

**Investment framework consolidated
policy & guidelines**

Draft for consultation

April 2010



OFFICE OF RAIL REGULATION

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Purpose of this consultation

We want to encourage investment in the railways. We can help do this by making the process as clear and user friendly as possible.

The process is described in various documents we have published over a number of years on our investment framework policy and guidelines. Because it is described in so many documents it is not as easy to use as it could be.

This document is a **draft** consolidation of our investment framework policy and guidelines. Once finalised, it will replace the previous documents (listed in Section 1.1 below). This consolidation has been undertaken on the basis that we are not at this stage proposing any changes in policy.

The document describes what the guidelines are, not how they have been arrived at. This background is set out in the relevant conclusions documents on our website¹.

We welcome comments on the **clarity and comprehensiveness** of this draft. We are particularly keen to hear which **areas of the guidance you find useful, where you think the process is unclear, and what, if anything, is missing**.

Responses to this consultation should be sent in either hard copy or electronic format, to be received as soon as possible but by no later than **16 July 2010**, to:

Chris Littlewood
Office of Rail Regulation
One Kemble Street
London WC2B 4AN

Email to: chris.littlewood@orr.gsi.gov.uk

We will make all responses available in our library and publish them on our website, and we may quote from them. If you wish all or part of your response to remain confidential, you should set out clearly why this is the case. Where your response is made in confidence, please attach a statement summarising the submission (excluding the confidential information) which we can then use as above. We will publish the names of respondents in future documents or on our website, unless you indicate that you wish your name to be withheld.

Following our review of consultation comments we will publish the final document before 29 October 2010.

¹ <http://www.rail-reg.gov.uk/server/show/nav.190>

1. Introduction

1.1 Background

1. Investment to enhance the rail network can be funded at periodic reviews, where we determine the outputs Network Rail needs to deliver as well as the amount of income it will receive for a 'control period' (five years at present).
2. There are advantages to funding enhancements in this way: in particular it allows Network Rail to plan its work efficiently over the medium term. However, stakeholders need a way of funding investment between reviews. It is for these investments that we developed our investment framework.
3. The framework is a set of policies and guidelines describing how investments arising between periodic reviews should be treated. It covers:
 - the process for investment;
 - what the different parties to an investment are obliged to do;
 - financing options – in particular the possibility of using the same mechanism for financing as used in the periodic review, that is adjustment of Network Rail's regulatory asset base (RAB);
 - how costs should be recovered through charges; and
 - the remedies available when problems arise.
4. It is designed to encourage investment and has been successful, with hundreds of millions of pounds invested in the rail network by government, operators and others.
5. However, the framework has been developed over time and so is currently described in over 25 documents². Of these most contain proposals for consultation, or conclusions that have been updated since their publication. Ten contain current policy or guidelines for potential investors:
 - Policy framework for investments: conclusions (October 2005);
 - Policy framework for investments: guidelines on implementation arrangements and processes (March 2006);
 - Policy framework for investments – update on implementation guidelines (March 2007);
 - Proposals for a rebate mechanism for investors in large-scale enhancements – final conclusions (June 2007);
 - Investment framework – ORR conclusions on our review of the approach to third party investments (May 2008);
 - CP4 pre-tax rate of return for the investment framework (December 2008);

² Available on our website at <http://www.rail-reg.gov.uk/server/show/nav.190>

- Investment framework – liabilities in Network Rail’s template investment contracts – conclusions (March 2009);
 - Policy framework for investments – guidance on stations charges conclusions (March 2009);
 - Policy framework for investments – obstacles to investment conclusions (March 2009); and
 - Improved template investment contracts – approval for England and Wales (February 2010).
6. To make the framework more accessible to investors we have consolidated these documents into this single draft document. This draft is much shorter than the sum of all the previous documents because we have removed material where the policy or guideline has been superseded (because it was a proposal which has since been concluded, or because our policy has moved on). We have also removed the explanatory text describing how we arrived at our conclusions. Hence this consolidated document describes what our investment policy and guidelines are – not the process for deciding them. This process is described in the relevant conclusions document on our website³.
7. This consolidation has been undertaken on the basis that we are not changing policy but simply describing it more clearly.
8. This consolidation of policy and guidance does not include the mechanism under section 16a of the Railways Act 1993 that allows us to direct the improvement or construction of a railway facility. This mechanism exists outside the investment framework, and given the mechanisms and remedies in place under the framework, we envisage the section 16a provisions would be used only in exceptional circumstances. We have a code of practice⁴ for applicants under section 16a.

1.2 Structure

9. This document is structured in three parts, as follows.
10. The first five chapters describe the investment framework process; the obligations on Network Rail; which ORR approvals are necessary under what circumstances, including how regulated charges should be calculated; and our approach to monitoring.
- **Chapter 1 – Introduction**
 - **Chapter 2 – Process overview** outlines the process for investing, what characteristics of investment schemes will affect the approvals that are necessary, and how costs should be recovered.

³ See <http://www.rail-reg.gov.uk/server/show/nav.190>

⁴ See <http://www.rail-reg.gov.uk/upload/pdf/309.pdf>

- **Chapter 3 – Network Rail’s role** sets out Network Rail’s obligations to its customers, and describes what it is expected to do to facilitate investment. This includes the choice of contractual mechanisms for managing projects, and how Network Rail is held to account for delivery.
 - **Chapter 4 – ORR approvals criteria** sets out the conditions that must be met when an approval from us is necessary.
 - **Chapter 5 – Monitoring the investment framework** outlines how we monitor the use of the investment framework and projects promoted using it.
11. The structure of the second part reflects the fact that the process differs somewhat depending on where the investment takes place and who the promoter is. It consists of three chapters outlining the specific requirements for investing at **stations**, on the **track** (including signalling, electrification for traction etc), and at **depots**, each with separate sections by type of promoter. Our intention is that an investor can read just the chapters that apply generally (1-5) and whichever of the subsequent chapters apply to their particular investment – so some material is repeated in each of these three.
- **Chapter 6 – Investing at stations**
 - **Chapter 7 – Investing on the track**
 - **Chapter 8 – Investing at depots**
12. The last chapter covers the **treatment of land** and rights to land, which is often relevant to the funding and financing of investment schemes.
- **Chapter 9 – Sale of land or rights to land**
13. Our guidance requires costs for some types of scheme to be recovered through a ‘facility charge’. An example calculation of such a charge is provided on our website as a spreadsheet annex to this document.

1.3 More help and information

14. Network Rail has published a code of practice incorporating guidance on its investment process, available on its website⁵.
15. We can also provide advice and help. Contact details are available on the ‘Investing in the industry’ page of our website⁶.

⁵ The code of practice is available from <http://www.networkrail.co.uk/asp/1606.aspx>
⁶ <http://www.rail-reg.gov.uk/server/show/nav.190>

2. Process overview

2.1 Introduction

16. This chapter describes the main steps in the investment process, and how the guidelines and approvals required by us relate to the enhancement project lifecycle. More detail on the approvals necessary is provided in Chapter 4.

2.2 Process overview

17. We want to make our role in the investment process clear to investors. This section outlines the investment framework process in the context of:
- the project lifecycle from inception, business case development and design through construction to commissioning and acceptance into use;
 - Network Rail’s guide to railway investment projects (GRIP) process for managing investment schemes, which sets the generic project lifecycle in a railway context; and
 - the means by which outputs are secured, that is whether the customer signs a contract for the delivery of its required outputs by Network Rail, or instead relies on the company’s network licence to govern delivery.

