

DfT response to ORR consultation document on Network Rail's investment framework

1. General

- 1.1 This draft framework is a useful document that reflects much of the work done over the past two and a half years since Network Rail's purchase of Railtrack, and particularly arising from the DfT chaired Investment Working Group.
- 1.2 DfT has some comments on several areas of the document and these are set out below. These comments are generally at quite a high level and focus on the main remaining issues that DfT thinks need further attention to deliver the investment framework that is required in the industry following the Rail Review. SRA will also respond to ORR's consultation. The two responses are aligned in their content and views; SRA will focus its response on some more detailed issues drawn from their close experience of investment schemes over the last few years and will raise some specific issues on Network Rail's submission on the third party investment framework.

2. DfT's objectives in its response

- 2.1 There are two main objectives behind DfT's response, related to its particular locus in respect of investments:
- 2.2 Firstly, the Rail Review White Paper envisaged DfT buying investments primarily through the High Level Output Statement ('HLOS'). The framework for the specification and delivery of these investments would be part of the overall periodic review process. However, DfT will also buy discrete large-scale projects over and above the HLOS requirements (sometimes on our own account and sometimes in partnership, for example with the Scottish Executive, the Welsh Assembly Government, Transport for London or a PTE). These investments may largely be on the existing network and delivered by Network Rail in whole or part, or they may be substantially off-network and possibly delivered by another vehicle. In either case their size and complexity is likely to require bespoke governance, funding, project management and risk allocation structures. We need ORR's investment framework to provide us with the necessary flexibility to deliver this, which it does not do at present.
- 2.3 Secondly we need to be sure that the framework facilitates third party investment. There is a wide range of parties (including local authorities, developers, TOCs, FOCs, port and airport operators) who may seek investment to be undertaken in or around the railway. In our view, ORR's framework needs to deliver to these parties a clear picture of what they should be able to expect from Network Rail and an effective set of arrangements for taking schemes forward. The framework should

also explicitly show how ORR will work to create an environment that encourages investment in and development of the railway, especially by third parties.

3. Output risk

- 3.1 ORR is right to give some focus in its consultation document to the proper allocation of investment risks between the industry parties (paras 3.6 to 3.15). DfT also agrees with the overall categorisation of risks that ORR makes in its document and, in most cases, with the suggested default allocation of risk.
- 3.2 However, in our view the reference to output risk in the consultation document (particularly in para 3.12) is ambiguous and the discussion is at too high a level for the framework to be properly defined in this respect. This is an important issue since the way in which output risk is defined and allocated will determine how much responsibility Network Rail is passed for delivering infrastructure outputs from the investments it makes in its assets and, by the corollary, how much responsibility will need to be taken by other parties. We consider that the proposals on this issue need to be developed further.
- 3.3 In our view there are different levels of output that can be achieved from rail investments. There are train services (passenger and freight), which can only be delivered by the whole railway system of infrastructure, rolling stock and operation. However, 'upstream' from these train service outputs, there are also 'infrastructure capability' outputs which Network Rail can generally deliver through its role. And feeding into these infrastructure capability outputs there are the inputs, or individual asset investments, that Network Rail makes on the network. The document needs to recognise these distinctions and address how Network Rail may carry risk for delivering infrastructure capability whilst at the same time delivering that infrastructure in such a way as to optimise the whole system solution.
- 3.4 If Network Rail takes responsibility only for delivering inputs then customers will be exposed by Network Rail being incentivised only to deliver assets and not to ensure these deliver the required improvements in infrastructure capability. If, on the other hand, Network Rail is passed the risk of delivering new or improved train services, it may be required to deliver overall industry outcomes that are not within its sole gift to achieve.
- 3.5 Recent and emerging agreements with Network Rail on investment schemes have seen some progress in defining an appropriate set of responsibilities, and therefore risks, that the company should take. In some cases these agreements have recognised that Network Rail can not commit to providing new access rights upfront. They have recognised though that the company can demonstrate, on the basis of modelling simulation, that some specific 'infrastructure capability'

outputs, which it can commit to deliver, should lead to these access rights being made available, so long as other parties deliver what is required of them. None of this implies that Network Rail should not play its part in helping manage those risks that are not fully under its control, as is required in the new industry model. DfT considers that approaches such as these constitute a sensible allocation of responsibility and risk and should form the basis of the risk allocation in ORR's framework.

