



OFFICE OF RAIL REGULATION

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## **REASONS FOR THE DECISION OF THE OFFICE OF RAIL REGULATION ON AN APPLICATION FROM GRAND CENTRAL RAILWAY COMPANY LIMITED UNDER SECTION 17 OF THE RAILWAYS ACT 1993**

### **Application**

- 1 On 25 July 2007, Grand Central Railway Company Limited ("Grand Central") applied to the Office of Rail Regulation ("ORR") under section 17 of the Railways Act 1993 as amended ("the Act"). In its application, it asked us to give directions to Northern Rail Limited ("Northern") to enter into a Depot Access Agreement ("DAA") in respect of Newcastle upon Tyne Heaton depot ("Heaton"), where Northern is the Depot Facility Owner ("DFO").
- 2 Grand Central has made an application under section 17 of the Act because the parties could not agree payment terms for depot access charges.

### **Grounds for disagreement**

- 3 The parties have agreed on most elements of the access contract. However, they have been unable to agree upon the terms for payment of the depot access charges. Having undertaken credit checks for Grand Central and for the other beneficiaries at Heaton, Northern considered that Grand Central posed a greater credit risk than the other beneficiaries. Northern decided that it was reasonable for it to seek to mitigate this risk by requesting that Grand Central pay invoices for depot access charges within 5 days of receipt (as opposed to the usual 28 days).

- 4 Northern stated that it did not seek to benefit from requiring payment of invoices within 5 days and notified Grand Central that:
- (i) it was willing to include provisions in the DAA that payment terms should move to 28 days if after 12 months Grand Central's operational and financial performance demonstrated that to be appropriate; and
  - (ii) it was also willing to account to Grand Central for any interest it received on payment of access charges between day 5 and day 28.
- 5 Northern also stated that it would consider accepting a 28 day payment period if Grand Central:
- (i) provided Northern with satisfactory security (bank guarantee, letter of credit or guarantee) securing Grand Central's payment obligations under the DAA in favour of Northern; or
  - (ii) made payment of access charges into an escrow account on day 5, to which Northern would have access on day 28, with the interest accruing being payable to Grand Central.
- 6 Grand Central argued that it was not reasonable for Northern to insist on payment terms of 5 days and that to do so amounted to undue discrimination. Grand Central also argued that ORR had carried out a financial fitness test when granting it a licence to operate and that Northern was now seeking to challenge the robustness of that process by questioning Grand Central's financial fitness.
- 7 Northern argued that it was not being discriminatory by seeking to apply different payment terms to Grand Central and that it was merely responding to a different credit risk that Grand Central represents when compared to other beneficiaries at its Heaton Depot. Northern also argued that it is entitled to discriminate and that its obligation is not to discriminate unduly.

## **Process**

- 8 In considering this application, we have followed the consultation procedure specified in Schedule 4 of the Act. Northern named the Department for Transport ("DfT") and Network Rail ("NR") as Interested Parties in this application.

## **Consultation Responses**

- 9 We received responses from NR (dated 22 August 2007) and DfT (dated 29 August 2007). Neither party had any specific comments on the case.

## **Decision**

- 10 We have decided to issue directions to Northern under section 17 of the Act, approving the terms of the proposed access contract submitted by Grand Central with its application, subject to certain modifications. Having consulted with Grand Central and Northern, we have issued directions to this effect.
- 11 In particular, and after careful consideration of all parties' representations, we have decided for the reasons set out below that it is appropriate to include provisions providing that:
  - (a) Grand Central pay Northern within 5 Business Days of submission of an invoice;
  - (b) Northern and Grand Central will review the invoice payment terms after 12 months; and
  - (c) Northern must account to Grand Central for any interest it receives on payment of the charges between the date of payment and 28 days after submission of the invoice.
- 12 For the reasons set out below, we are content that this decision represents the appropriate balancing of our section 4 duties under the Act.
- 13 The directions stipulate that the contract must be entered into no later than 8 November 2007. Our directions have been issued separately to Northern and will be published on our website (<http://www.rail-reg.gov.uk>).

