



STRATHCLYDE PASSENGER TRANSPORT'S RESPONSE TO THE OFFICE OF RAIL REGULATOR'S INITIAL CONSULTATION ON A POLICY FRAMEWORK FOR INVESTMENTS

1. Introduction

SPT agrees that in order to meet the needs of passengers and freight users, and the growth in demand, it is essential that there is an effective framework for delivering infrastructure enhancements.

As third party strategic planners, promoters and funders of investment on the Strathclyde Network for over 30 years SPT would welcome a regulatory and contractual framework that overcomes the barriers to investment as set out in the consultation document.

- a lack of clarity over Network Rail's role in investments, its obligations under condition 7 of its network license, 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 under Part G of the Network Code;
- 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 of operational emergency on the network or a scheme; and
- the approach to risk allocation, and risk avoidance.

SPT has experience of one or more of the above barriers impacting on its projects from feasibility to implementation. However, of particular concern to SPT is the way in which these and other the barriers have been translated into project specific contracts. The proposed development of regulated template clauses is welcomed. However, the "customisation" of such templates by "negotiation, with a monopoly supplier, leads to project specific clauses being introduced or projects being escalated to the next tier of Network Rail's templated agreements, at their sole discretion. In certain circumstances the templated structure of the agreements can be by and large abandoned in favour of "negotiated" development agreements for larger or more complex projects.

It is accepted that ORR can usefully rule on the applicability of templated clauses, or their variation, for specific projects. However, it is doubted whether ORR has the resource to review and rule upon bespoke contracts, or that a project programme could afford the time to have this carried out, where Network Rail have deemed the project to fall outside the types of project covered by the templated agreements. Unfortunately, in such a situation, the project promoter does not have the same power to negotiate terms, as does the sole supplier.

SPT accepts that the proposal by ORR to address these barriers by providing clarity on:

- Network Rail's obligations and how it should meet the customer's requirements;
- ORR's role in ensuring Network Rail meets these obligations; and
- The appropriate terms on which Network Rail should carry out investment schemes which have not already been funded at a periodic review;

will be of assistance. However, it is believed that the first two objectives will be easier to deliver than the last, which will be complicated by the many non-standard or complex projects that are difficult to fit within the templates. Network Rail's initial submission to ORR already demonstrates this.

The proposal that the effectiveness of the initiatives to remove barriers will be reviewed in the light of experience is welcomed. However, the relative speed of this consultation and planned timing of the solutions will result in some projects getting caught up in an interim period of uncertainty, until sufficient time has passed to provide the material for review. There is also the problem that many of the customers will have difficulty in responding to Network Rail's latest draft templates fully to allow the interests of this disparate group to be taken into account.

SPT also have some concerns about the lack of objectivity that Network Rail may have in approaching investments given the differing roles that they now have. We may have greater clarity on what they are paid to do under the terms of the Licence but it is inevitable that they will review investments with regard to their overall performance responsibilities and Route Utilisation Strategies. This could lead to perverse incentives, which may introduce a barrier to the progress of investments. Furthermore, it will be difficult to assess the efficacy of the policy until the separate documents on related areas of work have been published. It is encouraging that amongst these will be modifications to Network Rail's licence to include whole industry performance, planning and Route Utilisation Strategies. SPT trusts that in the light of the outcome of that consultation the content of the template agreements will be subject to review by both Network Rail and ORR.

It is also hoped that the implementation of Part 12 of the Network Code relating to information provision will be brought forward at an early stage. SPT's experience is that during feasibility studies the provision of information and, just as importantly, discussion thereof with the third party or its consultants attracts significant fees, in some cases in excess of the fees to consultants involved. Also there can be a condition attached where, as part of a Basic Services Agreement legal fees require to be paid in advance in anticipation of an Implementation Agreement being required.

There are also further hidden charges connected with the adequacy of the information supplied where Network Rail will seek the cost of updating records, which have not been updated when prior work on those items was last undertaken by others.

2. Network Rail's Role in Investments

Consultee's are asked whether or not they agree:

- **with ORR's proposed approach to securing Network Rail's obligations in respect of investments; and**
- **that Network Rail has an appropriate set of incentives to facilitate and deliver investment.**

SPT welcomes a uniform approach to network investment schemes and third party schemes that has appropriate appraisal criteria to prioritise between those activities. This is particularly important where Network Rail is providing the professional resource as delay in a project can be attributed to that resource being required for the core business. Advance planning of the resource should avoid this situation if it takes the enhancement obligation into account.