3.6 DfT would therefore seek that ORR develops its proposals further in this area. In particular it would suggest that ORR:

- defines in more detail what is meant by outputs and output risk, recognising the difference between infrastructure capability and whole system output, and the different levels of output risk that can be considered. In particular, it should seek to identify those that are directly related to the investment itself (that is the delivery and functionality of the new assets), those that are a function of the wider environment but largely under Network Rail's control and those that are part of the wider environment and largely outside the company's control;
- on the basis of this, proposes in more detail, what types of infrastructure capability risk Network Rail would be expected to take, how it would ensure that the overall railway system is optimised despite Network Rail's exposure to risk on part of that system only, and what types of risk customers should bear. It should also consider how this allocation of responsibility should allow DfT the necessary flexibility in influencing *how* outputs are achieved;
- in doing so, considers how different types of investment, for example stations versus track, or route upgrades versus specific asset investments, influence the definition and allocation of such risk.

4. Third party investment

4.1 DfT considers it very important that the investment framework facilitates investments by third parties. In its conclusions we hope that ORR will also express this objective and set out the framework clearly for doing so. DfT and SRA have worked with Network Rail in the development of its proposals, to which ORR refers in its document, and believe that they are an important step forward in meeting this purpose. The ultimate success of these proposals will depend both on their detailed workings (on which SRA will respond to ORR) and on Network Rail behaving positively and constructively towards third parties in its execution of the arrangements. It is our understanding that ORR will undertake a detailed and challenging review of Network Rail's proposed template arrangements and ensure that the final versions to be implemented are fit for purpose.

- 4.2 However, in this response DfT needs to raise some issues that relate to its role in such investments. This role is defined through its strategic interest in developing the network and by it being ultimately required to fund scheme costs through their inclusion in the RAB.
- 4.3 Firstly, DfT agrees with the principles of Network Rail's fee fund and industry risk fund (para 3.51) and of Network Rail being exposed to a band of risk beyond the capacity of those funds. However, since Government is to be exposed to risk on such schemes beyond that point (through inclusion of costs in the RAB) it is important that these arrangements are properly designed, as far as they efficiently can be, to minimise the prospects of Government being inappropriately exposed in this way. It is also important that the provision for some risks through a fund does not lead to a less clear and focused management of these risks by the responsible party. To this end, it is important that there is a clear and transparent process for properly allocating claims for risks to these funds and ensuring that they do not become a sink for all cost overruns.
- 4.4 Secondly, the ORR document is not as clear as it might be in describing how the framework applies to different groups of promoters for investment. For example, it should explicitly state whether projects promoted by Government third parties, for example the Scottish Executive, are to be treated differently to those promoted by other industry and non-industry third parties. It should also be considered whether the default risk allocation can effectively be identical in third party schemes, given Government's unique role.
- 4.5 Thirdly, in DfT's view the impact of incidents elsewhere on the network (para 3.55) should not be set against the industry risk fund as this would create a perverse incentive for Network Rail to prioritise its own and fixed price schemes at the expense of third party schemes.
- 4.6 Fourthly, the proposed arrangements largely focus on sponsorship by third parties and do not address in any detail how delivery of investments could be made by third parties. DfT considers it important for ORR to make clear what scope there is for such third party delivery and how it would work.
- 4.7 Finally, it is our view that ORR's framework needs to encompass the contractual arrangements that are being developed but also provide to third parties:
- clarity about what Network Rail is already funded to deliver, principally through its Periodic Review settlement;
 - a process for ensuring the fit of third party investments with the strategic development of the network under HLOS and the RUSs;

- time limits within which Network Rail should give a positive or negative response to a proposition and commit to a price;
 - a realistic apportionment of risk; and
 - a straightforward and expeditious appeal and dispute resolution mechanism where Network Rail is considered not to be delivering.
- 4.8 In reality, it is likely that this framework needs both to be managed carefully and to develop over time. We would seek that ORR recognises this in its conclusions and takes the leading role in the ongoing governance of this framework.

5. Price setting

- 5.1 In ORR's document, there is some emphasis on the fixing of an 'efficient' price of investments by Network Rail (for example para 3.3). It needs to be recognised that the scope for significant cost overruns on investment schemes (as evident from the past) gives Network Rail an impetus to set any fixed price in a very conservative manner. Its monopoly position will always make it difficult for ORR to scrutinise and prevent this. It needs to be recognised, therefore, that setting fixed prices may lead to disproportionately high costs for investment schemes. However, it should also be noted that Network Rail is motivated by reputation and future performance improvements from capital projects delivery. It is our view therefore that the pricing regime outlined in the ORR document should be based on a more sophisticated view of Network Rail's incentives.
- 5.2 Whether Network Rail should offer a fixed price depends on the level of project development (and thus confidence of scope and risk), on the scale and type of the project, on the nature of the customer and on the outputs that Network Rail is being required to deliver. On this last point, it would seem logical that the more achievable are the required outputs within the scope of activity of Network Rail, the more appropriate should be a fixed price arrangement. A fixed price must be set to reflect equitably the incentives on Network Rail (as described above) and the treatment of risk. For all but the smallest schemes a target cost mechanism might be preferable, with an upper cap to protect third parties in particular.
- 5.3 We agree with ORR's proposal not to apply differential rates of return to different schemes (para 3.18). This is principally because applying differential values of return to cover investment risk would take the visibility of and control of risk away from project managers, who then have little or no incentive to invest in risk mitigation measures during development and construction. However, it is DfT's view that the proposals on the treatment of risk and contingency (para 3.23, in particular) need further consideration.

