should provide these services in an efficient[21] and facilitative manner, and charge for their provision such that it generally recovers only its incremental direct costs.

Monitoring/change control/governance

2.36 Network Rail should provide scheme promoters with the necessary information to monitor progress on schemes, ensuring that arrangements for changes to the specification of a project are set out in advance, with responsibility for their financial consequences identified as part of the risk allocation. These monitoring and change control processes need to be reflected in project governance arrangements, for which there are two broad models:

- through Network Rail's Network Licence, which should be used for most projects sponsored by Government[22]; or
- 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[23].

2.37 In certain exceptional cases, schemes promoted and funded by Government (such as the SRNTP) may require bespoke arrangements through a Protocol or similar document, which would form part of the customer's or funder's reasonable requirements under Condition 7 of Network Rail's Network Licence. The nature of bespoke governance arrangements for major schemes will be described in more detail in our *Guidelines for investment* but a typical Protocol would generally comprise the following elements:

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[21] Our criteria for assessing efficiency are discussed in paragraphs 3.26 onwards.

[22] The Scottish Executive (SE) has followed a contractual model for major schemes, such as the upgrade of Edinburgh Waverley station. We continue to discuss with the SE appropriate arrangements for major schemes given the transfer of responsibility to Scottish Ministers for specifying and funding railway outputs in Scotland.

[23] The application of these templates is discussed in more detail in Chapter 3.

- 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;
- the funding mechanism(s) for the scheme, explaining clearly how Network Rail will recover its costs;
- risk allocation, and a description of the roles and responsibilities of the stakeholders involved;
- cost control, monitoring and management processes, including the process for approving variations to the scope or cost of the scheme; and
- the dispute resolution processes.

Securing and incentivising delivery of obligations

2.38 Network Rail's obligations in respect of investments will be secured through:

- its Network Licence;
- access contracts, including the Network Code[24];
- sections 16A–I of the Railways Act 1993 (as amended), once these sections are commenced by DfT; and
- an appropriate set of incentives to drive efficient behaviour by Network Rail and other stakeholders.

2.39 Most respondents to the February document supported the way in which Network Rail's obligations will be secured, although concerns were expressed at some of the workshops about whether the incentives on Network Rail are adequate to produce the appropriate behaviours. Many consultees also expressed concern that Network Rail still did not have the right culture and organisation to deliver and facilitate investments, and that its attitude to investment proposals was often unhelpful and, on occasion, obstructive.

2.40 Network Rail recognised in its response that it has not always been as responsive to customers and funders as it should be and stated that it is addressing this issue within the company.

[24] And the corresponding obligations under the station and depot access conditions.

Network Rail's Network Licence

Condition 7

2.41 Condition 7 of Network Rail's Network Licence requires the company to improve, enhance and develop the network "so as to satisfy the reasonable requirements of persons providing services relating to railways and funders in respect of the quality and capability of the network". This obligation is identical to (and therefore has the same importance as) the company's obligations relating to operation, maintenance and renewal of the network.

2.42 We would expect to deal with any systemic and network-wide failures on the part of Network Rail in relation to its obligations to improve, enhance and develop the network, through the enforcement of Condition 7. On the other hand, we would generally expect project-specific issues to be addressed through contractual processes.

Condition 24

2.43 Under Condition 24 of its Network Licence, Network Rail is required to produce detailed information on its assets. The information contained in the asset register should be sufficiently reliable for the purposes of scheme promoters and designers requiring information for planning and designing schemes, and should include information on the condition as well as the capability of the network.

2.44 Additional costs may be incurred by Network Rail in providing scheme promoters and designers with necessary information if it is over and above that required by the company in the normal course of its operations. The scheme promoter should remunerate Network Rail for any efficiently incurred incremental costs.

Condition 25

2.45 Network Rail has now produced a draft supplementary section to its code of practice (under Condition 25 of its Network Licence) to explain to third party customers how it will deal with their requests related to investments. We are currently reviewing the draft section, and the final version will be published in our *Guidelines for investment* and on Network Rail's website. The section covers:

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

(b) the timescale for responding to customers;

(c) points of contact;

(d) the process for contracting with Network Rail should the scheme progress; and

(e) remedies available to customers if things go wrong.

2.46 The obligations under Condition 25 are particularly important for scheme promoters who do not have a contract with Network Rail, i.e. for promoters at the feasibility stage of a scheme who may be considering contracting with Network Rail to buy services from the company, but who are not party to the Network Code.

The Network Code

2.47 Our emerging conclusions for Phase 2 of Network Code reform include proposals to make further changes to Parts F (vehicle change) and G of the Network Code that would help to facilitate appropriate and efficient investment, including:

- clearer obligations on Network Rail to facilitate enhancements, both general obligations and also arrangements for scheme-specific facilitation contracts;
- ensuring that network and vehicle change proposals take due account of the whole-industry approach to improvements to the railway;
- bespoke contractual arrangements for larger and more complex projects, such as GSM-R/ERTMS;
- a mechanism for including third parties in facilitation arrangements, such as the scheme-specific contracts; and
- a proposal that Network Rail and train operators should develop a code of practice setting out how they will consult interested third parties in respect of industry processes in the Network Code.

2.48 We intend to publish our conclusions on the next stage of Network Code reform in October 2005.

Section 16A-I of the Railways Act 1993 (as amended by the Railways Act 2005)

2.49 Under the amendments made to the Railways Act 1993 by the Railways Act 2005, we will have powers to direct Network Rail (or another “appropriate person”) to either build a new railway facility or enhance an existing facility, once Sections 16A-I of the Act are commenced. Such a direction could 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.