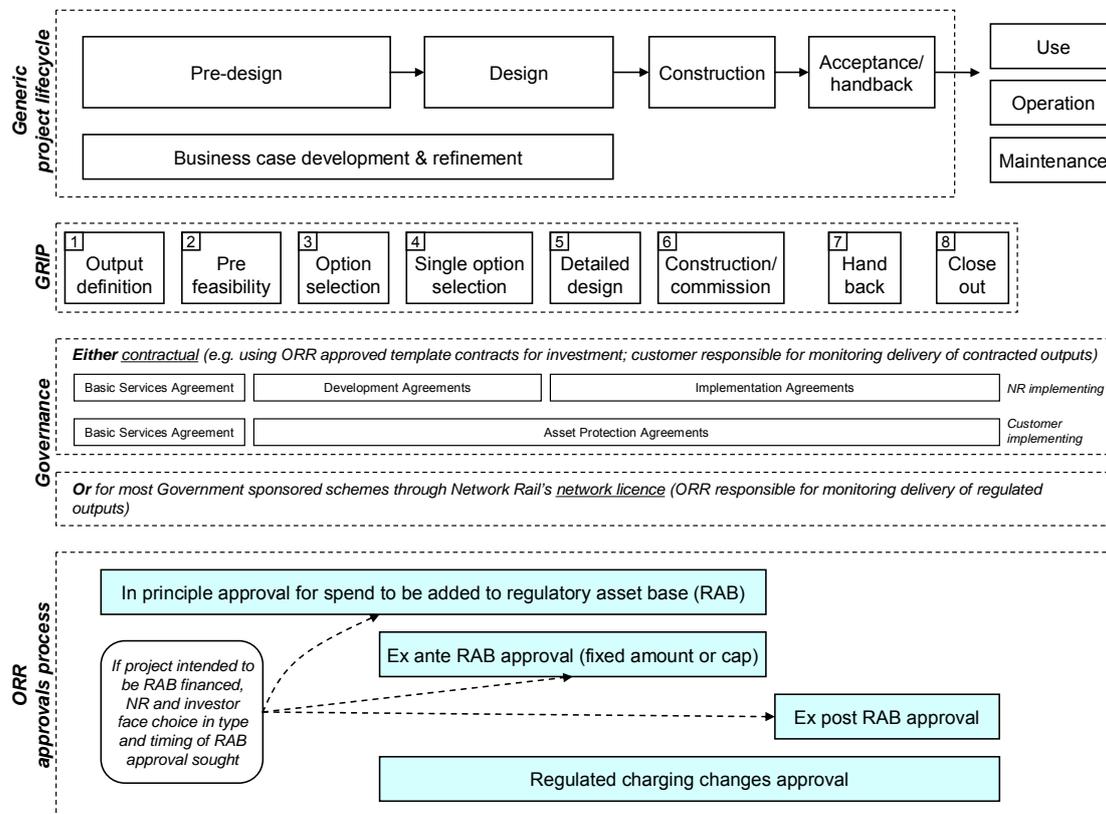


Figure 1: Investment framework process overview

18. More detail on the governance choices outlined in Figure 1 can be found in Chapter 3 of this document, where we describe the role of Network Rail.
19. The required ORR approvals illustrated in Figure 1 are expanded on in Chapter 4.
20. The monitoring responsibilities during the project lifecycle are covered in Chapter 5.
21. The investment framework approvals process for enhancements on the rail network varies according to three main factors.
 - **Who** is promoting the enhancement. Investment schemes can be sponsored by third parties (that is anyone besides Network Rail or Government⁷), franchised train operators (a special case of third party because of their franchise agreement with Government), or Government itself.
 - **What** is being enhanced (a station, the track, or a depot).
 - **How** the work is financed (particularly whether RAB finance is sought).
22. The rest of this section describes our approvals process from the perspective of the three main types of investor:
 - third party investors (Figure 2);
 - franchised operators (Figure 3); and
 - Government (Figure 4).
23. Each of these process diagrams refers to the detailed description (set out later in this document) of the criteria that must be satisfied and charging guidelines that should be followed.
24. Each diagram starts by setting out the business case decisions required. In the case of RAB financed schemes approval of the scheme is contingent on the acceptance of the business case, because RAB finance requires a scheme to add economic value to the rail network. Where RAB finance is not sought the business case still needs to be developed to the extent that the options chosen for delivery (and ultimately cost recovery) are clear.
25. Franchised operators are a particular class of third party, because they have a franchise agreement with Government (which in some circumstances described below stands behind commitments made by the franchise). They also have a pre-existing contractual relationship with Network Rail so it is straightforward for us to issue guidance as to how costs of investment should be recovered through changes to these contracts.
26. There is nothing to stop franchised operators acting as 'ordinary' third parties, and following the guidance we set out in this document for those third parties. Similarly a third party can request similar terms from Network Rail to those

⁷

Government in this document means Department for Transport or Transport Scotland.

applied to franchised operators, so long as the terms result in similar risks for Network Rail (in particular in terms of recovery of the whole-life costs of the investment).

27. In almost all cases where a RAB addition is required to finance the scheme, an approval from Government is required. The exception is for a class of schemes promoted by franchised operators which we refer to here as '*self-financing schemes*'.
28. These are defined as schemes where a specific Government approval is not required if certain conditions concerning the scheme's business case, size and cost recovery terms are met⁸. The investment framework process for these schemes differs again, as set out in Figure 3. It is important to note that we are using this term (self-financing schemes) to refer to this specific class of schemes, and not any scheme which recovers its costs.

⁸ These conditions are set out from paragraphs 106 and 128 for station and track schemes respectively.

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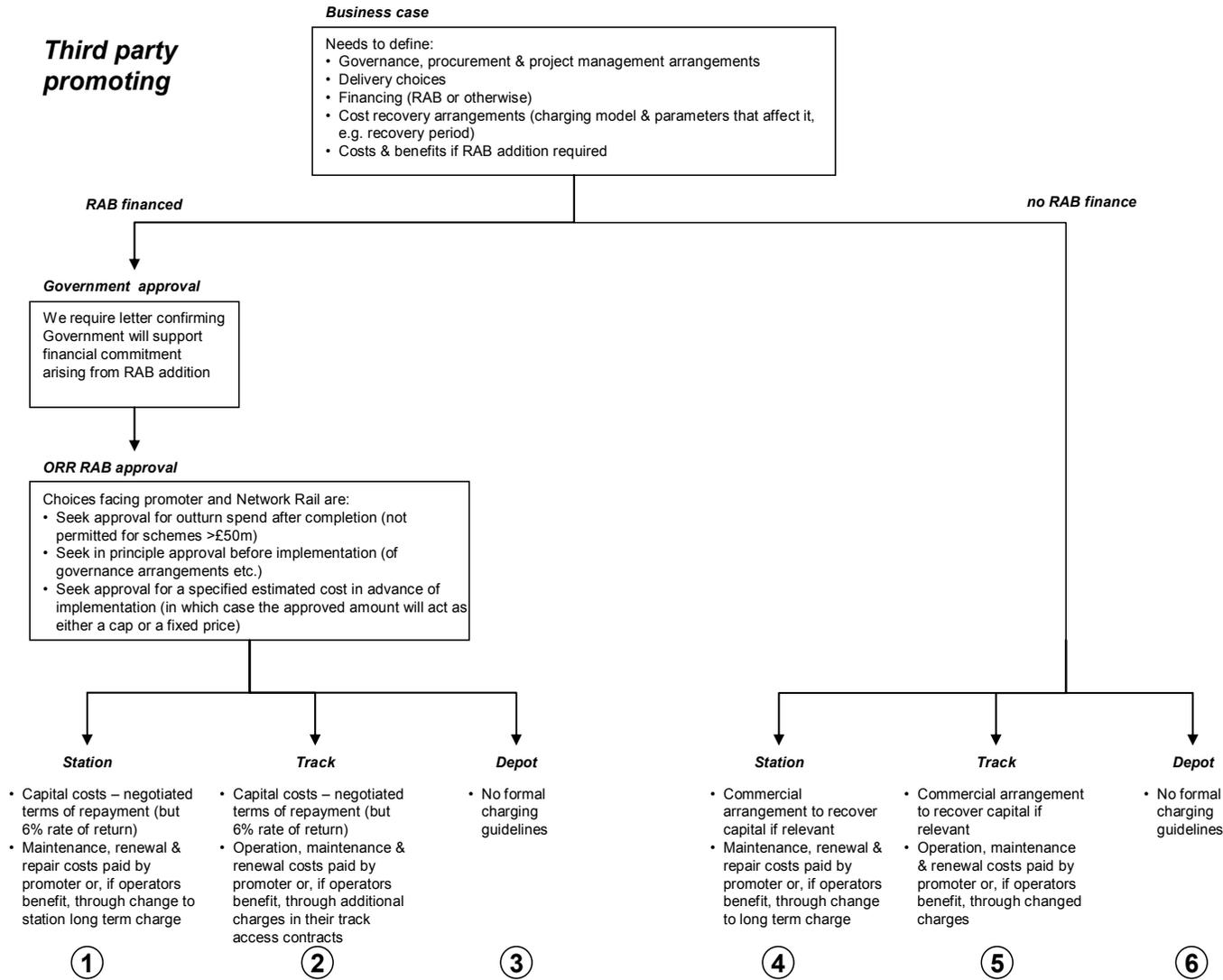


Figure 2: Investment framework process – third party investors

Notes to
Figure 2

- ① RAB approval criteria are set out in section *4.1 Financing using the RAB*. Cost recovery guidelines set out in *4.2 Approval of charges* and *6.2 Third party promoted schemes*.
- ② RAB approval criteria are set out in section *4.1 Financing using the RAB*. Cost recovery guidelines set out in *4.2 Approval of charges* and *7.2 Third party promoted schemes*.
- ③ RAB approval criteria are set out in section *4.1 Financing using the RAB*. No formal cost recovery guidelines for depots.
- ④ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. Incremental ongoing cost recovery arrangements are described in *4.2 Approval of charges* and *6.2 Third party promoted schemes*.
- ⑤ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. Incremental ongoing cost recovery arrangements are described in *4.2 Approval of charges* and *7.2 Third party promoted schemes*.
- ⑥ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. No formal cost recovery guidelines for depots.

