



**NOTICE, IN ACCORDANCE WITH SECTION 57C OF THE RAILWAYS ACT 1993, AS AMENDED, OF THE OFFICE OF RAIL REGULATION'S DECISION TO IMPOSE A PENALTY ON NETWORK RAIL INFRASTRUCTURE LIMITED**

**6 September 2007**

1. This document constitutes a notice, given in accordance with section 57C(6) of the Railways Act 1993, as amended (the "Act"), stating that:
  - a) the Office of Rail Regulation ("ORR") has imposed a penalty of £2,400,000 on Network Rail Infrastructure Limited ("Network Rail");
  - b) the penalty is in respect of a contravention by Network Rail of Condition 7 of its network licence;
  - c) the contravention is in respect of the Portsmouth resignalling project ("the Project") and comprised Network Rail making decisions which put it at risk of failing to meet the reasonable requirements of its customers over a significant period of time, without taking all reasonable steps to evaluate and mitigate the risk involved. ORR informed Network Rail on 5 June 2007 of its decision that Network Rail had breached its network licence. The acts and omissions which, in the opinion of ORR, constituted the contravention and justify the imposition of the penalty are more fully set out in paragraphs 10 to 12 of this notice;
  - d) the other facts which, in the opinion of ORR, justify the imposition of the penalty are set out in paragraphs 13-57 of this notice;
  - e) the penalty, which ORR has decided to impose on Network Rail, relates solely to the past conduct of Network Rail between September 2006 and December 2006, and it is without prejudice to any other enforcement action and/or penalty which ORR might deem appropriate in relation to Network Rail's completion of the Project. Network Rail has assured ORR that the Project will be complete by 29 October 2007, and ORR reserves its position with regard to any failure by Network Rail to meet this, or any revised, completion date of the Project; and
  - f) in accordance with the Act, the penalty should be paid to the Department for Transport. The penalty must be paid by 21 September 2007 to the Department for Transport by BACS transfer to account number 19761000 (sort code 10-14-99).
2. This notice follows publication of a notice under section 57C of the Act on 30 July 2007 describing ORR's intention to impose a penalty on Network Rail. Representations on this notice were received from Network Rail on 13 August 2007. No other representations were received.
3. ORR has taken account of Network Rail's representations. ORR considers that its assessment of the position, in particular Network Rail's failure: (i) to identify the risks effectively and to develop adequate mitigation measures to address the

possibility of extended disruption to services and the potential effect on third parties; and (ii) to manage the Project competently, remain as stated in its earlier notice. Furthermore, Network Rail has stated that it took action to mitigate the effect of the breach. ORR has already considered the mitigating effect of the circumstances of this case in reducing the sum from £6,000,000 to £2,400,000.

4. ORR has therefore decided to confirm the penalty of £2,400,000 described in the notice published on 30 July 2007.

### **Relevant legal provisions**

5. Under section 57A of the Act, ORR may levy a penalty of such amount as is reasonable if it is satisfied that the licence holder is contravening or has contravened a licence condition. The amount may not exceed 10 per cent of the licence holder's turnover defined in accordance with the Railways Act 1993 (Determination of Turnover) Order 2005 (SI 2005 No 2185). In broad terms, the Order defines applicable turnover as turnover on regulated activity in Great Britain in the business year preceding the penalty notice under section 57C, plus, where the contravention lasted for more than a year, an additional sum for such additional period (provided that the total sum is not more than double the preceding business year's turnover). Network Rail's turnover for 2006-2007 on regulated activity was approximately £5.5 billion.
6. No penalty may be imposed in respect of a contravention unless a notice is served on the licence holder within two years of the time of the contravention.
7. Under section 57A(6) of the Act, ORR shall not impose a penalty if it is satisfied that the most appropriate way of proceeding is under the Competition Act 1998. In this case ORR considers that the issue is one of a breach of a specific licence obligation and is not satisfied that it is most appropriate to proceed under the Competition Act 1998.
8. The relevant condition of Network Rail's licence is Condition 7.
9. Condition 7 requires Network Rail, by virtue of paragraph 2, to:

“take such steps as are necessary or expedient so as to achieve the purpose to the greatest extent reasonably practicable having regard to all relevant circumstances including the ability of the licence holder [Network Rail] to finance its licensed activities”.

“The purpose” referred to in paragraph 2 of Condition 7 is defined in paragraph 1, and is:

“to secure:

- (a) the operation and maintenance of the network;
- (b) the renewal and replacement of the network; and
- (c) the improvement, enhancement and development of the network,

in each case in accordance with best practice and in a timely, efficient and economical manner so as to satisfy the reasonable requirements of persons providing services relating to railways and funders in respect of:

- (i) the quality and capability of the network; and
- (ii) the facilitation of railway service performance in respect of services for the carriage of passengers and goods by railway operating on the network.”