## **The Railways Act 1993**

- 14 Under the Act, anyone seeking access to a light maintenance depot for the purposes of obtaining light maintenance services must enter into a contract approved or directed by us. An access contract that we do not approve or direct will be void. Where an applicant for access cannot agree the terms of access with the facility owner the applicant is entitled to apply to us under section 17 to direct the facility owner to enter into the access contract on specified terms. Light maintenance services are defined in the Act to include refuelling.
- 15 When we exercise our functions under Part 1 of the Act, we are governed by our statutory duties, most of which are set out in section 4 of the Act. There is no statutory order of priority amongst these duties, and it is for us to balance them and give each appropriate weight in the circumstances of an individual case. In considering the application and in reaching our decision as to appropriate directions in this case, we have had regard to our duties under section 4 of the Act as amended, complied with the statutory procedures, and adhered to the process and timescales set out in Schedule 4 to the Act.

16 In relation to this case and for the reasons set out below, we have given particular weight to the following duties:

- Section 4(1) (a) otherwise to protect the interests of users of railway services;
- Section 4(1) (b) to promote the use of the railway network in Great Britain for the carriage of passengers and goods and the development of that network, to the greatest extent that we consider reasonably practicable;
- Section 4(1) (d) to promote competition in the provision of railway services for the benefit of users of railway services;
- Section 4(1) (g) to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance; and
- Section 4(2) to exercise the functions assigned or transferred to it [ORR] under or by virtue of this Part [Part 1 of the Railways Act 1993] or the Railways Act 2005 that are not safety functions in the manner which it considers is best calculated to protect –
  - (b) the interests of persons providing services for the carriage of passengers or goods by railway in their use of any railway facilities which are for the time being vested in a private sector operator, in respect of –
    - (i) the prices charged for such use.

### **Issues for consideration**

17 In the present case, we have particularly considered the following:

- (iii) whether Northern used a fair and reasonable procedure to reach its decision to require Grand Central to accept payment terms that are different to those enjoyed by other beneficiaries at the depot; and
- (iv) whether the provision sought by Northern was proportionate to the increased risk facing Northern and the materiality of that risk to Northern's business.

### **Has Northern adopted a fair and reasonable approach?**

18 In paragraph 5 of its Representations, Northern set out the reasoning for its insistence on a 5-day payment period for Grand Central.

- 19 Northern included, with its Representations, credit rating reports on Grand Central and on the other beneficiaries at the depot. We consider that it is reasonable and justifiable for Northern, as a commercial undertaking, to manage the credit risk it incurs, and to use such reports as part of its decision making process.
- 20 Northern obtained a credit report for Grand Central and all other Beneficiaries at the depot, except for Serco Ltd. Grand Central's credit report recommended that Northern offer no credit at all to Grand Central. The credit reports for all other beneficiaries recommended at least some level of credit. Northern has relied on these credit reports to assess the risk posed by doing business with Grand Central as compared to other beneficiaries at the depot.
- 21 Northern pointed out, in its representations at paragraph 7.7, that it was unable to obtain detailed information on Grand Central's finances or its ownership/group structure, despite having requested this information from Grand Central. Further, Northern stated in its letter to Grand Central, dated 3 August 2007 (a copy of which was provided with Northern's representations), that "If [Grand Central] could provide information showing our business risk under a Grand Central DAA will be broadly equivalent to that under a DAA with other beneficiaries, we would consider adjusting our requirements to match that".
- 22 We therefore consider it reasonable for Northern to rely on the credit reports as a reason to vary the credit period for Grand Central and we are satisfied that Northern has used a fair and reasonable approach in reaching this decision.