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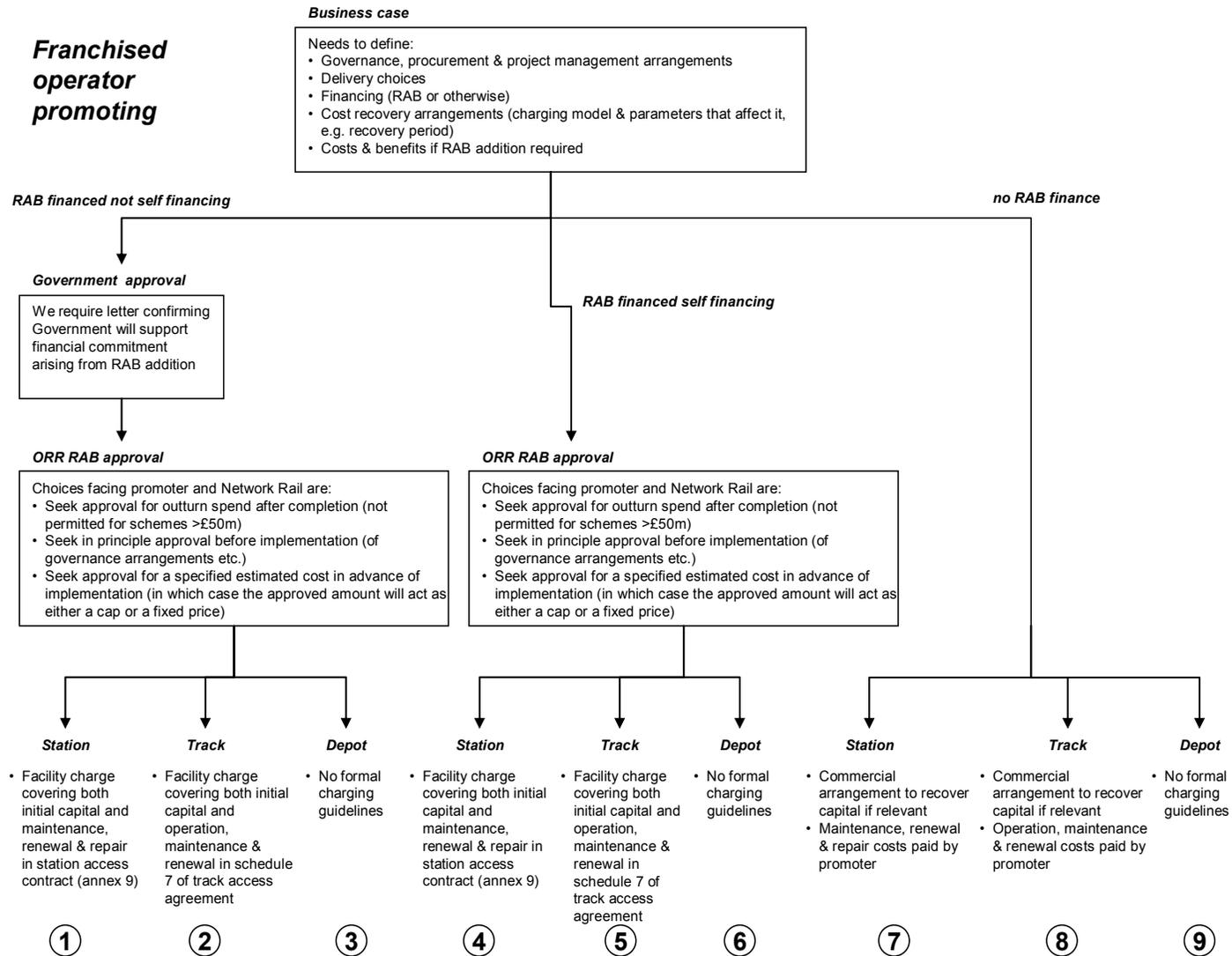


Figure 3: Investment framework process – franchised operators

Notes to
Figure 3

- ① RAB approval criteria are set out in section 4.1 *Financing using the RAB*. Cost recovery guidelines set out in 4.2 *Approval of charges* and 6.3 *Franchised train operator promoted schemes*.
- ② RAB approval criteria are set out in section 4.1 *Financing using the RAB*. Cost recovery guidelines set out in 4.2 *Approval of charges* and 7.3 *Franchised train operator promoted schemes*.
- ③ RAB approval criteria are set out in section 4.1 *Financing using the RAB*. No formal cost recovery guidelines for depots.
- ④ RAB approval criteria are set out in section 4.1 *Financing using the RAB*. *Self-financing schemes* are a class of schemes where specific support for RAB funding is not required of Government; they must meet the additional conditions set out in section 6.3 *Franchised train operator promoted schemes*. Cost recovery guidelines set out in 4.2 *Approval of charges* and 6.3 *Franchised train operator promoted schemes*.
- ⑤ RAB approval criteria are set out in section 4.1 *Financing using the RAB*. *Self-financing schemes* are a class of schemes where specific support for RAB funding is not required of Government; they must meet the additional conditions set out in section 7.3 *Franchised train operator promoted schemes*. Cost recovery guidelines set out in 4.2 *Approval of charges* and 7.3 *Franchised train operator promoted schemes*.
- ⑥ RAB approval criteria are set out in section 4.1 *Financing using the RAB*. No formal cost recovery guidelines for depots.
- ⑦ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. Incremental ongoing cost recovery arrangements are described in 4.2 *Approval of charges* and 6.3 *Franchised train operator promoted schemes*.
- ⑧ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. Incremental ongoing cost recovery arrangements are described in 4.2 *Approval of charges* and 7.3 *Franchised train operator promoted schemes*.
- ⑨ Promoter provides finance in this case, so no RAB approval or capital recovery mechanism necessary. No formal cost recovery guidelines for depots.