- 5.4 In our view, risk should be measured by a structured risk quantification process that forecasts the total outturn cost for investments at different levels of required confidence (probability). Contingency and risk allowances are usually assessed to cover very different circumstances. Risk allowances are based on bottom-up quantitative risk analyses and are set to cover the impact of foreseen or unforeseen events on the cost of delivering a set scope or outputs. It must be right that these are included in the scheme price. Contingencies are a top-down allowance set to cover the cost implications of changes to scope or output deriving from customer or external changes. Given that these latter changes to scope or outputs may not largely be at Network Rail's risk but instead at that of the investment customer, particularly if output risk is allocated as proposed above, it needs to be considered how any contingency be held proportionally by Network Rail and the customer.

6. Remunerating Network Rail

- 6.1 In respect of the proposals for logging up investments to the RAB (para 3.34), some clarification would be useful from ORR on the treatment of net revenue increases to Network Rail through increased track access charges or other payments arising from the investment - and in particular whether the addition to the RAB is adjusted to reflect such incremental revenues having arisen in a period before which they can be taken into account through the single till mechanism. It is DfT's view that this issue has been properly addressed and the approach properly set out in some recent investment agreements and that these should be referred to in developing the treatment of this issue in the investment framework.
- 6.2 The principle of assessing the efficiency of schemes 'ex ante' (set out in para 3.38) is strongly supported, with the proviso that this must be an exercise carried out in sufficient timescales to support the investor's programme objectives, and must assess the efficiency of the proposed scope, and not just the efficiency of price for a defined scope. In reality this will necessitate ORR's active participation in the later stages of project development and pricing if the efficiency assessment itself is to be effective.
- 6.3 Reference is made (para 3.46) to development activities not involving Network Rail diverting resources from other obligations. It is DfT's view that this in itself should have a test of reasonableness, with Network Rail obliged to provide development services as a part of its network stewardship obligations.

7. The planning framework

- 7.1 There is an implication in ORR's document (paras 1.1. and 1.2) that investments will normally be planned and authorised to a timetable that aligns with five yearly access charges reviews. Whilst the merits of including investments in periodic review settlements are clearly understood, in reality it seems unrealistic to adopt this principle

exclusively for an investment planning framework. Instead, the investment framework must recognise:

- that project development takes a reasonable period of time (and cost) in advance of a decision to invest. Work to reach that point must be funded, and allowed to progress to a proper project timetable rather than being made to fit with a 'once in five years' opportunity;
- that projects will be promoted and commenced in accordance with Network Rail's business planning cycles (annual); TOC franchise periods; government spending reviews; emergent route strategies; and emergent external demand.

8. Other issues

- 8.1 The consultation document is not explicit about whether DfT needs to have a contractual relationship with Network Rail where the latter is commissioned to deliver additional investments during a control period. Establishing contracts for investments might arguably complicate Network Rail's accountabilities, given its regulatory obligations, but might also clarify the requirements placed on Network Rail where complex and bespoke arrangements are being put in place for schemes. It is important to consider whether such arrangements would be necessary and, if so, under what circumstances.
- 8.2 In order to ensure that infrastructure investments lead to useful train services, in some cases it will be necessary to safeguard future access rights since any investor (and especially a third party) will want confidence that it will be able to use its investment and realise the benefits. We would seek the investment framework to explain what means there are available for doing this, which may include the use of the Network Code or the use of 'access options'.
- 8.3 Whilst it is agreed that it is not efficient for Network Rail to bear all liabilities relating to the accuracy of information it provides (para 2.19), it should carry a duty of care (reasonable skill care and diligence or similar) for the information that it does provide, and should provide clear statements to the user of Network Rail's opinion as to the quality (currency and completeness) of that information. Consideration might also be given to Network Rail being obliged to validate or undertake further surveys to meet the promoter's reasonable requirements – albeit at the promoter's cost.
- 8.4 The arrangements for compensation provisions (para 2.41) need review, particularly in the context of medium and large scale investments where there is significant impact on the franchise. The mechanism must allow for genuine reimbursement of direct TOC costs, with arrangements for treating lost (or gained) revenue to be determined by the franchising authority. There must also be arrangements for the TOC(s) to be funded

and (if necessary) incentivised to support delivery of the overall investment outputs (which may include changes to operating practice and cascade or procurement of rolling stock).

Department for Transport
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