Office of Rail and Road and Network Rail

Independent Reporter Lot 2

Review of the Industry Risk Fund and Network Rail Fee Fund

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1 Executive summary

Arup has been appointed by the Office of Rail and Road (ORR) and Network Rail as Lot 2 Independent Reporter to monitor and evaluate Network Rail's delivery of its enhancements. The purpose of this Mandate (dated 14th December 2017) is to provide an independent opinion on whether the current Risk Fund Mechanism is the most appropriate way of covering liabilities associated with enhancement projects funded by third party promoters outside the Periodic Review process.

The Investment Framework[1] was established in 2005 with the agreement of the ORR and DfT[2] in "The Policy Framework for Investments" (ORR, October 2005) to facilitate the process of third party promoters specifying, funding and delivering projects on the railway outside of the Periodic Review process. These third party projects are typically funded by private investment, Train Operating Companies (TOC's) and alternative sources of non-central government funding. From 2006 to 2017 the Investment Framework has facilitated the delivery of approximately £1.84bn[3] of rail related investment in the network through nearly 800 contract agreements.

Some of the liabilities associated with 3rd party investment are managed through a component of the Investment Framework known as the "Risk Fund Mechanism". The mechanism identifies certain principles for Network Rail and industry risk allocation between Network Rail and third parties and establishes two funds, the Network Rail Fee Fund (NRFF) and the Industry Risk Fund (IRF), to address the associated Network Rail contractual liabilities and the systemic industry risks associated with working in a rail environment. These funds enable Network Rail to stand in front of these risks and liabilities in the template agreements with third parties.

The Network Rail Fee Fund enables Network Rail to fund its contractual liabilities to the promoter (e.g. for breach of contract or negligence) whilst the Industry Risk Fund enables Network Rail to fund the associated liabilities for risks specific to the rail industry such as changes to railway safety standards, mandatory changes as a result of a change in the law and disruption caused by safety critical events.

Based on the findings of the Shaw Report[4] of 2016, the Department for Transport (DfT) is promoting the use of third party sources of funding and finance to increase investment in the network[5]. In this context, it is timely to review the appropriateness of the Risk Fund Mechanism.

[1] Stakeholder relations code of practice – investing in the network, Network Rail
[2] Policy Framework for Investments, ORR, October 2005
[3] Risk Fund Mechanism financial data, Network Rail Corporate Commercial, July 2018. The figure quoted is for project agreements up to £50m in value and excludes projects at GRIP stages 1-4.
[4] Shaw Report: The future shape and funding of Network Rail, March 2016
[5] https://www.gov.uk/government/publications/rail-market-led-proposals

The purpose of this study is to provide an independent opinion on whether the Risk Fund Mechanism process is appropriate and address the following questions:

1. Is the current mechanism to cover liabilities associated with the risk fees the most appropriate?
2. What have been the successes of the current mechanism?
3. Is there evidence that the mechanism has acted as a deterrent to investment?
4. What alternatives to the Risk Funds can be identified to fund these risks and to encourage investment?

Our approach has been to undertake a desk based review of the documents relating to the Investment Framework and to carry out a series of interviews with Government Agencies, scheme promoters, Network Rail staff and the Office of Rail and Road.

Contributors to the study have been selected on the basis of recent experience of the Investment Framework and an indicative sample of Network Rail Routes. We have taken care to differentiate between performance issues at a project level and the broader strategic intent of the framework. It should be noted that the sample size of contributors is relatively low.

1.1 Is the current mechanism to cover liabilities associated with the risk fees the most appropriate?

In addressing this question it is important to understand the levels of investment that have been facilitated in the network since the establishment of the Investment Framework. From 2006 to CP5 year 3, £1.84bn in value of rail related projects funded by third party promoters has been delivered on the network. During this period, contributions to the NRFF and IRF have totalled £71.15m as detailed below.

Agreements (No.)	**NRFF contributions (£m)**	**Outgoing NRFF payments (£m) ***	**IRF contributions (£m)**	**Outgoing IRF payments (£m) ***
796	46.93	(9.02)	24.21	(17.24)
Net position	37.91		6.97	
Current headroom	44.89			
Estimate of known liabilities**	41.20			
Potential headroom if all known liabilities are realised/validated	3.69			

* Value of completed successful claims paid

**Value of current outstanding claims (in progress). Note these may be IRF or NRFF

Figure 1.0: Status of risk fund contributions from 2006 till CP5 Year 3

From this total contribution, successful applications to the funds for payment have totalled £9.02m for the NRFF and £17.24m for the IRF. This results in a theoretical "headroom" of £44.89m. Forecast overall liabilities for the two funds as estimated by Network Rail to total £41.20m resulting in a smaller headroom of £3.69m.