2.50 We intend to publish a draft code of practice for consultation shortly on the application of these powers.

Incentives

2.51 Network Rail has the following incentives to facilitate and deliver investment schemes:

- if it has offered the customer a fixed price for delivery of a scheme, Network Rail generally retains the surplus from any outperformance against this fixed price;
- the return on the RAB, where it is allowed to earn the same rate of return on additional investments as for renewals (i.e. the allowed rate of return, comprising its cost of debt and an additional surplus); and
- reputational incentives to facilitate and deliver investments. Network Rail should be seeking to facilitate efficient whole-industry solutions and deliver outputs in a timely and efficient manner to ensure customer satisfaction. If it can do this, Network Rail will enhance its reputation in the industry and with the wider community.

2.52 Some consultees believed that the incentives for Network Rail to facilitate and deliver investments might not be sufficient to outweigh Network Rail’s perception of investment as a risk to performance, or as a diversion from other activities. Consultees believed that evidence suggests that incentives on Network Rail have not in the past had the intended impact.

2.53 We do not believe that additional marginal financial incentives, in themselves, will necessarily resolve the cultural/organisational issues that have adversely affected the development and delivery of investments. However, this investment framework makes clear what is expected of Network Rail, and the company now needs to address any organisational constraints impacting on its ability to perform its required role effectively.

2.54 Network Rail is proposing to make changes within its organisation to ensure greater customer focus and delivery of its investment obligations. These changes involve a significant increase in the number of front-line staff responsible for day-to-day contacts with customers, in particular the creation of new Route Enhancement Manager posts that will be directly accountable for taking forward customer-sponsored schemes in a consistent manner.

2.55 We welcome these organisational changes and will monitor closely whether or not they are improving Network Rail's delivery and its responsiveness to customers' needs. The monitoring arrangements are described in more detail in Chapter 4.

Remedies under the investment framework

2.56 We believe that customers (other than Government) should generally enter into appropriate contracts with Network Rail for the provision of required services and, where necessary, use the remedies available in these contracts when things go wrong. Often the contracts will be based on the templates for third party investment, although remedies may also be available through relevant access agreements or other agreements.

2.57 Generally, if Network Rail does not meet its obligations as described in this Chapter, stakeholders can seek as a remedy under their contracts either:

- a requirement for Network Rail to provide services which have not been adequately provided (specific performance); or
- damages as compensation for non-provision or non-performance of services.

2.58 If a stakeholder was seeking the first type of remedy (specific performance) it could:

- apply to the Court for an order for Network Rail to comply with its obligations. A Court would only grant such an equitable remedy if it considered damages to be inadequate; and/or
- seek to apply a contractual performance order regime through the contract with Network Rail[25]. For instance, where Network Rail is facilitating a scheme, the customer should be able to use such an order[26].

2.59 For cases where the stakeholder does not have a contract with Network Rail for providing services, a range of remedies are potentially available as a result of our powers to enforce Network Rail's compliance with its Network Licence, e.g. through Condition 7 or Condition 25, as discussed above.

2.60 If Network Rail was not meeting stakeholders' requirements (and the stakeholder had not yet entered into a contract with Network Rail), we would be able to enforce compliance through the supplementary section to the code of practice under Condition 25, with reference to the timescales and processes set out in that document. As noted in paragraph 2.42, we would not generally expect to enforce compliance under Condition 7 unless there was evidence of a more systemic failure.

2.61 If stakeholders believed that Network Rail had not complied with the supplementary section to the code of practice under Condition 25 [27], they should write to us explaining which requirements had not been met, with reference to the relevant obligations and sections in the code of practice. We would then ask Network Rail to explain its position and provide any relevant information, and would assess whether or not Network Rail had complied with the terms of the code of practice. If we believed that Network Rail was not compliant, we would consider what action to take, including requiring Network Rail to provide the required services within a certain timescale.

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[25] If this is available – customers can require this through the template contracts for third party schemes.

[26] For example, through the Asset Protection Agreement (see also our separate technical note on third party issues, which will be available shortly on our website).

[27] This assumes the customer had already been through the relevant escalation and dispute procedures with Network Rail under the supplementary section to the code of practice.

3. Terms for carrying out investments

Introduction

3.1 This Chapter sets out policy conclusions on how Network Rail should be remunerated for investments not funded through a periodic review. The intention is to provide clarity to Network Rail and its customers and funders on what we deem to be reasonable terms on which investments should be undertaken, and this should result in schemes being taken forward and delivered efficiently. This does not preclude parties from adopting different terms if they believe alternative arrangements are more appropriate in particular circumstances, but these proposed terms should provide customers and funders with clear baseline expectations of how schemes should be taken forward. These terms reflect the obligations set out in the previous Chapter.

3.2 Specifically, this Chapter sets out conclusions on:

- the basis of the price to be offered by Network Rail;
- a default risk allocation;
- degrees of risk and appropriate levels of contingency in scheme costs;
- our criteria and logging-up process for adding the costs of investments sponsored by Government to the RAB;
- the treatment of project development costs; and
- Network Rail's proposed terms for investments sponsored by third parties.

3.3 This Chapter also sets out the principles of a rebate mechanism to allow third party investors to recover costs from other beneficiaries of an investment, and a mechanism for remunerating incremental operating and maintenance costs.