**Was Northern's response proportionate to the increased risk and to the materiality of that risk to Northern's business?**

- 23 We would expect, other things being equal, a start-up company to have a poorer credit rating than a more established company. A start-up company (such as Grand Central) would be unable to present any evidence of its trading history. We would expect this to change over time and so we have incorporated a mechanism to re-open the disputed clause in this contract once Grand Central has 12 months credit history at the depot.
- 24 In its response<sup>1</sup> to Northern's Representations, Grand Central has raised (paragraph 7.2 - 7.3) the fact that [redacted information] does not have a significantly better credit rating score than itself. However, we have taken note of the fact that the credit check company, n2check, recommended that Grand Central be offered no credit at all. In contrast, it suggested a credit limit of [redacted information] for [redacted information]. This seems directly relevant to the treatment of the disputed clause. It also demonstrated Northern's willingness to act

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<sup>1</sup> Dated 28 August 2007

reasonably by allowing Grand Central a degree of credit, rather than insisting on payment on delivery.

- 25 We also note that the report from n2check on Grand Central stated that, “No group structure is available for this company”. Northern included in its Representations a letter<sup>2</sup> to Grand Central requesting further information as to its financial and operational risk. Northern advised us that it received no response to this request. Northern did take this non-supply of information into account in deciding credit terms and indicated this information was sufficiently material that its supply could have altered their decision to Grand Central’s advantage. We consider it was reasonable for Northern to take into account this non-supply of information in its assessment of risk.
- 26 We have considered Northern’s argument that Grand Central represents a greater contractual risk because it does not have a franchise agreement. We do not wholly accept this reasoning. In particular, Northern has sought to rely on the Franchising Authority’s obligations under section 30 of the Act. This section does not place any obligation on the Franchising Authority to make good outstanding debts. This means that Northern could equally suffer financial loss if a franchised operator went into insolvency leaving Northern’s debts unpaid.
- 27 Section 4 (1) (g) of the Act, set out above, requires us to have regard to Northern’s ability to plan the future of its business with a reasonable degree of assurance. Northern stated in its Representations (paragraph 6.3) that it has obligations to act in the best interests of the company and to exercise due care and skill in the performance of its duties. We consider it reasonable for Northern to take this into account in reaching its decision. We have given particular weight to this duty in reaching this position.
- 28 Northern has demonstrated in its Representations the potential impact on its business of Grand Central defaulting on payment. These conclusions are logical and rational.
- 29 Where we decide that it is legitimate for an operator to require different contractual arrangements for different customers, the question remains whether the degree of difference in the contract terms is justified. In this particular case, we have considered whether the different payment terms offered to Grand Central are justified by the risks identified by Northern if it enters into an access contract with Grand Central.
- 30 Following careful consideration, we are satisfied with Northern’s explanations and its reasons for offering different payment terms to Grand Central. We consider that

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<sup>2</sup> Dated 3 August 2007

the credit period suggested would limit Northern's potential loss caused by a payment default by Grand Central and would not impose an unnecessary burden on Grand Central.

- 31 In particular, we consider that the 5 Business Day credit period, combined with the additional contract changes listed in paragraph 11 and again below, create a fair and proportionate protection for Northern from the additional potential risks posed by contracting with Grand Central.

### **The granting of a licence by ORR to Grand Central**

- 32 Grand Central argued that, in granting it a licence, ORR carried out a financial fitness test. It claimed that Northern's decision to vary the payment terms for Grand Central based on concerns over its financial fitness amounted to a challenge of the robustness of the ORR process.
- 33 We do not agree with this argument. In deciding whether to grant a licence, we have regard to our duties (summarised on our website<sup>3</sup>), and to criteria set down in *The Railways (Licensing of Railway Undertakings) Regulations 2005*<sup>4</sup>. Therefore, we will need to see evidence of an applicant's suitability to operate railway assets and its ability to meet the various obligations that come with such a licence. However, the granting of a licence does not provide any form of assurance upon which third parties may rely in relation to the financial position of the licence holder. The documents *Licensing Review: Conclusions (January 2006)*<sup>5</sup> (in particular paragraph 2.12) and also *Railway Licensing: Guidance for Applicants (March 2006)*<sup>6</sup> (in particular paragraphs 1.7 and 3.8) give more information.
- 34 Once a licence has been granted, it is then a matter for contracting parties to seek to agree the terms of their access agreements, based on commercial and other relevant factors. Where agreement is not possible, it is open to the applicant seeking access to ask ORR to issue directions (as happened in this case). We determine each case on its individual merits.

