

Mr Jon Clyne
Head of Financial Economics
Office of Rail Regulation
1 Waterhouse Square
138-142 Holborn
London EC1N 2TQ

13 April 2005

Dear Mr Clyne,

**COMMENTS ON ORR POLICY FRAMEWORK FOR INVESTMENTS:
AN INITIAL CONSULTATION**

Thameslink Rail and Southern, the Go Ahead Group Train Operating Companies are pleased to respond further to the ORR's initial consultation on the policy framework for investments.

We welcome the proposals to establish a policy framework for investments in the industry. This is essential to protect the interests of parties who want to make investments that do not feature highly on Network Rail's priorities, and establish guidelines in both time and costing to be observed by Network Rail in costing, developing, implementing and charging for infrastructure investments. This applies equally to the timely acceptance of maintenance responsibilities as to the costing and execution of capital works.

Having studied the initial consultation document in detail, we offer the following proposals and comments on the specific issues raised in the document.

2.51 Consultees are asked whether or not they agree:

- *with ORR's proposed approach to securing Network Rail's obligations in respect of investments; and*

Go-Ahead agrees with the approach proposed by ORR. It will clarify Network Rail's obligations and addresses many of the current barriers to investment, notably those related to the allocation and management of risk. The efforts to learn from other regulated industries are to be commended.

- *that Network rail has an appropriate set of incentives to facilitate and deliver investments.*

We remain concerned that the incentives for Network Rail will prove inadequate. The financial incentives for Network Rail will be relatively modest in relation to its overall investment programme, and are unlikely to offset the natural tendency of the organisation to focus on what it perceives as its highest strategic priorities. Our experience is that it is difficult to engage NR in schemes which deliver local and customer facing benefits as the company does not have directly customer facing KPIs. There is a tendency for local asset stewards in NR to regard local enhancements as additional maintenance responsibilities, without consideration of the benefit to the convenience of passengers and TOC operation. A regulatory mechanism to deal with this tendency would be extremely valuable – a set of decision criteria which enabled the ‘whole industry’ benefits to be agreed may be useful in this, backed up with a regulatory lever which links to NR’s enhancement responsibilities under its Licence.

3.15 Consultees are asked whether or not they agree:

(a) with ORR’s proposal that, in most cases, it is appropriate for Network Rail to offer the customer a fixed price or target price for delivery of the required outputs; and

The proposal for Network Rail to offer either a fixed or target price is a good one, however we remain concerned that residual risk aversion may lead to unacceptably high prices and discourage or prevent investment.

(b) with ORR’s proposed default allocation of risk.

Go-Ahead agrees with the proposed default allocation of risk.

3.24 Consultees are asked whether or not they agree with ORR’s proposal to reflect differing levels of scheme risk through the contingency, and also for their views on the appropriate levels of contingency, given the discussion above.

Go-Ahead agrees it would be impractical to apply different rates of return to reflect differing risks. Our main concerns with the proposed approach are with how it will be applied in practice. There is a concern that it will institutionalise cost-over runs and that too many projects will default to the 25% level of contingency. Who will decide the level of contingency if Network Rail and the proposer cannot agree?

3.42 Consultees are asked to comment on:

- *ORR’s proposal to make additions to the RAB for expenditure that has been efficiently incurred and adds to the economic value of the rail network;*

Go-Ahead agrees with the four criteria for adding investment expenditure to the RAB presented in clause 3.26 and supports the modification proposed in clause 3.27 to allow inclusion of expenditure that does not add value to Network Rail’s assets, but which enhances the economic value of the rail network.

Allowing expenditure on investments that do not add to the value of Network Rail’s physical assets should help to facilitate whole-industry solutions. It is important to avoid Network Rail blocking schemes that could be of net benefit to the whole industry on the ground that it was exposed to modest costs. Similarly, the framework needs to provide mechanisms that encourage co-operation between the infrastructure operator and its users.

- *The proposals for logging up investments to the RAB;*

The proposals look broadly acceptable. Network Rail would be unlikely to facilitate investments that could cause it to incur future expenditures if there was not a reasonable prospect of their being added to the RAB. It would however be iniquitous for Network Rail to receive a full return on investments that it had declined to fund, thereby obliging a third party to finance the investment. Clause 3.34 appears to address this issue.

- *The conditions which ORR believes should be met to achieve an efficient outcome; and*

The criteria set out in clause 3.35 appear reasonable. It is unclear how it will be possible to determine whether Network Rail's pricing was efficient for relatively small projects. Rail projects worth less than £5 million may not be attractive to contractors, given their complexity and the onerous terms that are often imposed so ad hoc tendering may not produce efficient prices. Conversely, Network Rail enjoys significant market power for procurement of rail investments. For example, it may be able to secure advantageous rates for plant hire through the use of frame agreements.

- *ORR's proposals to assess the efficiency of schemes on an ex ante basis.*

This is a good idea in principle, but may prove difficult to apply in practice. A key concern is the ability to establish consistent relevant pricing references to allow ex ante analysis.

3.49 Consultees are asked for their views on ORR's proposal to allow efficient written-off development costs incurred by Network Rail on schemes required by the Government to be added to the RAB.

This is largely a matter between Network Rail and the Government however, because these costs are added to the RAB, they may influence future track access charges. While it is reasonable that Network Rail is compensated for abortive works in pursuit of Government sponsored schemes, it is less obvious that these costs should be recovered via track access charges.

3.64 ORR would welcome consultees' views on any of the issues discussed above or other issues in relation to Network Rail's proposals not covered here.

The time taken from conception to completion for the smaller scale investments discussed in this proposal is of great concern. Train operators with seven year franchises could be left with only a very small time window in their franchise within which it is advantageous to propose projects. Similarly, the phasing of franchises may make it difficult for train operators to influence the Network Rail business plan.

It is our experience that Network Rail can add considerably to the cost and duration of projects by being dilatory in its acceptance of maintenance responsibilities upon their completion. The proposed framework will not address this important issue.

There is a need to establish mechanism to facilitate CAPEX/OPEX trade offs between Network Rail and its users. At present it is extremely difficult for a train operator to strike a deal with Network Rail to make capital investments that will achieve reductions in operating costs where these will not accrue to Network Rail directly.

The level of technical scrutiny that Network Rail gives to third party projects is often out of all proportion to their likely impact and Network Rail's risk exposures. It is our experience that such excessive scrutiny adds significantly to project costs and durations.

Yours sincerely,

KEITH LUDEMAN
Chief Executive – Rail