Basis of price

3.4 The February document explained that, in broad terms, there are four types of price estimate which can be offered by Network Rail:

- fixed price, where the scheme promoter seeks a fixed price from Network Rail for delivery of a scheme. Network Rail will then usually take all risks associated with construction and management of the scheme;
- target price, where a target price estimate is agreed in advance between scheme stakeholders and there is a pre-defined allocation of risk in the event of variations from this estimated target price, often with a pain/gain share mechanism which shares both downside and upside risks between stakeholders;
- emerging cost, where the costs incurred by Network Rail on the scheme are remunerated, usually subject to a cap on costs and review(s) of actual cost against estimates at defined stages, which may include an *ex post* efficiency review; and
- cost reimbursable, where all costs incurred are reimbursed in full to Network Rail by the customer (or funder).

3.5 Most respondents to the February document agreed with us that fixed or target prices will generally incentivise greater efficiency than contracts based on emerging cost or equivalent. However, some respondents felt that setting fixed prices may lead to higher costs for investment schemes. The risk is that Network Rail may have an incentive to set a high fixed price in order to compensate for the perceived risks connected with such an arrangement.

3.6 We recognise that in some cases, customers will prefer variable price arrangements where risk allocation and variation mechanisms are clearly specified in advance. The draft templates for third party schemes should provide suitable contractual forms for such arrangements.

3.7 However, if a customer wishes Network Rail to provide a fixed price for provision of services, Network Rail should generally do so, and clearly explain to the customer the implications of the fixed price i.e. what level of contingency is included and whether or not alternative arrangements might be more efficient for a particular scheme.

Allocation of risk

3.8 Our February document set out a default allocation of risk, based on the principle that risks (and liabilities) should be borne by those best able to manage and mitigate them, while recognising the requirement to remunerate Network Rail (or other stakeholders bearing risk) through appropriate cost-reflective fees. The risks to be borne by Network Rail largely arise from the obligations set out in Chapter 2.

3.9 In summary, the default risk allocation (see the Glossary in Annex C for the detailed definition of these risks) is that:

- *Network operator risks* should always be borne by Network Rail;
- *Design risk* should be borne by the scheme designer*;*
- *Construction risks* should be borne by Network Rail (where a promoter has required Network Rail to deliver the scheme);
- *Funding/financing risks* should usually be borne by Network Rail, unless a third party is arranging finance separately; and
- *Output risk*: the customer may choose to bear this risk itself but if the customer wishes to pay Network Rail to take output risk, it should be offered a price to do so and Network Rail should bear it.

3.10 We consider that, following consultation, the default risk allocation set out in the February document remains appropriate, although several consultees (notably Network Rail, the Strategic Rail Authority (SRA) and the DfT) made the point that the definition of output risk should be tightened to make it clear that some elements of the output (e.g. availability of new train paths) will depend on other stakeholders and so will not be wholly within Network Rail's control.

3.11 The element of output risk remaining within Network Rail's control can be referred to more precisely as "infrastructure capability risk". This is reflected in the definition in the Glossary in Annex C.

Rate of return and contingency

3.12 Where a scheme is costed on a fixed price or target price basis, a cost estimate is prepared in advance which should contain an amount (the contingency) based on allowances for unforeseen risks, which is over and above allowances for identified risks.

3.13 Respondents generally agreed with the principle that different levels of risks should be reflected in the level of contingencies rather than by applying different rates of return to various schemes. This approach is consistent with best practice in investment appraisal and is used widely by regulators in other utilities.

3.14 Some respondents noted that, on average, the contingencies included in any fixed price should reduce over time, and asked for further clarification on the circumstances under which different levels of contingency might be appropriate. Other respondents noted that a level of contingency of up to 25% was excessive by private sector standards, and that a maximum level of the order of 10% was more appropriate.

3.15 We recognise the difficulty in setting fixed contingency levels across different types of scheme, given the differences in risk profile between schemes and in the ability of Network Rail to mitigate or diversify scheme-specific risks. Nevertheless, based on our analysis of selected schemes and other evidence described in our February document, we consider that 10% should be the maximum contingency applied to Network Rail's estimates for schemes where there is very limited interaction with the operational network (i.e. no disruptive possessions) or for schemes costing less than £5 million[28].

3.16 For other schemes, on the basis of available evidence and taking into account best practice, we consider that the level of contingency included by Network Rail[29] should generally not exceed 15% (with a maximum contingency of 25% in exceptional circumstances[30]) and should be established with reference to:

- whether or not specific outputs are required on specific dates (a non-diversifiable risk);
- the complexity of the scheme (e.g. are there technology risks?); and
- the level of interaction with the rest of the railway network.

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28 In exceptional circumstances, schemes costing less than £5 million could require a higher contingency, e.g. in cases of high technical complexity.

29 At the GRIP 5 stage in Network Rail's scheme development process.

30 For example, major schemes with a high degree of complexity/technology risk.

In many instances, confidence in Network Rail's estimates and level of contingencies would be assisted by a review of these by the independent regulatory Reporters, with their findings shared between the parties.

3.17 We agree with consultees that the average contingency should be expected to reduce over time, as risks are better understood and managed, and we will monitor this closely through the detailed annual information on all enhancements provided through Network Rail's annual regulatory accounts.

Criteria for adding investment expenditure to the RAB

3.18 Before making an addition to the RAB for an investment scheme, we need to be satisfied that the arrangements should deliver an efficient outcome, based on an appropriate risk allocation and governance arrangements.