To understand the proportion of risk fund contributions to the work delivered, the value of Network Rail charges and the value of the proposed 3rd party schemes needs to be considered. The value of Network Rail charges for works and service through agreements during the same period, is £903m associated with third party projects valued at £1.84bn. Accordingly, the level of contribution to both the NRFF and the IRF versus project value is 3.87% combined. This gives an approximate measure of the charges made by Network Rail in their agreements with promoters when compared with the value of work delivered.

As an overall comparator our studies suggest that construction project insurance (e.g. for Contractors All Risk or CAR insurance) is typically between 1 to 1.5%[6] of project value. However, traditional construction project insurance is far less relevant in the context of this study. The risk coverage is very different and, based on Network Rail's own internal review and our own investigations, is not freely available on the market. As such, any back to back insurance product would cost a great deal more than traditional CAR.

Our analysis indicates that the general trend for the NRFF headroom is upwards with a relatively small number of applications, but all of those submitted have been successful in securing funding to support validated contract claims. Generally, applications under the NRFF are harder to demonstrate (e.g. for Network Rail contractual breach or negligence). This compares to the IRF where claims have been more frequent and the funds held are more in balance with the levels of contributions received.

Our key recommendations are firstly, that the current[7] level of contributions made to the NRFF should be reviewed by the ORR and Network Rail. There is evidence to suggest that the fund headroom will continue to grow even once current forecast liabilities are taken into account[8]. In comparison we believe that the IRF shows a more balanced picture with a closer alignment between the value of IRF risk fees collected and the value of payments against validated claims.

Secondly, whilst there have been problems in implementing the Risk Fund Mechanism on some projects the overall level of contributions is of similar magnitude to other forms of project insurance seen in industry. We have explored the potential cost of a bespoke form of insurance product for the risks inherent in the rail environment. We have been advised that such insurance cover, whilst feasible to obtain in principle, is likely to be uncompetitive and offer poor value for money. Furthermore, our research has not identified any schemes similar to the Risk Fund being used by other public and private sector organisations. Approaches taken by organisations

[6] See Section 8
[7] See Section 5
[8] Contributions to the NRFF are a snapshot at CP5 year 3 whereas liabilities represent a forecast. Contributions beyond CP5 year 3 will therefore continue increase the available headroom.

such as the Environment Agency are based upon the Agency acting as the direct funder of similar risk events should they occur. In summary we recommend that no further consideration is given to obtaining back to back insurance arrangements with the market.

Thirdly, contributors have challenged the levels of transparency in the current Risk Fund Mechanism. In our opinion this is driven by a number of factors including 1) The absence of interim reports by the Office of Rail and Road or Network Rail to explain governance and oversight, 2) A misconception that promoters "own" the risk funds that they have contributed and 3) The high turnover of Project Sponsors and/or lack of knowledge at Route level resulting in poor communication with promoters when a risk event occurs. This results in the misunderstanding of the process, timescales and governance which reduces the confidence and trust of promoters.

Overall the Risk Fund Mechanism provides an innovative and, subject to review of the NRFF, a reasonably economical basis on which to fund risk events that impact promoter's schemes.

We have identified the following opportunities to improve the Risk Fund Mechanism by:

- Making reviews of the Risk Fund Mechanism more transparent to industry whilst recognising that promoters do not "own" the funds. Improvements to Project Sponsor training can improve the communication of the funds purpose and application, increase industry confidence and ultimately continue to facilitate investment; and
- Resolving 'disputes' more quickly. We understand that several promoters are in 'dispute' with Network Rail regarding project costs although this had not yet escalated to a formal process such as adjudication or arbitration. Feedback was that these 'disputes' take a considerable time to resolve and also cause significant financial uncertainty to organisations in the public sector. Conversely, evidence has been provided that some promoters withhold payment to Network Rail whilst disputes are being resolved. Going forward, referring these 'disputes' to a form of non-binding Alternative Dispute Resolution (e.g. Mediation) could benefit both parties and avoid unnecessary referrals to Adjudication.

In summary, we consider that the Risk Fund Mechanism is a reasonably appropriate mechanism to cover liabilities (subject to the findings and opportunities set out above).

1.2 What have been the successes of the current mechanism?

The Investment Framework and associated Risk Fund Mechanism has facilitated an anticipated additional investment of £1.84bn of works value delivered in rail related projects since inception. Over this timeframe a total of 17 applications have been made to meet the additional costs of risk events amounting to £26.24m (1.42% of project value).

Our first finding is that at a strategic level the Risk Fund Mechanism looks to have been very successful in meeting both the cost of risk events and in minimising the number of disputes that proceed to adjudication or arbitration.