The principle underlying "logging up" of investments not identified at periodic review is accepted. However, it is unclear whether the true cost to the state of such investments being "logged up" is recognised where the third party is a public body such as SPT, which is not covered under paragraphs 2.14-2.15. This issue will be returned to later.

SPT supports ORR's division of Network Rail's role into five broad areas. SPT's comments, on how ORR expects NR to carry out that role, are made with reference to each of those areas.

Planning/project development

SPT agrees that Network Rail's role in planning and developing investment schemes are underpinned by its business plan, its route plans and RUSs and knowledge of its assets.

In theory each of these will assist in identifying and developing potential investments. Unfortunately, to date, no detailed business plan or robust RUS has been developed that would assist with this. It will be crucial that ORR assists in the development, and enforces the delivery, of such work for the benefit of investment.

On the issue of knowledge of its assets SPT has experience of how poor Network Rail's records can be. SPT accepts that scheme promoters may have to pay to carry out surveys to provide information on assets beyond what is required for Network Rail's core business. However, as this better asset knowledge should assist with Network Rail's ability to better plan the use of its network it should not seek to recover all costs for participating in such surveys. It is suggested that below a certain cost no charge should be made to recognise the benefit of access to such improved information. As referred to earlier SPT has had the unfortunate experience of being asked to pay Network Rail to enable them to update information which SPT believes should have been held for the purposes of its core business, and which should properly have been provided by them under its Licence.

Delivery

Whilst it is encouraging to note that Network Rail is strongly incentivised to deliver schemes effectively through a “fixed price” for schemes emanating from outputs established at periodic reviews, as identified by ORR, no such incentivisation exists for third party schemes. SPT’s experience is of emerging cost schemes with indicative prices, which contain generous contingencies.

SPT supports ORR’s expectation that Network Rail puts in place efficient delivery arrangements and offers fixed and target prices. SPT remains concerned that such fixed or target prices could be padded in certain areas of variable cost and could have over generous contingencies, particularly where these relate to risks that it has accepted as being in the best position to manage. It is unclear from the consultation paper how ORR will, or can, seek to avoid this except by its *ex post* or *ex ante* assessments. In the absence of competitive bids or a register of third party costs for comparable work it will be very difficult for a third party to effectively challenge Network Rail’s costs.

Financing

SPT have no experience of Network Rail financing projects and being remunerated by an income stream over time:

As identified earlier in the consultation paper Railtrack/Network Rail have required SPT projects to meet the “customer reasonable requirements” i.e. fully funded by SPT. Given the flow of railway funding in Scotland this leads to the following.

- SPT funds Network Rail and carries the capital debt for the investment or is grant funded for this by the Scottish Executive.
- SPT as signatory to the franchise funds the TOC to pay the access and other charges levied by Network Rail until the assets is accepted unto the RAB. There is normally no Long Term Charge during this period to recognise SPT’s capital contribution.
- The asset is accepted into the RAB. SPT is unclear whether Network Rail receives the same return on such assets as for those created by it and/or begins to levy a Long Term Charge.

At privatisation of the railway SPT received Deed of Assumption payments, as a proxy for the loan debt it carried for railway assets it had created, to avoid it having to pay twice for access to the same asset through access charges and servicing capital debt. It would be helpful to understand whether grant or debt funded assets promoted by a third party, which is a public body, once accepted into the RAB, leads to the public sector paying twice. This question is raised as at paragraph 3.33 of the consultation it refers to “...Network Rail buying the enhancement on completion....” Which suggests that ORR view an asset being accepted into the network, and ultimately the RAB, arising from Network Rail purchasing that asset. SPT’s experience is that not only are Network Rail costs high and contractual conditions dictated in its favour but the asset is viewed as a “gift”.

With regard to the investments undertaken by third party sponsors the suggestion that Network Rail acts in an essentially facilitation role underplays the ability of this role to cause cost and delay. Any investment adjoining a railway requires an Asset Protection Agreement under which NetworkRail take to themselves many of the controls normally held by an employer under a construction contract. They also seek high levels of protection for their existing asset during construction (soon to be dealt with by an additional insurance policy) and significant indemnification from issues arising post construction. This is not a facilitation role. SPT have found this situation particularly difficult in relation to an interchange project it is developing, largely on SPT land, adjoining an operational railway and replacing an existing interchange. Network Rail control of the scheme has been sought outside the boundaries of the heavy rail station to relate to SPT's subway station and the adjoining, but physically separate, bus stances.