3.19 Our February document proposed four criteria for adding investment expenditure to the RAB, which were welcomed by consultees. Our conclusions are that the following criteria should be met before we consider making a RAB addition.

- 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?
- Have the outputs required by the scheme promoter or customer been delivered?
- Has the expenditure been incurred efficiently?
- 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.

Logging up investments to the RAB

3.20 We will continue our current policy of logging up the efficient costs of investments (including contingency) undertaken by Network Rail, from the time of completion of the project (i.e. on delivery of required outputs) until the next periodic review, and allowing Network Rail to accrue the total efficient costs, including an annual allowance for the allowed rate of return until the next periodic review. This approach is used widely in other regulated utilities and is consistent with the treatment of all other investments funded at periodic reviews. This enables Network Rail to finance projects as well as allowing for an additional return to reflect the risk associated with the ongoing operation and maintenance of the assets.

3.21 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. Drawing on practice from other regulated sectors, one option could be for Network Rail to retain the use of 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. We are developing proposals for a suitable mechanism, and will shortly consult with stakeholders on this issue.

3.22 Some respondents asked for further explanation on the treatment of changes in net revenues, and/or cost reductions from the investment, in logging up the cost to the RAB, and proposed that final costs should be adjusted accordingly before logging up.

3.23 Any cost savings (such as reductions in ongoing maintenance costs), increases in Network Rail's revenue, contributions from third parties or benefits in kind that can be quantified in financial terms, need to be netted off the final cost estimate before Network Rail proposes a RAB addition for that scheme.

3.24 Where a third party is implementing an enhancement and Network Rail is simply buying the enhancement on completion of the project, Network Rail takes little risk during the development and construction phases of the project (except in relation to provision of network operator services). Network Rail's risk is in ongoing operation and maintenance of the enhanced assets.

3.25 Therefore we consider that, for schemes where Network Rail is not responsible for delivering the scheme but simply for 'buying back' the enhanced assets, it should only receive the allowed rate of return on the cost of the project, and not on the premium (profit) element of the third party undertaking the project. Also, this means that if the company is not taking ongoing operational risk on the enhanced assets[31], it should not receive the full allowed rate of return, but simply the financing costs, until the next periodic review when the allowed rate of return would be re-assessed across the whole business.

What constitutes an efficient outcome?

3.26 When considering recent proposed RAB additions for investments, we have set out criteria for what constitutes an efficient outcome. We will expect to conclude that proposed scheme arrangements should produce an efficient outcome if the following conditions are met:

- 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;
- 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;
- 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
- cost estimates put forward by Network Rail represent efficient prices.

3.27 When assessing the efficiency of a cost estimate prepared by Network Rail, we have regard to appropriate market-tested values for each element of cost

[31] As may be the case under a Design Build Finance Operate (DBFO) delivery model.

included in the estimate. Cost estimates submitted to us should show costs according to the following categories:

- development costs (showing clearly any sunk costs);
- 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;
- management costs incurred by Network Rail;
- the allowance for identified, quantified risk usually estimated through a Quantified Risk Analysis (QRA) or similar process; and
- the contingency or allowance assumed for unidentified risks.

3.28 We intend to provide further details in our *Guidelines for investment* document of:

- our methodology for the assessment of efficiency, including worked examples; and
- detailed criteria for the assessment of shared value benefits that arise as a result of developments at stations (or elsewhere).

Which schemes should be assessed?

3.29 The White Paper[32] suggested that we should assess the costs of many investment schemes in future. We believe that, at least in the short term, we should continue to assess the efficiency of arrangements (including cost estimates) for major schemes in advance (*ex ante*), rather than reviewing the efficiency of schemes at a future periodic review (*ex post*).

3.30 We consider that both approaches have benefits in terms of incentivising appropriate behaviour from Network Rail, and that the *ex post* approach should require less direct regulatory intervention. The *ex ante* approach is consistent with the approach adopted in other regulated utilities, such as the water industry, although *ex post* assessments have also been carried out, notably in the energy sector.

[32] *The Future of Rail*, Department for Transport, Cm 6233, July 2004.

3.31 However, we also note that the *ex post* approach, where scheme costs are reviewed at periodic reviews, may currently be difficult to implement given:

- the current lack of benchmarks and reliable unit cost data held by Network Rail; and
- that in practice Network Rail will have incurred sunk costs on the project financed through additional debt.

3.32 Respondents strongly supported the principle of generally assessing the efficiency of schemes *ex ante* rather than *ex post*. Many respondents also suggested that there would be benefits in our carrying out a small sample of *ex post* efficiency assessments.

3.33 A sample of NRDF schemes will be assessed on an *ex post* basis and we may choose to assess the efficiency of a small sample of third party schemes delivered by Network Rail at year-end on an *ex post* basis as part of its 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 issue and seek further information from Network Rail.

Project development costs

3.34 Network Rail requires clarity on its remuneration for costs efficiently incurred on developing schemes for Government that are not then taken forward. We confirm our proposals set out in our February document, and supported by consultees, that Network Rail should be allowed to add efficiently incurred development costs to the RAB, provided that Government is content to support the financial commitment of adding these costs to the RAB.

Investments sponsored by third parties

3.35 Issues relating to investments sponsored by third parties have been the subject of extensive discussion and analysis since publication of the February document, including:

- discussions at workshops with key industry stakeholders in April 2005;
- a detailed review by us of Network Rail's draft templates for third party schemes; and

- discussions on the proposed approach and on Network Rail's draft templates at two meetings of a sub-group of the IWG, which we chaired.