The template agreements between Network Rail and promoters seem to clearly identify how the Risk Fund works with guidance available on line. In addition they form a good basis for a promoter to negotiate with Network Rail. Evidence from contributors illustrates that once promoters have this fuller understanding of the mechanism, they view their level of contribution much more positively.

Secondly, in terms of coverage and cost the Risk Fund Mechanism compares favourably with other possible alternatives. Based on our research a bespoke insurance scheme is likely to be more costly and be difficult to source from the insurance market. There is also no guarantee of a successful claim on such a policy with uncertain timescales and high costs likely to be incurred by a promoter in demonstrating a claim is valid. Other 3rd party investment strategies, e.g. of the Environment Agency for flood alleviation works, do not address the complex issue of industry risks for third party funded projects. As such, the Environment Agency is required to meet the cost of such events itself and has no funds in place other than traditional project or programme risk allowances to mitigate the impact.

Thirdly, compared to traditional forms of insurance policy, there is no excess for promoters to pay should a risk event occur when compared to traditional forms of insurance.

These are significant benefits and should be balanced against the negative feedback legitimately raised by contributors in the implementation of the Risk Fund Mechanism at a project level.

1.3 Is there evidence that the mechanism has acted as a deterrent to investment?

Firstly, given the 800 contract agreements entered into from 2006 up to CP5 year 3 and the anticipated rail project values, the mechanism appears to have been successful in encouraging investment. Our review has not identified any objective evidence that the Risk Fund Mechanism has significantly deterred investment. However it should be noted that no statistics are maintained on the number of promoters that have walked away from an investment due to the mechanism.

Based on feedback received from some promoters there is evidence that there have been problems with implementation of the mechanism or failures at project level which can and will deter investment now and in the future if not addressed. Network Rail's Licence Condition 1.19 encourages such a review. Accordingly, our second finding is that to enable greater investment, Network Rail should consider providing further training and guidance to its Project Sponsors to improve the practical delivery of the Mechanism. Much of the negative feedback received from contributors was consistently due to failings in process, timescales and governance upon which the promoter relies in order to manage their financial exposure.

[9] Licence Condition 1.1 states that Network Rail 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".*

In summary, whilst we have not identified any specific evidence at this time to identify that the Risk Fund Mechanism has acted as a deterrent to investment, we have identified concerns with the operation of the Mechanism at project level. It is suggested that improved training and guidance for Network Rail Project Sponsors would be useful.

1.4 What alternatives to the Risk Funds can be identified to fund these risks and to encourage investment?

Given the unique challenges of working on the rail network, some kind of risk sharing or risk pooling mechanism seems highly appropriate to encourage third party investment. The risk funds offer a unique solution and it is difficult to draw direct comparisons from other industries. However, some overall lessons can be learnt from how other industries manage risks associated with third party investments.

In the energy sector, the Regulator (Ofgem) or an Ombudsman is used to provide independent dispute resolution between energy companies and domestic users or micro-businesses. This provides consumers with an independent and free service to access in the event a dispute occurs. Such a role appears to be absent from the governance of the risk mechanism and could add value particularly given the reliance on only the statutory minimum requirements[10] in the contract to resolve disputes.

We believe that the ORR could improve confidence in the Mechanism by routinely reviewing the following aspects of the Risk Funds (in addition to the base data provisions already made by Network Rail), namely:

- Overarching trends such as the value of contributions vs anticipated project expenditure;
- Projected liabilities and the corresponding timeframe for realisation or mitigation;
- New applications to the fund made by Promoters with a focus on any high value applications and the period taken for parties to reach agreement;
- The level of headroom in both funds and the corresponding contribution levels to indicate the Value for Money being achieved;
- Transparency of project liabilities; and
- The frequency of contracts both in ‘dispute’ and those progressing to a form of formal dispute resolution.

We did not identify any specific alternative approaches to the Network Rail contract templates already in common use. Whilst risk allocation clauses in the contract templates can be complex

[10] Ref. Section 108 of the Housing Grants, Construction and Regeneration Act 1996. Where there is no adjudication procedure in a contract, or where the procedure does not comply with the legislation, a statutory default Scheme is used.

the promoter can negotiate alternative terms and conditions. As in any agreement it is incumbent on each party to seek qualified advice before entering into contract

Finally, our own research and also that of Network Rail has highlighted the challenge of obtaining a value for money alternative from the insurance market. Based on research to date it seems unlikely that insurance will be able to provide a cost-effective solution. This difficulty seems to arise from the bespoke nature of the investment and the complexities of allocating risk and undertaking claims management.

1.5 Acknowledgements

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