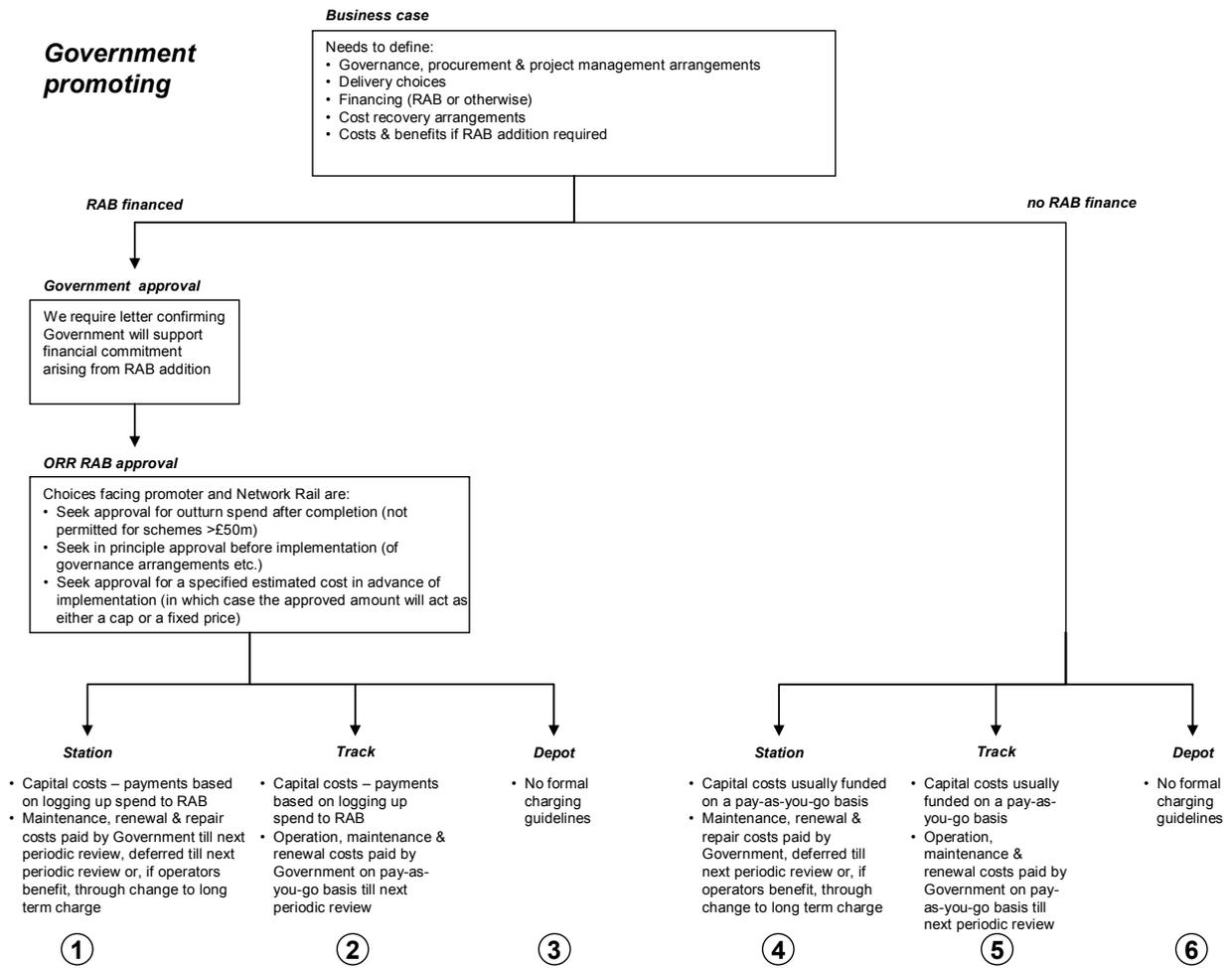


Figure 4: Investment framework process – Government

Notes to Figure 4

- ① RAB approval criteria are set out in section 4.1 *Financing using the RAB*. Cost recovery guidelines set out in 6.4 *Government sponsored schemes*.
- ② RAB approval criteria are set out in section 4.1 *Financing using the RAB*. Cost recovery guidelines set out in 7.4 *Government sponsored schemes*.
- ③ RAB approval criteria are set out in section 4.1 *Financing using the RAB*. No formal cost recovery guidelines for depots.
- ④ Cost recovery guidelines set out in 6.4 *Government sponsored schemes*.
- ⑤ Cost recovery guidelines set out in 7.4 *Government sponsored schemes*.
- ⑥ No formal cost recovery guidelines for depots.

3. Network Rail's role

3.1 Network Rail's duty to facilitate enhancements

29. Network Rail is the principal point of contact for investors in the rail network. It has a dedicated information section on its website:
<http://www.networkrail.co.uk/asp/1536.aspx>.
30. Network Rail's role in relation to enhancement schemes is underpinned by its obligations as network operator. Network Rail's Licence Condition 1.1 states that it must secure:
- "the improvement, enhancement and development of the network ... in accordance with best practice and in a timely, efficient and economical manner so as to satisfy the reasonable requirements of persons providing services to railways and funders, including potential providers or potential funders"*.
31. The investment framework, and Network Rail's own processes and guidance for investment, have been developed to fulfil this objective.
32. Network Rail's role in investment framework projects is to:
- 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 RAB at the next periodic review;
 - facilitate development of, and where appropriate deliver, schemes proposed by franchised operators or other third parties, or Government;
 - as part of that facilitation provide the services that only Network Rail can perform (non-contestable services) for investors;
 - where appropriate finance schemes proposed by franchised operators or other third parties through a RAB addition; and
 - prioritise between these different activities in accordance with its standard investment appraisal criteria.

Delivery

33. For many investment framework schemes Network Rail will act as 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, including design and construction risks where appropriate.

Facilitation of schemes delivered by third parties

34. Network Rail should facilitate schemes promoted and delivered by third parties, such as station improvements, by providing services on fair and

reasonable terms. Part of being fair and reasonable in its terms means Network Rail must only recover its additional efficient costs when it is taking a facilitative role (for example when it is providing non-contestable services relating to its role as network operator).

35. In many cases the third party will also want Network Rail to design, develop, finance and deliver schemes, whether or not the enhanced assets will then be 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 services⁹, for example design and delivery services. This competition can drive efficiency and create additional capacity in the market for scheme delivery.
36. Network Rail should not use its monopoly position to require third party promoters to buy contestable services from it. Nor should it offer preferential treatment to customers who depend on its delivery of non-contestable services.

Financing

37. Network Rail should be prepared to finance schemes which add economic value to the rail network on appropriate terms, subject to any financing constraints. Network Rail would receive an income stream over time and this income generally has a contractual status as a supplemental access agreement or facility charge. Similar arrangements could be put in place for third parties who do not have access agreements. In such cases we would expect Network Rail to take steps to ensure the recovery of the income over time.

Monitoring/change control/governance

38. There are two broad models of project governance for investment schemes:
 - through Network Rail's network licence, which should be used for most projects sponsored by Government; or
 - through contracts – for third party sponsored schemes, contractual mechanisms will be put in place, for example through template agreements approved by us under Part G of the network code.
39. In the former the responsibility for monitoring progress on the project rests mainly with us unless bespoke arrangements are put in place (for example using a 'protocol', see section 3.3 *Bespoke arrangements for schemes governed via the licence*).
40. In the latter it is the scheme promoter who should monitor progress and Network Rail should provide scheme promoters with the necessary information to do this. It should also ensure that arrangements for changes to the specification of a project are set out in advance, and that responsibility for

⁹ Contestable services are project development; scheme design and scheme implementation. Non-contestable services are asset protection, asset information and booking of possessions, engineering safety management and the processing of some necessary consents.

the financial consequences of any changes is identified as part of the risk allocation.

3.2 Template terms for investment

41. Network Rail has drafted, and we have approved, a set of template contracts that investors may choose to use as the basis for contracts to deliver enhancements. Guidance, and the templates themselves, can be found on Network Rail's website¹⁰. They are provided to reduce transaction time and cost for investors compared to negotiating a contract from scratch with Network Rail, and are designed to offer a fair balance of risk between Network Rail and investors. They are primarily designed for contract values of less than £50m; for larger schemes there might be a need for more tailored arrangements to cope with the particular risks of the scheme.
42. There are four main types of template:
- **Basic Services Agreement.** A simple agreement, aimed at quickly putting in place a contractual relationship to cover pre-feasibility works to scope the scheme and develop the business case.
 - **Development Services Agreement.** For development and design work undertaken by Network Rail on behalf of a promoter.
 - **Implementation Agreement.** With Network Rail acting as a construction manager, this is an agreement for enhancement work on or about the controlled railway infrastructure to provide detailed design and implementation of the promoter's scheme with the contracting strategy agreed between Network Rail and the promoter.
 - **Asset Protection Agreement.** An agreement for promoter led works on the controlled railway infrastructure, where Network Rail facilitates the promoter's enhancement scheme interface with the operations, maintenance and renewals business.
43. There are two options for the implementation agreement, either fixed price or emerging cost. There are basic versions of the asset protection and implementation agreements for simpler schemes. Also, a Framework Agreement is available covering basic services, development services and asset protection in a single agreement.
44. Customers may have particular concerns and individual projects may have particular risks. We expect both parties to be open to negotiation of alternative provisions that suit individual circumstances, while acknowledging that they must control or manage the risks they take on.

Risk funds

45. At each periodic review Network Rail is funded for costs and risks arising from the outputs required in the review. It is not funded for third party enhancements that arise between periodic reviews, or for the cost risks associated with them. In order to provide it with funding for the risks

¹⁰ <http://www.networkrail.co.uk/asp/1606.aspx>

associated with investment using the templates, risk funds have been established to fund these costs.

46. Investors pay into two funds to cover Network Rail's potential liabilities arising from investment using the templates, and to cover specific industry cost risks:
- **Network Rail fee fund (NRFF):** intended to cover Network Rail's potential liabilities arising from the template agreements. Network Rail must contribute £10m to this fund in the event it is exhausted to ensure it is incentivised to minimise the risk of calls on the fund.
 - **Industry risk fund (IRF):** to act as insurance against low-probability, high-impact industry risks, such as the impact of an operational emergency elsewhere on the network on a scheme.
47. These contributions to the funds (the Network Rail fee and the industry risk fee) are calculated as percentages of costs. The percentages and the costs in scope are defined in the template agreements themselves.

3.3 Bespoke arrangements for schemes governed via the licence

48. For some large schemes Government has asked for bespoke governance arrangements, for example to reflect a risk allocation which differs significantly from the default. This approach has been used in the protocols set up for the Thameslink and Crossrail projects.