3.36 Network Rail has made significant progress in developing its approach to third party schemes, and made improvements to the draft contract templates following discussions with industry stakeholders. This section summarises the key policy conclusions which Network Rail's approach needs to capture and which need to be reflected in the templates, with reference to the obligations in Chapter 2. These templates will be submitted to us for approval under Part G of the Network Code.

Network Rail's proposed approach

3.37 Network Rail's proposed approach to third-party schemes has been consulted on with stakeholders over the past two years, and is set out in more detail in its March 2005 *Regulatory Submission*[33]. The key elements of Network Rail's proposed approach are as follows.

- Risks allocated to the party best able to manage and mitigate them but in order to address issues of risk aversion holding up projects, Network Rail is proposing that most liabilities are capped (for both customers[34] and itself) and that two new funds are established as follows:

  (i) a Network Rail Fee Fund (NRFF): a ring-fenced fund, where payments from customers to cover Network Rail's own costs and liabilities are put into the Fund and the Fund 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[35]; and

[33] This is available at http://www.networkrail.co.uk/Documents/ORRSubmission2005.pdf.

[34] The customer is the party contracting with Network Rail; see the Glossary in Annex C for more details.

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

(ii) an Industry Risk Fund (IRF), funded by customers contributions based on a proportion of scheme costs, which will effectively act as insurance against the low-probability, high-impact industry risks[36].

- A set of template agreements with model terms and conditions to be approved by us under Part G of the Network Code, which provide customers with transparency on:
  - risk allocation;
  - payments to Network Rail; and
  - the company's obligations and accountability.

3.38 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 the Funds 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 in paragraph 3.46 onwards.

3.39 Many consultees recognised that the two proposed risk Funds are driven by the objective to facilitate investments by third parties and welcomed the intent behind them.

3.40 Following recent discussion between Network Rail and Government, we understand that DfT is content to accept the potential RAB addition arising from the two Funds. The Scottish Executive is currently considering the precise form that its support for the Funds should take, and what transition

[36] Although it would also be drawn on to fund Network Rail liabilities if the Network Rail Fee Fund was exhausted and also to fund customer liabilities if liability caps had been breached.

arrangements it should put in place, in advance of the creation of the new Scottish Transport Agency.

Key policy issues

3.41 The February document sought consultees' views on a number of key policy issues relating to Network Rail's proposed approach to third party investments. Our policy conclusion on each of these issues is set out below. More detail on the reasons for, and effect of, these policy conclusions, is set out in a separate technical note, which will be published shortly on our website.

3.42 It is important that Network Rail and customers bear appropriate risk and that customers have clarity on the risk allocation before entering into contracts. Network Rail will need to ensure that this clarity is achieved in the templates before they are submitted to us for approval. We expect Network Rail to ensure that the templates adhere to the proposed default risk allocation principles set out in paragraph 3.9.

3.43 The coverage of the IRF and NRFF: we are broadly content with the risks covered by the two Funds as per Network Rail's March 2005 submission, but we have suggested some drafting changes to the templates to improve clarity. To aid clarity, Network Rail will provide guidance notes for customers using the templates, setting out precisely which risks are covered by the two Funds.

3.44 Level of customer contributions and liability caps: we believe that given the innovative nature of the approach put forward by Network Rail, it is difficult to estimate accurately in advance an efficient level of customer contribution to the two Funds and appropriate liability caps. Through monitoring actual use of the two Funds, we will be able to assess whether or not the levels are appropriate, by examining how claims on the Funds arise. The initial levels of contribution will generally be as stated in Network Rail's March 2005 *Regulatory Submission* to us (although see the technical note to be published shortly on our website for further discussion on the liability caps).

3.45 Network Rail's fee levels for providing services: we are content with Network Rail's proposed fee levels having compared them (where applicable) to market rates for the provision of similar services. All mark-ups on the fees are paid into the NRFF, so any excess is 'recycled', i.e. used to fund liabilities arising on all third party schemes.

Monitoring delivery of third party schemes

3.46 Payments into the Funds are governed by the terms of the draft templates, which we continue to discuss with Network Rail. We will set out the detailed governance and reporting arrangements for the Funds in our *Guidelines for investment* and also in the *Regulatory Accounting Guidelines*, which we intend to re-issue in early 2006[37].

3.47 Consultees generally agreed with our proposal to review the arrangements for the Funds at the relevant year-end once the Funds have been used for over a year, so that the arrangements for the Funds have had time to 'bed down' and sufficient information is available to enable a comprehensive review. This review would not be expected to lead to an automatic adjustment to contributions to the Funds, as we will need to consider the reasons for variances in the levels of the Funds at the time. We would expect to carry out a full review of the levels and arrangements for the Funds at the next periodic review.

3.48 We are content with the form of reporting on third party schemes proposed by Network Rail in its March 2005 submission, which enables us to monitor the use of both Funds by providing a complete record of all payments into the funds and drawdowns from them.

3.49 We expect Network Rail to demonstrate continuous improvement in its efficiency, and in its management of risks relating to third party schemes. To monitor this, Network Rail needs to provide us with information on:

- the number of third party schemes progressed/delivered;
- value of schemes being taken forward;
- variances against agreed timescales; and
- variances against agreed prices.

3.50 Network Rail is also considering what information it can provide on:

- transaction costs before a scheme is implemented; and

[37] The current version of this document is available at http://www.rail-reg.gov.uk/server/show/conMediaFile.7134.