Network Operation Services

SPT supports ORR's expectations but has experienced difficulties both with the quality of information and the expectation that it pay to correct any pre-existing defect. Furthermore the level of associated charges do not appear to be incremental. Are indicative or maximum charges proposed, as is the case for information provision by public bodies?

Monitoring/charge control/governance

SPT supports the high level policy in relation to this. However, the practical delivery of this is very much dependent upon the terms of the template agreements, or any variation thereof, (at time of writing SPT have not been able to review the latest drafts) and adequate secural of Network Rail's obligations through:

- the network licence
- access contracts including the Network Code
- sections 16A-1 of the Railways Act 1993 (as amended)
- an appropriate set of incentives to drive efficient behaviour by Network Rail and other stakeholders.

Without the time or opportunity to review the above SPT can only hope that the laudable objectives of this consultation will, in time, achieve the appropriate regulatory and contractual teeth.

Network Rail's network licence

Whilst SPT support ORR's proposal to have common standards, insofar as is possible, in relation to enhancements under the licence and third party schemes, it is more realistic for ORR to achieve this where licence conditions apply than where contracts with third parties rule. It is a nigh impossible task for ORR to oversee or arbitrate on every contract, especially where local complexities require a departure from template

conditions. ORR has in SPT's experience had difficulty in the past in successfully intervening in situations where SPT considered conditions were being dictated by a monopoly supplier and the same issues were being perceived or represented as "commercial negotiations" and therefore outside ORR's remit.

The Network Code

SPT would welcome a review of the way in which Network Change relates to investments. There is a tendency for the Network Code implications to be recognised at an early stage in a project but not to be progressed until the asset is physically complete. It can therefore be perceived to introduce delays to actual use of the asset. It may be beneficial for there to be a process that allows the change to be agreed in principle during the construction of the asset with a fast track sign off following physical completion.

Simplification of compensation provisions would be welcome.

Sections 16A-I

It is disappointing that this useful provision has not yet been brought into force as it could have assisted with the progression of a number of projects. SPT believe that the existence of the threat that the process could/would be used would be sufficient in many cases to unlock negotiations with Network Rail.

Incentives on Network Rail

The incentivisation of Network Rail by permitting it to keep any out performance against an agreed price with contingencies will need to be carefully managed. The customer will need some benchmark or independent review of the price to ensure that it is not over generous and easy to outperform.

With regard to the retention of the out performance on the RAB SPT would again seek clarification on the treatment of assets funded by a third party.

Reputational Incentives are heavily influenced by the existing perception the body and. The reputation of its predecessor and its own subsequent actions have led to a reputation in this area that will take Network Rail some time to recover from.

3. The terms on which Network Rail should carry out investments

Basis of Price

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 or target price for delivery of the required outputs; and**
- (b) with ORR's proposed default allocation of risk.**

SPT agrees that the price offered to a scheme promoter or funder by Network Rail also acts as an important mechanism for controlling the risk of cost overruns on schemes. Of the types of price estimates considered:

- fixed price;
- target price;
- emerging cost; and
- cost reimbursable,

SPT has only been offered emerging cost for projects ranging from feasibility studies to implementation agreements.

It is understood how the offer of a fixed price agreement and transfer of risk can be achieved for investments funded through periodic reviews. However, SPT is concerned that there are insufficient powers available to ORR to ensure that third parties obtain similar offers. Indeed Network Rail's submission to ORR shows that their analysis of the situation differs from ORR's and that fixed prices will only be available under two of their ten template agreements and in those cases only for projects of low risk of less than £2m or for other tendered projects of less than £10m. While this is an improvement on the current situation it falls far short of what ORR envisages.

It is also not set out how ORR expect Network Rail to arrive at those fixed prices or how ORR or the customer can effectively monitor their fairness in the absence of relevant benchmarks or a market based comparator. It is a basic principle of tendering that costs can be "hidden" in variable elements or provided for in over generous contingencies. Network Rail's approach to this is yet to be experienced as is the method and effectiveness of ORR's monitoring of the situation.

The consultation recognises that all transactions will not have to follow the templates if the parties wish to depart from them. This is a reasonable position given the complexity of the many projects that are on or adjoin the network. However, arriving at equitable contract terms is difficult when each party has unequal bargaining power. A sole supplier who is at best ambivalent about the enhancement has considerably more negotiating strength than a promoter who wishes to achieve its objective. There is a danger that there is a return to contracts that favour Network Rail if there is not adequate monitoring of such contracts. It has been suggested that the promoter can refer non-templated conditions to ORR for a ruling. However, it may be more effective if Network Rail had to clear with ORR why it could not offer a templated solution.