3.4 Remedies

49. Remedies are available to investors during the contract negotiation stage and after contracts are signed.

Before contracts are signed

50. If investors are unhappy with Network Rail's approach in negotiating a contract for investment, then in the first instance they should escalate the issue within Network Rail.
51. If that does not resolve the concern, or is not practical, investors may refer the matter to us. We would raise the issue with Network Rail and if necessary decide if Network Rail was complying with its network management and stakeholder relationships licence conditions, and take enforcement action if necessary¹¹.

After contracts are signed

52. After contracts are signed the available remedies depend on the scheme's governance model, i.e. whether it is governed through a contract or through Network Rail's network licence.

¹¹ See our website at <http://www.rail-reg.gov.uk/server/show/nav.1362> for more on our enforcement policy.

53. In the case of schemes governed through the network licence, if the investor cannot resolve an issue with Network Rail they can refer the matter to us. We will raise the matter with Network Rail and escalate it as appropriate.
54. In the case of schemes using a contract-based approach, once signed, the template investment contracts incorporate an escalation and disputes process which either investors or Network Rail can follow in the event of a dispute.
55. The template contracts set out the terms for engaging with Network Rail on an enhancement project; there are almost always subsequent contractual processes necessary in order to deliver the enhancement. These include changes to leases; station, depot or network changes; and asset purchase agreements.
56. Ultimately Network Rail still faces obligations under its network licence. If customers or potential customers consider that Network Rail is acting unreasonably they can refer the matter to us. In accordance with our enforcement policy we can then consider whether Network Rail was complying with its network management and stakeholder relationships licence conditions, and take enforcement action if necessary.

4. ORR approvals criteria

57. Our approval is usually required during the investment process if any of the following apply:
- Network Rail will be financing an enhancement through its RAB;
 - the cost recovery arrangements require new or amended regulated charges (for example, a facility charge is required to recover the costs of an enhancement, paid by the enhancement's promoter – see below) to be levied by Network Rail to pay for the work; or
 - a change approval is required under either the network code, the station access conditions, or the depot access conditions. These change processes are usually required for any physical works, but also – depending on the scheme promoter and funding arrangements – they may also be used to establish or change charges.

4.1 Financing using the RAB

Approvals criteria

58. This set of criteria only applies to investment where Network Rail has agreed to provide finance backed by a RAB addition; if customers pay cash for an investment this approval is not necessary.
59. The following criteria must be met before we will approve a RAB addition.
- the expenditure must be incurred as a result of a reasonable requirement of Government (or another funder directly supported by Government), and Government must therefore be content to support the financial commitment arising from the associated RAB addition.
 - the expenditure must 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 for the rail industry as a whole.
 - for very large schemes, we need to be satisfied that Network Rail can afford to finance the planned expenditure, and has the capability to deliver.
 - the expenditure must be incurred efficiently.
 - the outputs of the scheme must have been delivered and Network Rail must own the enhanced asset.

Which schemes do we assess, and why?

60. The RAB addition approvals criteria set out above apply to any investment framework projects where RAB finance is sought. However, in order to make the investment process as streamlined and accessible as possible, we review schemes at a level of detail that is proportionate to their size and complexity. Generally this means we will assess any scheme where the cost is more than £5 million against the RAB addition criteria. We review smaller schemes (usually after implementation) on a sample basis or if they are particularly complex.
61. For schemes with a value below £50 million investors and Network Rail face a choice as to whether to seek approval for RAB financing before implementation, or to wait and seek approval of an outturn cost after completion.
62. If an 'in advance' approval is sought, that approval can be either:
 - **in-principle** (that is an approval that states the scheme costs would be eligible for RAB addition if they were demonstrated to be efficient); or
 - **capped/fixed price** (an approval for a RAB addition of an efficient price determined in advance, or an efficient cap on cost).
63. In order to carry out an assessment of a price during scheme development the scheme usually needs to have reached GRIP stage 4 or 5 in Network Rail's development process, i.e. when detailed design is complete (or nearly complete) but before Network Rail (or another delivery agent) has gone out to tender. It is at this stage that the detailed information required for our assessment should be available but is before contractual commitments have been entered into. If we receive information later, this may delay the assessment process and ultimately could result in an ex post adjustment to any RAB addition.
64. We assess the arrangements (including cost estimates) for major schemes (costing above £50 million) in advance.
65. For these major schemes we require an in-advance submission (for in principle approval at around GRIP stage 3), along with early estimates of the cost of the work, in order to avoid the risk of significant cost being incurred which is ineligible for RAB addition.

How we make our efficiency assessment

66. In assessing whether a scheme is efficient, we consider whether:
 - the proposed risk allocation is appropriate (for instance, whether the consequences of any risk to the project would be felt by the party best able to mitigate the risk);
 - the procurement and governance arrangements, including management and cost control arrangements, are clearly specified and provide appropriate incentives on all parties. Design and implementation services

- should usually be procured through a transparent, competitive process to ensure market-tested prices are obtained;
- outputs and acceptance requirements are clearly specified, so that it is clear when the scheme is complete and under what terms Network Rail will be paid; and
 - cost estimates put forward by Network Rail or the scheme promoter represent efficient prices.
67. When assessing cost estimates we look at market-tested values for each element of cost included in the estimate. Where appropriate we also take into account the potential for cost efficiency improvements during the project life.
68. The detail of cost estimates submitted to us should be commensurate with the size and complexity of the scheme. In general the estimates should be disaggregated by:
- development costs (showing any sunk costs);
 - estimated construction costs, including contractors' preliminary 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;
 - the contingency or allowance assumed for unidentified risks; and
 - other delivery costs, for example land purchase or legal fees.

4.2 Approval of charges

Our role

69. We approve most new charges and changes to regulated charges. This includes the track access charges defined in operators' track access agreements with Network Rail, station charges defined in station access contracts and 'facility charges' associated with particular enhancements. We do not regulate the level of the 'QX' charge, which is set to recover operating costs at stations.

Rate of return

70. For investments where the capital cost is recovered through regulated charges, the charges should be set so that the cost of capital is at the Network Rail regulated pre-tax rate of return. Network Rail must offer the promoter the following options:
- to use the (pre-tax, real) return on the RAB, set at the most recent periodic review, for the duration of the charge; or
 - to use the (pre-tax, real) rate of return set at the most recent periodic review but to move to the rate of return determined at the next periodic review when the conclusions of that review are implemented; this rate is then the basis for the charge for the remainder of the recovery period.

71. This second option is to prevent any inappropriate incentive to change the timing of investment towards the end of a control period (arising from expectations of a change to the rate of return in the next periodic review).
72. The pre-tax allowed real rate of return for CP4¹² is 6.0% p.a. This rate of return differs from the 4.75% 'vanilla' rate of return¹³ which was used in the calculation of Network Rail's CP4 revenue requirement, because the investment framework rate compensates Network Rail for the expected corporation tax implications of additional investment.

Calculating facility charges

73. A facility charge is a charge set to recover the costs of an enhancement and is paid by the promoter of a scheme. These charges must be used for *self-financing schemes*, where promoters can make use of RAB financing without specific government approval, subject to the conditions set out in paragraph 108 (at stations) or paragraph 130 (on the track). They can also be used by franchised train operators as outlined earlier in this document in Figure 3 (where the facility charge is incorporated into an existing access contract with Network Rail) or by other third parties subject to Network Rail being satisfied that there is sufficient certainty that the scheme costs would be fully recovered from the promoter.
74. The facility charge should be calculated with reference to the following guidelines. An example is shown in the spreadsheet at Annex A.

Recovery period

75. The facility charge should be paid by the promoter (or in the case of a franchised operator, the franchisee and its successors) for the agreed recovery period.
76. The maximum recovery period is 30 years, and shorter periods can be agreed between Network Rail and promoters (for instance where the asset life of the enhancement is shorter than 30 years, or for *self-financing schemes* where a default maximum of 15 years applies).

Depreciation

77. The default approach is that the depreciation should be calculated on a straight-line basis over the recovery period. This approach means that the capital recovery element of the charge reduces over the recovery period.
78. So that the charges for enhancements better reflect the likely timing of benefits arising from schemes, we will also allow an alternative (at the scheme promoter's request) to re-profile the charge (keeping its net present

¹² CP4 is the current control period running from 2009-2014.

¹³ This is the allowed cash return on the RAB. A 'vanilla' return is based on a pre-tax cost of debt and post-tax cost of equity.

value constant) so that payments are constant in real terms over time. An example of such re-profiling is shown in the spreadsheet at Annex A.

Allowed return

79. Network Rail should offer the promoter the options described in paragraph 70.

Incremental ongoing costs

80. Incremental ongoing costs due to the enhancement (for example, for the operation, maintenance or renewal of the asset during the recovery period) should also be included in the facility charge. If the anticipated incremental costs from the scheme vary by year, the charge can be re-profiled so that it has a constant real annual value. This value should be calculated so that the charge has the same present value as the incremental ongoing costs over the recovery period. An example incremental costs charge is shown in Annex A.