- unit costs for providing services, where appropriate.

Next steps

3.51 Once we are content with Network Rail's templates for third party schemes, we will approve these templates under Part G of the Network Code. Although we continue to work closely with Network Rail, approval has not been possible before publication of this document. See Chapter 4 for more details of next steps in this process.

Recovery of third party investment costs from other beneficiaries

3.52 We have been considering what kind of mechanisms might be appropriate to allow recovery of a fair proportion of costs by a funder of a project in situations where other parties benefit from the use of an enhancement to the network (e.g. provision of additional capacity or higher gauge).

3.53 Under current arrangements, funders cannot charge operators directly for access to enhanced assets, which means that operators may be able to free ride on these investments. This 'free rider' problem reduces the promoters' incentives to invest and ultimately may mean that a beneficial investment does not go ahead.

3.54 We have already put in place a rebate mechanism (through the freight model clauses) whereby investors can recover some costs from beneficiaries where, effectively, operators using the enhancement pay a charge to the investor via Network Rail. However, this rebate mechanism currently only applies to schemes with a value below £250,000.

3.55 We consider a rebate should also be paid for schemes with value above £250,000 (the majority of schemes), 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.

3.56 We are developing proposals for a suitable mechanism, on which we will shortly consult with stakeholders.

Incremental operating and maintenance costs

3.57 Several consultees (particularly freight customers) have asked for clarification on the treatment of incremental operating and maintenance (O & M) costs for schemes promoted by third parties which are transferred to Network Rail on completion.

3.58 Having discussed this with stakeholders and funders, we consider the following approach is appropriate:

(a) between hand-over and the next periodic review: efficient incremental O & M costs should be funded by the relevant third party promoter or funder (to the extent these costs cannot be recovered directly from another beneficiary); and

(b) after the next periodic review: incremental O & M costs should be included in Network Rail cost submissions/business plans and efficient costs allowed by us in the revenue requirement assessment for the next control period. In principle, these costs should be funded by the beneficiary.

3.59 In both cases "incremental" 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.

3.60 We will discuss this approach further with industry stakeholders, and give details of the treatment of incremental O & M costs in our upcoming *Guidelines for investment* document.

4. Implementation and monitoring of the framework

Introduction

4.1 Appropriate monitoring of outcomes is key to measuring the success of the policy framework set out in this document and in addressing the barriers to investment described in paragraph 1.6. Also, in order to make the framework operational, there are a number of further activities required to implement the policies set out in the Chapters above.

4.2 We set out below how we will implement the policy framework, summarising the monitoring arrangements that we are putting in place, and describing the next steps in related areas of work.

Implementing the policy framework

4.3 There are a number of activities we will now take forward in order to implement the policy framework for investments set out in this document. We will:

- through discussion with Network Rail, ensure that the policy principles set out in Chapter 3 on third party enhancements are fully reflected in the template contracts. Once appropriate amendments have been made to the draft templates, Network Rail should then formally submit them to us for approval under Part G of the Network Code;
- ensure that Network Rail produces and publishes an appropriate supplementary section to its code of practice under Condition 25 of its Network Licence, to clarify how it will deal with investment proposals from third parties;
- finalise the arrangements for:
    - the application and reporting of the Industry Risk Fund and Network Rail Fee Fund;
    - the NRDF, including appropriate reporting and appraisal criteria; and

- self-financing schemes promoted by Network Rail.

4.4 The outputs from the above activities will be set out in our *Guidelines for investment*, which we intend to publish by the end of 2005. Our *Guidelines for investment* will comprise the following elements:

- the supplementary section to the code of practice under Condition 25;
- the arrangements for the NRDF;
- the arrangements for self-financing schemes;
- the arrangements for use of, and reporting on, the IRF and the NRFF;
- more detail on how we assess the efficiency of prices for schemes, including worked examples; and
- details of key industry processes relevant to investments, including network change, station and depot change, and Network Rail's approval processes.

4.5 As well as these activities, there are a few related areas of policy where further development is required before we can finalise our policy on these issues. These are:

- the rebate mechanism which allows third party investors to recover costs from other beneficiaries; and
- the treatment of incremental operating and maintenance costs.

4.6 We will convene meetings with industry stakeholders to take forward these aspects of policy, based on the proposals in this document.

Related workstreams

4.7 Other related workstreams, which continue to progress and which are directly related to implementation of the policy framework, include:

- reform of the Network Code and in particular Part G, which allows the approach to third party schemes to become contractually operational;
- further work to introduce and implement the Stations and Depots Codes;

- development of a code of practice for sections 16A-I of the Railways Act; and
- Network Rail's work to produce a detailed description of the capability of the network, putting forward proposals, in consultation with stakeholders, to address differences between actual and published capability.

Monitoring the framework

4.8 As noted above (in paragraphs 2.13 and 3.49), we have now agreed with Network Rail the form of reporting on the NRDF and on the use of the Network Rail Fee Fund and the Industry Risk Fund, based on proposals in Network Rail's March 2005 *Regulatory Submission* on third party enhancements. This information will be provided to us and Government on a regular basis, as described below.

4.9 To recap, Network Rail will provide the following information on NRDF schemes.

- At year-end, Network Rail should include details in its regulatory accounts of all NRDF schemes, using the standard reporting template, and the independent regulatory Reporters will assess a representative sample of schemes to confirm delivery of outputs and that the renewal/enhancement split of costs is appropriate.
- Network Rail will also produce quarterly summary reports, setting out actual and budgeted NRDF expenditure and showing progress in achieving outputs. These reports should have the benefit of identifying any material issues with NRDF schemes on an ongoing basis.