At a policy level SPT agrees that Network Rail should offer customers a fixed or target price for most projects. However, SPT remains concerned about the associated costs and the effectiveness of the sanctions available to ORR to achieve this.

Risk Allocation



SPT agrees that risk should lie with the party best able to manage it. In particular the following default allocation to Network Rail is supported:

- Network Operator risk;
- Design risk (when carried out or approved by Network Rail);
- Construction risk;
- Output risk (where Network Rail design and construct); and
- Operating risk

SPT also accepts that in circumstances where Network Rail funds a project it should take funding/financing risk and the third party should take Operational risk.

However, where the third party funds and Network Rail gets the benefit of the asset these roles should be reversed.

SPT broadly agrees with ORR's default allocation of risk but notes that Network Rail's submission does not appear to follow this.

Risks and levels of contingency for different schemes

- **Consultees are asked whether or not they agree with ORR's proposal to reflect differing levels of scheme risk through contingency, and also for their views on the appropriate level of contingency.**

In principle SPT are comfortable with ORR proposal, that the different levels of risk in different schemes are funded by different levels of contingency, where the scheme is being provided at a fixed or target price. The range of maximum contingencies with 15% for schemes less than £100m and 25% for those more than £100m seems reasonable. However, it would be hoped that Network Rail would still engage with the customer to arrive at a project specific risk no greater than the maxima proposed. This would avoid unnecessary ring fencing of public money, which would therefore be unavailable for other projects.

SPT remains concerned that from its experience with emerging cost projects with contingencies that those contingent amounts can become target prices with other previously unidentified risks being allocated against them or risk categories being artificially expanded to meet an emerging cost. The funder can only effectively manage such contingencies where it controls the draw on contingencies.

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 SPT**

agree that the four criteria identified for addition of an investment to the RAB remain fit for purpose.

SPT supports the proposal that assets which would not add value to Network Rail's physical assets but would add overall to the economic value of the rail network by delivering a whole-industry efficient solution should be added to the RAB if they meet objective appraisal criteria.

Consultees are asked to comment on:

- **The proposals for logging up investments to the RAB. In principle SPT supports this approach.**

However, as stated earlier SPT is concerned that ORR's analysis of third party funded projects may not fully reflect what actually happens where funding is by grant and the public sector services the debt. Greater clarity is requested for situations where Network Rail do not "buy back" the enhancement, but receive it as a "gift" or do not take on maintenance or operational risk.

Consultees are asked to comment on:

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

SPT supports the criteria proposed by ORR.

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

SPT would see the benefit of *ex ante* assessments being undertaken if they were also shared with the third party funder as it could give comfort on some of the areas about which SPT has raised concern earlier in this response. A sample audit carried out *ex post* together with the ability of a third party to refer an investment for an *ex post* assessment where it was unhappy with the outputs would strengthen this approach.

Consultee are asked for their views to allow efficient written-off development costs incurred by Network Rail on schemes required by Government to be added to the RAB.

SPT accepts that such sums should be funded and notes the preferred way forward.

Investments sponsored by third parties

SPT supports ORR's proposal that the default risk allocation should be included in the template agreements. However, as stated earlier in his response only two of the current drafts envisage the fixed prices for which such an allocation was developed.

SPT supports the creation of the industry risk fund and its use to cover:

- events elsewhere on the network;
- risks that arise as a result of industry processes which are beyond the direct control of the customer; and
- certain Governmental risk

SPT accepts that a flat rate 2% of project cost as a “premium” for the protection of the industry Risk Fund is acceptable. It does not support the unspecified share of liabilities on top of this. If it were possible for customers to manage industry risk there would be no need for the fund. Accordingly, Network Rail’s argument that the sharing would incentivise the customer is ill founded.

A schedule of fees assessed for reasonableness by ORR would be welcomed. SPT’s experience is that where there is a comparator to Network Rail’s fees it is cheaper, but the project costs are then greater because of Network Rail’s fee to deal with the consultants.

The funds should be established in a robust manner and therefore an annual review is unnecessary. However, it may be beneficial to review such funds in a similar timescale to the periodic review.

SPT is content with ORR’s proposed governance arrangements.

SPT would support a review of the appropriateness of Network Rail’s liability caps by ORR.