Minimum threshold for incremental ongoing costs

81. To reduce negotiating and transaction costs, if the annual incremental ongoing cost of the scheme is below £50,000 then that cost should not be included in the facility charge.
82. Since this threshold is intended to remove the cost of negotiating small incremental ongoing charges, it should apply for each (station or network) change application (rather than at the level of an individual project within a change application, or at a broader programme-level).

What happens at the end of the recovery period?

83. In the periodic review prior to the control period in which the charge expires, it is expected that allowance will be made for the enhanced asset, as for all other Network Rail assets. Network Rail would therefore be funded either to manage the asset beyond the recovery period of the charge, or to decommission it.

4.3 Approval of changes to the network

84. The network code¹⁴ provides a procedure by which changes can be made to the network which are likely to have a material effect on its operation. Part G of the code sets out the processes for proposing, consulting on and, implementing a network change. It also details the associated compensation and appeals procedures.
85. Proposals for network change can be initiated by either Network Rail or a train operator.

¹⁴ <http://www.rail-reg.gov.uk/server/show/nav.241>

86. Part 3 of the independent station access conditions (which govern those stations managed by Network Rail) and part C of the national station access conditions (which govern most other stations on the network) outline the process for making a change to the common station services or amenities at a station (set out in annex 1 of the relevant access conditions). The change procedures in the access conditions apply when the proposed change will materially affect the condition, standard or quantum of the services or amenities that are offered to all users of the station.
87. The station facility owner, Network Rail or any other operator at the station can make a change proposal.
88. The station access conditions can be found on our website¹⁵.

¹⁵

See <http://www.rail-reg.gov.uk/server/show/nav.224#Conditions>

5. Monitoring the investment framework

89. We monitor how the investment framework is working in terms of:
- how well Network Rail is carrying out its obligations in general. For example we are currently carrying out a review of third party promoted investments to check how effective Network Rail's service culture initiatives have been in addressing some of the issues identified in our 'obstacles to investment' review¹⁶;
 - calls on the risk funds, to establish if the fee levels are still appropriate; and
 - use of the variation mechanism included in the template contracts since the contracts rely on parties to the contracts being reasonable in requiring or objecting to variations.
90. We also respond to concerns raised with us by investors.
91. We welcome any feedback from customers – positive or negative – on their experience of the use of templates or of the investment framework more generally, including on Network Rail's responsiveness to customer requirements.
92. Where an investor has engaged with Network Rail through a template contract, or through another contract, it is the investor's responsibility to monitor and manage their project through that contract. We do not monitor progress of third party schemes.
93. Most projects sponsored by Government will be governed through Network Rail's network licence, and once the required outputs have been established these will be included in Network Rail's delivery plan¹⁷ and will be monitored against agreed milestones in the same way as projects funded through a periodic review. These monitoring arrangements are set out on our website: <http://www.rail-reg.gov.uk/server/show/nav.2231>

¹⁶ http://www.rail-reg.gov.uk/upload/pdf/investment_obstacles_conclusions_310309.pdf

¹⁷ This is Network Rail's plan to deliver the outputs required in a periodic review. Its current delivery plan (for CP4) is for the outputs required in the 2008 periodic review.

6. Investing at stations

6.1 Introduction

94. This chapter covers investment in enhancements at stations, and how the costs of those investments should be recovered.

6.2 Third party promoted schemes

95. Third parties include any scheme promoter other than Government (DfT or Transport Scotland) and Network Rail. Examples might be a PTE, a local authority, Transport for London or a train operator. For schemes promoted by third parties we will consider applications for RAB financing according to the criteria set out in section 4.1 *Financing using the RAB*.
96. Where a RAB addition is approved, third parties must pay for all capital costs, including financing costs, associated with schemes they promote. The terms of repayment (for example the timing of payments) are a matter for negotiation between Network Rail and the promoter, and will depend on the costs and the risks involved.
97. Where no RAB addition is required and the promoter provides the finance there is no need for a charge to recover capital costs.
98. Whether or not there is a RAB addition, the incremental ongoing costs should be paid for by the promoter if they exceed a threshold of £50,000 per annum, or through a change to the long term charge where operators benefit from the enhancement.

6.3 Franchised train operator promoted schemes

99. Train operators are a special category of third party, but can choose to promote schemes in the same way as any other third party, according to the guidelines set out in section 6.2 *Third party promoted schemes*.
100. In addition a train operator's existing access agreement with Network Rail means scheme costs can be recovered through a facility charge included in the operator's station access contract (rather than relying on negotiated repayment terms as is necessary for other third parties).
101. If the investment is RAB financed the initial capital costs and incremental maintenance repair and renewal (MRR) costs of the enhancement will be recovered through a facility charge paid only by the promoter of the scheme.
102. Although each facility charge is paid by the scheme promoter alone, station users can themselves arrange to share the costs of an enhancement through joint promotion of a scheme.

103. Guidelines on calculating a facility charge are set out from paragraph 73. At stations the following specific requirements apply.

Incremental ongoing costs

104. At stations incremental ongoing costs are defined to be expected maintenance, repair and renewal costs associated with the enhancement during the recovery period. Operating costs at stations are recovered through the QX charge, the level of which we do not regulate.

Station access contracts

105. The initial capital and incremental MRR charge components need to be calculated and set out separately in annex 9 of the station specific annexes which form part of the station access contracts.

Self-financing schemes at stations

106. Additionally, schemes promoted by franchised train operators but financed by Network Rail can qualify for treatment as *self-financing schemes*. The term *self-financing* is applied to schemes that:

- do not require government's financial support; and
- do not otherwise generate liabilities for government.

107. Under this approach, schemes are financed through additions to Network Rail's RAB, the costs being recovered by Network Rail through a facility charge, without the need for specific government approval of the RAB financing. This approach can facilitate schemes promoted by a franchised passenger operator with a strong business case but which do not pay back within the remainder of a single franchise period.

108. The eligible schemes should meet the following key conditions.

- the estimated cost is less than £10 million, although schemes above this value can be included on a case-by-case basis with government approval.
- the scheme promoter prepares the business case and must pay for all the costs resulting from the scheme (including any relevant incremental maintenance, renewal and repair costs that fall within the charge recovery period, subject to the £50,000 threshold described in paragraph 81) for an agreed period. For franchisees this will generally be the remaining term of the franchise agreement, which should have at least two years remaining – successor franchisees then usually take on the payment obligations at the end of the promoter's franchise. Franchisees with less than two years remaining can qualify if government supports the case.
- Network Rail must confirm its support for the scheme in writing and confirm that the scheme is consistent with other relevant policies and

strategies (including its delivery plan and relevant route utilisation strategies).

- the scheme must satisfy our criteria for adding investment expenditure to the RAB.

109. Costs should be recovered through a facility charge. For *self-financing schemes* a default recovery period applies.

Recovery period for *self-financing schemes*

110. For *self-financing schemes* the default maximum recovery period is 15 years, so that most franchisees will pay a reasonable proportion of scheme costs, and so the business case must be robust to provide a return on investment. We recognise that there may be good schemes for which a longer recovery period is appropriate and we are prepared to approve schemes with longer recovery periods, but in such cases we need confirmation of Government support.

6.4 Government sponsored schemes

111. Government sponsored schemes are those which are promoted by DfT or Transport Scotland that were not required by their high level output specifications (and so were not funded in the periodic review). The approach to cost recovery for these schemes mirrors the approach taken to setting stations charges in PR08¹⁸.

- The efficient enhancement spend is added to the RAB. We would generally expect payments for the incremental investments to begin at the point at which Network Rail incurs expenditure on those investments, rather than logging up the financing costs within the control period and adding these to the RAB at the next periodic review. At the next periodic review the amount of the RAB addition would be reviewed to ensure it was both efficient and represented the economic value added by the investment. It is then expected that the investment would be reflected in an increase in access charges or government grants at the next periodic review.
- Any incremental maintenance, repair and renewal costs arising from the scheme would be recovered either
 - from a change to the long term charge from the point in time when the costs occur (if the operators at the station accrue the benefit of the enhancement);
 - on a pay as you go basis from Government until the next periodic review; or, if Network Rail agrees
 - from the start of the next control period through inclusion in the next periodic review (with Network Rail bearing the costs until then).

¹⁸ PR08 was the most recent periodic review, setting Network Rail's income and delivery obligations for CP4.

At the next periodic review these incremental maintenance, renewal and repair costs of the enhancement will be considered together with those of other assets in determining Network Rail's revenue requirement and charges.