4.10 Network Rail will provide the following monitoring information on third party schemes (which are covered by the IRF and the NRFF), on a quarterly basis:

- a record of all payments into and drawdowns from the Funds (an appropriate summary of this information should also be provided);
- the number of third party schemes progressed/delivered;
- value of schemes being taken forward;
- variances against agreed timescales;

- variances against agreed prices; and

- suitable information on transaction costs before a scheme is implemented.

4.11 We will also monitor progress on all enhancements that Network Rail is involved in, through reports provided using a standard template as part of Network Rail's annual regulatory accounts.

Annex A: Respondents to initial consultation document

1. Angel Trains
2. Arriva Trains Wales
3. Association of Transport Co-ordinating Officers (ATCO)
4. Association of Train Operating Companies (ATOC)
5. BAA
6. Chartered Institute of Logistics & Transport (UK) (CILT)
7. Department for Transport (DfT)
8. English Welsh & Scottish Railway Ltd (EWS)
9. Fife Council
10. Freight Transport Association
11. Freightliner
12. Go-Ahead Rail
13. Highland Council
14. Health and Safety Executive (HSE)
15. Hutchison Ports UK
16. JM Parry People Movers
17. Laing Rail
18. Martin Blaiklock
19. Merseytravel
20. National Express

21. Network Rail
22. North Lanarkshire Council
23. North West Rail
24. PD Ports Plc
25. Passenger Transport Executive (PTE) Group
26. Rail Freight Group
27. Railway Industry Association (RIA)
28. Rail Passengers Council (RPC) / London Transport Users Committee (LTUC)
29. Scottish Executive (SE)
30. Sestran
31. South East Wales Transport Alliance (SEWTA)
32. Shearman & Sterling
33. South Hampshire Rapid Transport
34. South Lanarkshire Council
35. Strategic Rail Authority (SRA)
36. Strathclyde PTE
37. Transport for London (TfL)
38. The Mersey Docks & Harbour Company
39. The Potter Group
40. TIE Ltd
41. Victa Railfreight
42. Warwickshire County Council
43. Yn Ein Blaenau

44. Yorkshire & Humber Assembly

Annex B: Arrangements for the Network Rail Discretionary Fund (NRDF)

1. Consultees said they would welcome some clarification on the process of identifying suitable schemes for the NRDF, and on how we plan to:

   - monitor the fund;
   - ensure Network Rail appraises these schemes using suitable criteria;
   - determine their enhancement element; and
   - guarantee "equal opportunities" between freight and passenger schemes.

2. The Department for Transport (DfT) has now confirmed that it supports the financial commitment for the NRDF of £200 million 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 DfT and the Scottish Executive (SE), 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.

3. We have assessed four pilot schemes which DfT has committed to fund as part of the overall NRDF funding, and is content that these schemes should deliver efficiently-priced outputs for the benefit of the industry, subject to receiving clarification from Network Rail on some technical issues, including alignment with Network Rail's GRIP[38] process. The following pilot schemes have been used to develop the appraisal and monitoring framework for the NRDF:

   - Peterborough-Werrington bi-directional signalling;
   - Tyseley South;
   - a new turnback at Tunbridge Wells; and
   - Basingstoke loop.

[38] See the Glossary in Annex C for an explanation of this term.

4. DfT and the SE, in discussion with us and Network Rail, are producing appraisal criteria which Network Rail will use 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. We are intending to publish these criteria in our *Guidelines for investment* document.

5. Network Rail should 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.

6. We will monitor Network Rail's use of the NRDF in two ways:

   - at year-end, Network Rail should include details in its regulatory accounts of all NRDF schemes, using the standard reporting template[39], and the independent regulatory Reporters will assess a representative sample of schemes to confirm delivery of outputs and that the renewal/enhancement split of costs is appropriate; and

   - Network Rail will also produce quarterly summary reports, setting out actual and budgeted NRDF expenditure and showing progress in achieving outputs. These reports should have the benefit of identifying any material issues with NRDF schemes on an ongoing basis.

7. In summary, the arrangements for identifying and delivering NRDF schemes are expected to 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 on a regular basis (at least quarterly) of this information for schemes under development;

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

- 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 and annual basis;
- the independent regulatory Reporters audit a representative sample of schemes, using the information on Network Rail's scheme files; and
- we will confirm the efficient net additional costs to be added to the RAB.

8. Detailed arrangements for the NRDF will be established and published by Network Rail before the end of 2005, and will be included in our *Guidelines for investment*. We expect that in future, NRDF schemes (or at least potential schemes) will be included in Network Rail's annual business plans.

Annex C: Glossary

This glossary contains a common set of definitions and descriptions for categories of investment, or types of works, for the stakeholders involved, for the different stages of a scheme and for categories of risk that commonly arise on schemes.

Types of works/investments

Accelerated renewals: renewals brought forward from future years, usually because of a link to a particular investment scheme, which means that it is more efficient to do the work now.

Enhancement: a change to network outputs, usually involving construction, that improves network capacity or capability (e.g. enabling higher speeds, allowing heavier loads) relative to the level of network outputs funded at the last relevant periodic review. Usually outputs are required at specific times (in contrast to most renewals).

Investment: investments cover all enhancements but also includes major projects such as route upgrades or the renewal of Network Rail’s telecoms network.

Project (or scheme): investment activity (involving capital expenditure) delivering specific outputs at specific times.