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<sup>3</sup> <http://www.rail-reg.gov.uk/server/show/ConWebDoc.5056>

<sup>4</sup> <http://www.opsi.gov.uk/si2005/20053050.htm>

<sup>5</sup> <http://www.rail-reg.gov.uk/upload/pdf/271.pdf>

<sup>6</sup> [http://www.rail-reg.gov.uk/upload/pdf/278\\_licguid.pdf](http://www.rail-reg.gov.uk/upload/pdf/278_licguid.pdf)

## **Other ORR decisions**

- 35 At paragraph 11 of Northern's Responses<sup>7</sup>, Northern explained why we should distinguish our previous decision concerning the terms Network Rail sought to impose in Grand Central's track access contract<sup>8</sup>. We consider that the two decisions can be distinguished on the basis that Network Rail's proposal did not follow proportionate efforts to establish whether Grand Central presented a sufficiently increased credit risk, nor did it take account of the different mechanisms in the track access contract relating to default.

## **Changes to the contract contained in the application**

- 36 Although we agree that Northern is justified in proposing a shorter period of credit in this case, we consider that there are significant benefits arising from standard charging provisions for essential light maintenance supplies, such as fuel. We do not believe that the circumstances which have arisen here, however, are likely to be common or to arise on a regular basis. Our experience is that nearly all train operators are able to demonstrate a sufficiently satisfactory credit record to justify the standard credit period. In addition, Northern has indicated that it has no desire to profit from its proposed approach and that it would be prepared to revert to standard terms of payment once Grand Central can demonstrate a reliable payment history. We have, therefore, included in the contract an additional clause (Clause 5) which provides that:
- (i) for the first 12 months of the contract or for a longer period agreed between the parties:
    - (a) Condition F.2.1 of the Depot Access Conditions does not apply; and
    - (b) Grand Central shall pay to Northern the Access Charge for each Accounting Period within 5 Business Days of the receipt of the invoice;
  - (ii) Northern shall account to Grand Central for Interest (to accrue daily) on the amount of paid Access Charges from the date of payment until 28 days after the receipt of the invoice. Interest will be calculated on the base lending rate at Barclays Bank PLC;
  - (iii) after the first 10 months of the contract, Northern and Grand Central shall meet to determine whether the 5 Business Days payment term should cease to operate; and

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<sup>7</sup> Dated 16<sup>th</sup> August 2007

<sup>8</sup> [http://www.rail-reg.gov.uk/upload/pdf/s17-GC\\_deklet.pdf](http://www.rail-reg.gov.uk/upload/pdf/s17-GC_deklet.pdf)

- (iv) where Northern and Grand Central are unable to come to agreement on whether the 5 Business Days payment should cease to operate, the parties shall refer the matter to us.

We have included a clause in the contract (clause 5.4) that directs the parties to meet not later than 10 months after the agreement commences to determine whether the 5 business days payment term should cease to operate. The purpose of this clause is to give the parties adequate time to decide upon this issue and, if agreement cannot be reached, to submit an application to ORR for determination, before a period of 12 months has elapsed.

### **Next steps**

- 37 Please note that until the access agreement is signed none of the provisions contained within it are applicable. The directions state that the access agreement should be entered into **not later than 8 November 2007**. As stipulated in section 72(5) of the Act, a copy of the signed access agreement must be sent to us **not later than 14 days** after the date upon which the access agreement is entered into.
- 38 The Office of Rail Regulation is required under section 72 of the Act to maintain a public register, which includes provisions of every direction to enter into an access contract and every access agreement. In entering any provision in the register, the Office of Rail Regulation is required to have regard to the need for excluding, as far as that is practicable, the matters referred to in section 72(3) of the Act.
- 39 I am therefore seeking representations from the parties about which (if any) aspects of the access agreement you wish us to consider excluding from the document that is placed on the public register (in addition to those matters already set out in our policy statement). Please submit your representations at the time you send the signed access agreement to me.

Yours sincerely

**Brian Kogan**