- Operating costs are recovered through QX, the level of which we do not regulate.

6.5 Accelerated renewals

112. The focus of this document is investment in *enhancements* of the network, but investors might also want to bring forward a like-for-like renewal, for instance so that it can be coordinated with an enhancement to minimise disruption to services.
113. If Network Rail brings forward renewals – either from within the current control period or from a future control period – to deliver periodic review outputs in the current control period it will not receive any extra income.
114. But where a promoter wants to bring forward a renewal from later in the same control period the promoter should pay Network Rail for any increased financing costs arising from the timing difference.
115. If renewals are brought forward from a future control period, Network Rail is not funded for the renewal. Network Rail should supply the scheme promoter with an estimate of the additional financing costs resulting from the accelerated renewal and the funder should pay for these additional costs until the renewal costs are added to the RAB. The efficient costs of the renewal works should be logged up and remunerated through the RAB at the next periodic review.

7. Investing in the track

7.1 Introduction

116. This chapter covers the specifics of investment in enhancements to the network outside stations and depots – in other words, on the track.

7.2 Third party promoted schemes

117. Third parties include any scheme promoter other than Government (DfT or Transport Scotland) and Network Rail. Examples might be a PTE, a local authority, Transport for London or a train operator. For schemes promoted by third parties we will consider applications for RAB financing according to the criteria set out in section 4.1 *Financing using the RAB*.
118. Where a RAB addition is approved, third parties must pay for all capital costs, including financing costs, associated with schemes they promote. The terms of repayment (for example the timing of payments) are a matter for negotiation between Network Rail and the promoter, and will depend on the costs and the risks involved.
119. Where no RAB addition is required and the promoter provides the finance there is no need for a charge to recover capital costs.
120. Whether or not there is a RAB addition the incremental ongoing costs should be paid for by the promoter if they exceed a threshold of £50,000 per annum; where multiple operators benefit from the enhancement, implications for existing track charges need to be considered. This flexibility is necessary to prevent a barrier to investment for parties that do not have access contracts with Network Rail.

7.3 Franchised train operator promoted schemes

121. Train operators are a special category of third party, but can choose to promote schemes in the same way as any other third party, according to the guidelines set out in section 7.2 *Third party promoted schemes*.
122. In addition a train operator's existing access agreement with Network Rail means scheme costs can be recovered through a facility charge included in the operator's access contract (rather than relying on negotiated repayment terms as is necessary for other third parties).
123. If the investment is RAB financed, the initial capital costs and incremental operations, maintenance and renewals (OMR) costs of the enhancement will be recovered through a facility charge paid only by the promoter of the scheme.

124. Although each facility charge is paid by the scheme promoter alone, operators can themselves arrange to share the costs of an enhancement through joint promotion of a scheme. For some investments, promoters may also be able to secure a financial contribution from users of infrastructure which they have enhanced, as set out in our rebate mechanism policy described in section 7.6 *Rebate mechanism*.
125. Guidelines on calculating a facility charge are set out from paragraph 73. The following specific requirements also apply for investment in the track.

Incremental ongoing costs

126. On the network outside stations incremental ongoing costs are defined to be expected operations, maintenance and renewal costs associated with the enhancement during the recovery period.

Access contracts

127. The facility charges should be included as a supplement to the operator's track access agreement, in Schedule 7.

Self-financing schemes on the track

128. Additionally schemes promoted by franchised train operators but financed by Network Rail can qualify for treatment as *self-financing schemes*. The term *self-financing* is applied to schemes that:
- do not require government's financial support; and
 - do not otherwise generate liabilities for government.
129. Under this approach, schemes are financed through additions to Network Rail's RAB, the costs being recovered by Network Rail through a facility charge, without the need for specific government approval of the RAB financing. This approach can facilitate schemes promoted by a franchised passenger operator with a strong business case but which do not pay back within the remainder of a single franchise period.
130. The eligible schemes should meet the following key conditions:
- The estimated cost is less than £10 million, although schemes above this value can be included on a case-by-case basis with government approval.
 - The scheme promoter prepares the business case and must pay for all the costs resulting from the scheme (including any relevant incremental operations, maintenance and renewals costs that fall within the charge recovery period, subject to the £50,000 threshold described in paragraph 81) for an agreed period. For franchisees this will generally be the remaining term of the franchise agreement, which should have at least two years remaining – successor franchisees then usually take on the payment obligations at the end of the promoter's franchise. Franchisees

with less than two years remaining can qualify if government supports the case.

- Network Rail must confirm its support for the scheme in writing and confirm that the scheme is consistent with other relevant policies and strategies (including its delivery plan and relevant route utilisation strategies).
- The scheme must satisfy our criteria for adding investment expenditure to the RAB.

131. Costs should be recovered through a facility charge. For *self-financing schemes* a default recovery period applies.

Recovery period for *self-financing schemes*

132. For *self-financing schemes* the default maximum recovery period is 15 years, so that most franchisees will pay a reasonable proportion of scheme costs, and so the business case must be robust to provide a return on investment. We recognise that there may be good schemes for which a longer recovery period is appropriate and we are prepared to approve schemes with longer recovery periods, but in such cases we need confirmation of Government support.

7.4 Government sponsored schemes

133. Government sponsored schemes are those which are promoted by DfT or Transport Scotland but that are not required by their high level output specifications (and so were not funded in the periodic review). The approach to cost recovery for these schemes mirrors the approach taken to setting charges in PR08.
- The efficient enhancement spend is added to the RAB. We would generally expect payments for the incremental investments to begin at the point at which Network Rail incurs expenditure on those investments, rather than logging up the financing costs within the control period and adding these to the RAB at the next periodic review. At the next periodic review the amount of the RAB addition would be reviewed to ensure it was both efficient and represented the economic value added by the investment. It is then expected that the investment would be reflected in an increase in fixed track access charges or government grants at the next periodic review.
 - Government must fund any ongoing OMR costs on a pay-as-you-go basis until the subsequent periodic review.
 - At the next periodic review these incremental OMR costs of the enhancement will be considered together with those of other assets in determining Network Rail's revenue requirement and charges.

7.5 Accelerated renewals

134. The focus of this document is investment in *enhancements* of the network, but investors might also want to bring forward a like-for-like renewal, for

instance so that it can be coordinated with an enhancement to minimise disruption to services.

135. If Network Rail brings forward renewals – either from within the current control period or from a future control period – to deliver periodic review outputs in the current control period it will not receive any extra income.
136. But where a promoter wants to bring forward a renewal from later in the same control period the promoter should pay Network Rail for any increased financing costs arising from the timing difference.
137. If renewals are brought forward from a future control period, Network Rail is not funded for the renewal. Network Rail should supply the scheme promoter with an estimate of the additional financing costs resulting from the accelerated renewal and the funder should pay for these additional costs until the renewal costs are added to the RAB. The efficient costs of the renewal works should be logged up and remunerated through the RAB at the next periodic review.

7.6 Rebate mechanism

138. The rebate mechanism is designed to allow third party investors in large-scale enhancements to recover a fair proportion of the costs incurred in funding an investment scheme where other parties benefit from the use of the enhancement.
139. While in most cases we have sought to consolidate all our investment policy and guidelines into this document, in the case of the rebate mechanism we refer investors to our conclusions on the mechanism¹⁹. This is because the rebate mechanism conclusions are self-contained (no further references are required), and these guidelines would otherwise be significantly longer. The rest of this section outlines the mechanism.
140. Once an enhancement to the network is operational, any train operator can apply to Network Rail for access to it. If granted, the charge for access is payable to Network Rail, and as a general principle reflects the marginal cost of providing access. Under current arrangements, therefore, a third party funder cannot charge operators directly for access to an enhancement in which it has invested. Consequently, operators may be able to ‘free ride’ on the investment of others.
141. This ‘free rider’ problem means that the investor could be at a competitive disadvantage, reducing the incentive to invest and ultimately meaning that beneficial investments may not go ahead.
142. Third parties investing in large-scale track infrastructure²⁰ enhancements to the network can apply to Network Rail for a rebate charge to be put in place.

¹⁹ <http://www.rail-reg.gov.uk/upload/pdf/cns-rebatemech-finconc.pdf>

²⁰ Track infrastructure enhancements include enhancements to track, signalling and structures

This charge will be levied on operators that access and benefit from the enhancement. Government-funded schemes are outside the scope of the mechanism.