Renewal: major capital works or replacement of the network in order to maintain its required capability. These may be required at specific times but are more often carried out according to Network Rail’s own timetable.

Stakeholders

Customer: the body that requires the outputs to be delivered by the investment, usually in order to make use of the outputs. The customer may be Government (where, for example, it has a specific requirement to comply with legislation), an operator or an ‘external’ third party such as BAA or a freight end-customer. Also referred to as the “client”, to differentiate from the term “customer” as defined in Network Rail’s Network Licence, where the term “customer” refers to a body with an access agreement with Network Rail.

Designer: the body commissioned by the scheme promoter to provide design and/or development services.

Delivery agent: the body responsible for delivery of the required works or outputs, usually through the management of contractor(s). In the existing investment framework, Network Rail is assumed to be the delivery agent for most schemes, and currently it is still the delivery agent for many schemes.

Facilitator: Network Rail is required to facilitate all investment schemes on the rail network through the provision of (at a minimum) network operator services e.g. possession management.

Funder: the body paying for the scheme. The funder is not necessarily the same body as the customer: for example, schemes financed with external capital usually have a funder separate from the customer. Government is currently the primary funder of investment schemes, either directly (e.g. SRNTP) or indirectly (through support for a local authority scheme), although other bodies providing funding to the rail industry (either directly or through support for local services) include:

- the Scottish Executive;
- the Welsh Assembly;
- Passenger Transport Executives (PTEs); and
- Transport for London (TfL).

Government: in the context of this document, “Government” is currently the Strategic Rail Authority (SRA), the Department for Transport (DfT) or Scottish Ministers. If responsibility for investment is passed to other devolved governmental bodies or regional funding bodies, these bodies would be assumed to have responsibility within their area(s) of jurisdiction.

Promoter/sponsor: the body acting as a champion for the scheme, who specifies the outputs required from the scheme - often the same as the customer.

Third party: a promoter, customer or funder other than central Government: including operators, Regional Assemblies, PTEs, developers or other providers of finance.

To illustrate some of the terms above, consider a typical scheme required by a Local Authority (who is a third party) and carried out by Network Rail, such as an upgrade to an existing rail station. In this case, the promoter is the Local Authority, the customer is the local operator(s), the (ultimate) funder is Government, and Network Rail is the delivery agent.

Stages of a scheme

The stages for a scheme (and associated processes) from Network Rail's perspective are set out in more detail in the Network Rail manual *Guide to Rail Investment Projects (GRIP)*, which provides an objective, structured approach to project management. GRIP has been rolled out across the company and is used for all renewals and enhancement schemes. The key stages in a typical project set out below can be directly mapped to GRIP Stages.

Feasibility *(GRIP Stages 1-2)*: a scheme is conceptualised by the customer, who typically carries out a high-level desktop analysis of whether or not the scheme meets the customer's investment criteria, which (for example) may relate to the estimated Net Present Value (NPV) of the scheme.

Design and development *(GRIP Stages 3-5)*: once the customer is satisfied that the scheme meets its investment criteria, it will then commission detailed design and development work to price the scheme, usually involving survey work and an analysis of the risk associated with implementing the scheme. At the end of this stage the customer should also have selected a suitable delivery agent, who will offer the customer a price for the scheme.

Implementation *(GRIP Stage 6)*: the delivery agent now manages or carries out the works to deliver the outputs required by the customer - this stage is also referred to as the construction phase of the scheme. Usually the delivery agent will employ contractors to carry out the construction work required.

Acceptance *(GRIP Stage 7)*: once the works are complete, any new infrastructure or changes to existing infrastructure needs to be accepted by Network Rail in accordance with relevant Group Standards, and any other acceptance criteria specified by Network Rail in advance. Usually the customer cannot be sure that its required outputs have been delivered until the enhanced assets have been accepted by Network Rail.

Operation *(following Project Close Out - GRIP Stage 8)*: following acceptance of the assets, the operations stage begins, where the enhanced assets are operated by a relevant facility operator (usually Network Rail) and ongoing risks are therefore passed to the relevant facility operator.

Types of risk

Network operator risks: risks due to provision of network operator services, i.e. providing information on existing assets, providing access to the network (through booking possessions and engineering safety management approvals), facilitating applications for consents such as Network or Station Change processes, and (in most cases) timetabling.

Design risk: the risk that design work is not carried out according to the promoter's requirements.

Construction risk: risks relating to the construction phase of a scheme.

Funding/financing risks: risks relating to availability/cost of providing funding and finance for the scheme.

Output risk: the risk that works are completed according to the design specification but required outputs (either specified physical assets or improvements to network capacity or capability) are not available. If Network Rail is asked to bear this risk, all parties must recognise that Network Rail can only bear and mitigate risk within its control, i.e. output risk is borne but with the qualification that if the output required depends on other elements of the railway (such as availability of suitable rolling stock), Network Rail will not bear this risk. The element of output risk within Network Rail's control is referred to as "infrastructure capability risk".

Demand risk: risks relating to volume of trains, freight or passengers.

Operational risk: risks relating to the operation, maintenance and renewal of the enhanced assets.

Other key terms

Contingency: where a scheme is costed on a fixed price or target price basis, a cost estimate is prepared in advance which should contain an amount (the **contingency**) based on allowances for unforeseen risks, which is over and above allowances for identified risks.

Regulatory Asset Base (RAB): our valuation of the Network Rail assets, on which Network Rail is allowed to earn a return.