143. Investors will only be eligible for the rebate mechanism if they can demonstrate to Network Rail (and us) that they satisfy one of two criteria:
- The funder is a private sector third-party funder and:
 - is not being funded for the investment through other mechanisms (e.g. franchising arrangements or grants);
 - there is a stand-alone business case for the investment in the absence of the rebate and free riding;
 - there is a real likelihood of free riding on the investment by competitors, which would mean that the project could not be undertaken without the prospect of such higher charges; and
 - the funder has explored thoroughly the possibility of joint funding arrangements before applying for the rebate mechanism.

or

 - The funder is a public sector third-party funder (e.g. Transport for London (TfL), Passenger Transport Executives (PTEs)) and:
 - is not being funded for the investment through other mechanisms (e.g. Transport Innovation Fund (TIF) grants);
 - the scheme represents value for money in the absence of the rebate;
 - funding constraints mean that the scheme could not proceed, or would be delayed with significant adverse effects, without the prospect of recovering higher charges via the rebate, due to a lack of available funding;
 - the prospect of recovering higher charges via the rebate would ease the funding constraint; and
 - the funder has explored thoroughly the possibility of joint funding arrangements before applying for the rebate mechanism.

The rebate charge

144. The rebate charge will be an (index-linked) tariff levied per benefiting path, and will be payable to Network Rail as a premium to the access charge. Network Rail will then have responsibility for distributing the tariff received to the appropriate investing party(ies), the rights to which will be set out in the relevant access contract or access option.
145. The level of the charge should be calculated by Network Rail and be based on the average annual cost of the investment per relevant path available. The charge will be applicable only for the ex ante payback period of the investment, as set out in the access rights or options of the investing entity. If the original investor loses its access rights with respect to the enhancement, the mechanism for paying rebate charge to the investor will survive, unless the investor has been appropriately compensated for its investment.

146. The mechanism will be implemented through applications under section 17 to 22A of the Railways Act 1993. The level of the rebate charge and the expiry date of the charge should be set out in schedule 7 of the track access contract.

8. Investing at depots

8.1 Depot arrangements

147. Contractual, operational and charging arrangements at depots are different from those in place at stations. Our role in enhancements at depots is limited to the light maintenance depots owned by Network Rail.
148. These depots provide a range of services, dependent on the size and structure of the depot, its technical capabilities, the equipment used, and the type of rolling stock provided for. Therefore, parties negotiate access to a depot depending on their specific circumstances and the services required.
149. For this reason we have not published formal guidelines on the process for investing in enhancements at Network Rail owned light maintenance depots, although Network Rail must comply with its licence condition obligations.
150. The situation is different if RAB financing is sought, as in these cases the scheme will be subject to the considerations set out in section 4.1 *Financing using the RAB*. In many cases expenditure on enhancements at light maintenance depots owned by Network Rail would be eligible for a RAB addition in principle.
151. For such RAB financed enhancements, charges to recover costs should be included in the annexes to depot access conditions, which form part of the depot access contracts.
152. If stakeholders think that more detailed guidelines from us would be useful in this area, we will consider this once this consolidation of existing investment advice is finalised.

9. Sale of land or rights to land

9.1 Introduction

153. This chapter deals with two types of land related transaction that sometimes accompany investment framework enhancement:
- changes to the value of land as a result of access to the land granted by another party ('shared value'); and
 - the potential for Network Rail to take an asset, or work done to enhance an asset, in lieu of a cash payment for land ('hypothecated gains').

9.2 Shared value

Background

154. Shared value is the term used where a land owner seeks a share of the increase in value created when it grants property rights in respect of its own land, to a developer, and this increases the value of the developer's land.
155. For example, a developer owns a piece of land to which access is difficult because of intervening land (e.g. a railway). If the owner of the intervening land grants access rights to the developer's site over its land, then the value of the developer's site will rise. The land owner would then normally seek a share of this increase.
156. The principle behind seeking a share of any valuation uplift as a result of granting such rights is part of property valuation practice, established in the case of *Stokes v Cambridge*²¹. In summary, those granting development rights can seek a percentage of the uplift of the value of land caused by the granting of those rights, usually between 25% and 50% of the value added.

Guidelines

157. Network Rail can seek to share in the benefit of an increase in land value where that increase has been unlocked by providing developers with access to its own land or over its land. In doing so Network Rail must comply with relevant legislation. We would expect Network Rail to be mindful of relevant precedents, and not to frustrate developments from going ahead or significantly delay their implementation by adopting an unreasonable position. Where proposed developments have either direct or indirect rail-related benefits, we would expect Network Rail to have regard to this when negotiating with developers.
158. While there may be circumstances in which competition concerns might be raised, it should be noted that our role in enforcing the Competition Act 1998 only applies to services relating to the railways. It is likely therefore that

²¹ *Stokes v Cambridge Corporation* (1961) 13 P & CR 77

competition issues relating to developments that are not connected to the railways will fall outside the scope of our powers.

159. With these points in mind, it is a matter for the parties concerned to agree between them whether, in particular circumstances, shared value principles apply and, if so, the appropriate level of shared value.
160. If a developer thinks that Network Rail is unreasonably frustrating developments from proceeding it can take its case to the Lands Tribunal but Network Rail offers other options in order to resolve disputes, including mediation. Network Rail has also confirmed that it is willing to discuss other possible dispute resolution mechanisms with investors.

9.3 Hypothecated gains

161. 'Hypothecated gains' are assets taken (by Network Rail in this case) in lieu of cash. They occur where a developer offers to carry out an enhancement in return for, for instance, acquiring Network Rail land for development.
162. If Network Rail accepted cash from a developer, it would benefit directly from those receipts, whereas the value of enhanced assets taken instead of cash typically falls to other parties such as TOCs, passengers and funders. We want to incentivise Network Rail to take hypothecated gains instead of cash in those scenarios where developers can offer an asset whose value exceeds any cash payment they are prepared to make.
163. In our PR08 determination we accepted Network Rail's forecast of hypothecated gains of £255m in CP4²². We monitor Network Rail's progress in achieving this figure, and Network Rail will not benefit from RAB additions for hypothecated gains up to this value. Once this total is achieved in CP4, we will allow RAB additions on the basis set out below, in order to incentivise Network Rail to pursue hypothecated gains where they are of greater (whole industry) benefit than any cash alternative.
164. We have established a formula for calculating a total value for RAB addition in order to achieve this incentive effect. The total value added to the RAB should be:

$$T_{VRAB} = C_V + x\% (I_V - C_V)$$

where:

T_{VRAB} is the total value added to the RAB;

C_V is the forgone cash equivalent;

I_V is the economically efficient value of investment (usually the efficient initial capital cost);

²² £255m in 2006/07 prices. If the proposed developments at Euston and Victoria do not proceed in CP4, this figure of £255m reduces to £109m as set out in Chapter 23 of our determinations. They are available at <http://www.rail-reg.gov.uk/upload/pdf/383.pdf>

And therefore $(I_V - C_V)$ is the incremental gain; and $x\%$ is a percentage as described below.

165. We have set x at 25% to provide enough incentive on Network Rail to accept assets where their value materially exceeds any cash alternative²³. The closer the equivalent cash value is to the value of the asset, the stronger the incentive on Network Rail to take cash; where the value of the asset is significantly greater than the equivalent cash value Network Rail faces a strong incentive to take the asset.
166. Where Network Rail can demonstrate that the equivalent cash value is either zero or impossible to estimate, the formula set out above should apply with C_V set to zero.
167. There will be some additional transaction costs when Network Rail accepts assets in lieu of cash, but we think that in most cases these will be small when compared with the value of the RAB addition.
168. To summarise the approach, a proportion of the value of assets received as hypothecated gains by Network Rail above the PR08 forecast level of gains for CP4 would be eligible for addition to the RAB, subject to certain conditions:
 - confirmation from Network Rail that the value of each asset represents an efficient price for delivery of the investment received, and adds to the economic value of the rail network by an amount greater than the cash contribution Network Rail has foregone. For hypothecated gains which result in physical changes to a station, all users of the station would also be consulted through the station change process;
 - a maximum RAB addition for hypothecated gains of £5 million per scheme, with all gains above this value requiring explicit approval from us, in consultation with government;
 - an annual cap on such RAB additions for hypothecated gains of £50 million (over and above the PR08 forecast), again any gains above this value can be recognised as long as we provide explicit approval, having consulted government; and
 - other incremental costs resulting from the hypothecated gain would be treated as set out in the earlier chapters of this document (in the same way as for any other scheme cost).
169. Network Rail must set out details of expected hypothecated gains in its annual plans, to inform customers and funders.

²³ We will monitor the effect of the new policy and keep the value of x under review.

Annex A. Example facility charge

An example calculation of a facility charge is included in the spreadsheet accompanying this document, available on our website:
<http://www.rail-reg.gov.uk/upload/xls/annexa-facility-charge-calculation.xls>