### **The Contravention**

10. On 5 June 2007 ORR wrote to Network Rail informing it of ORR’s decision that Network Rail’s planning and executing of the Project was in breach of Condition 7 of its network licence and set out its reasons for this decision.<sup>1</sup>
11. ORR concluded that Network Rail contravened Condition 7 by failing to comply with the duty and achieve the purpose to the greatest extent reasonably practicable having regard to all relevant circumstances including the ability of the licence holder to finance its licensed activities. In particular, between September 2006 and December 2006, Network Rail failed to secure the operation and maintenance of the network and the renewal and replacement of the network in accordance with best practice and in a timely, efficient and economical manner, and made decisions about the planning and execution of the Project which put it at material risk of failing to meet the reasonable requirements of its train operator customers over a significant period of time, without taking all reasonable steps to identify, properly evaluate and mitigate the risks involved.
12. Two particular areas of concern led ORR to its conclusion. The first was Network Rail’s assessment of risk and the effect on third parties. ORR considered that Network Rail had failed to identify the risks effectively and to develop adequate mitigation measures, including contingency plans, to address the possibility of extended disruption to services and the potential effect of this on third parties. The second was Network Rail’s failure to manage the Project competently. In particular, ORR considered that Network Rail had failed properly to assess the plans and scrutinise the work of its contractor, to the extent that one would expect of an infrastructure manager striving for best practice, even after it became aware that there was a high level of risk to the Project and given the relative inexperience of its contractor in delivering works of this nature.

### **Network Rail representations on penalty**

13. Network Rail’s response to the notice of 30 July 2007 proposing the penalty, which was received by ORR on 13 August 2007, states that it considers the level of ORR’s penalty to be disproportionate in the circumstances of the case.
14. Network Rail accepts that the failures associated with the delivery of the Project have caused disruption for both train operators and passengers. However,

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<sup>1</sup> <http://www.rail-reg.gov.uk/server/show/nav.158>

Network Rail believes it has taken every step possible to mitigate this level of disruption and that its previous successful delivery of a number of major projects should be taken into account. It is on this basis that Network Rail considers the level of penalty to be disproportionate.

15. Network Rail also notes that ORR has given regard to steps that it has taken to mitigate the effect on passengers and the lessons it has learnt from this project.
16. In addition, Network Rail states that it has already set out its views on the ORR's reasons for proposing the penalty in previous correspondence. In this regard, ORR has received letters from Network Rail on 30 April 2007, 11 May 2007 and 12 June 2007 and a meeting took place with ORR on 8 May 2007. ORR has taken these comments into account in its decision on the licence breach and its proposal in its notice of 30 July 2007 to impose a penalty.
17. Network Rail's full representations can be viewed on the ORR website.

#### **Whether to impose a penalty**

18. Section 57B(3) of the Act provides that, in deciding whether to impose a penalty, and in determining the amount of any penalty, ORR must have regard to any statement of policy published at the time when the contravention occurred. In April 2006, ORR published its economic Enforcement Policy and Penalties Statement.<sup>2</sup>
19. At paragraph 5 of ORR's Penalties Statement, ORR states that, in deciding whether to impose a penalty, it will act in accordance with its duties under section 4 of the Act and will take account of five principles of good regulation: proportionality, targeting, consistency, transparency, and accountability.
20. ORR also says in its Penalties Statement that the penalty should be proportionate to the nature and severity of the contravention. In paragraph 7 of the Penalties Statement ORR has stated that it will consider, in particular:
  - (a) the seriousness of the breach;
  - (b) whether the breach or possibility of the breach would have been apparent to a diligent licence holder;
  - (c) culpability;
  - (d) the extent to which a penalty or reasonable sum would provide additional incentives on the licence holder to remedy the breach;
  - (e) the impact the breach has had on third parties;
  - (f) whether the licence holder has profited from the breach; and

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<sup>2</sup> <http://www.rail-reg.gov.uk/upload/pdf/287a.pdf>

- (g) the licence holder's record of compliance or non-compliance with this and other obligations and the need to provide an incentive for it to comply with its licence obligations generally.

21. On this basis, following its decision that Network Rail has contravened Condition 7, ORR has decided that it should impose a penalty on Network Rail. This notice relates solely to the past conduct of Network Rail between September 2006 and December 2006, and it is without prejudice to any other enforcement action and/or penalty that ORR might deem appropriate in relation to Network Rail's completion of the Project. Network Rail has assured ORR that the Project will be complete by 29 October 2007, and ORR reserves its position with regard to any failure by Network Rail to meet this, or any revised, completion date of the Project.

22. In reaching this decision, ORR has had regard to its economic Enforcement Policy and Penalties Statement which is considered in more detail below.

*(a) Seriousness of the breach*

23. The consequences of the breach have affected a limited part of the network - the route section between Fratton and Portsmouth Harbour. The standard train service is eight trains per hour in each direction, serving a variety of destinations. Following the blockade on 1 - 4 February 2007 during which no trains ran, the service was initially restricted to three trains each way per hour for around two months, before being increased to five trains per hour.

24. ORR considers that the success of the Project depended on thoroughly sound project management and decision-making and that in this case Network Rail's internal risk assessment was deficient. ORR considers that, if Network Rail's risk assessment approach is not reviewed and strengthened, there is a risk of further similar problems, potentially affecting wider areas of the network and larger numbers of operators and passengers. ORR therefore believes it important to demonstrate to Network Rail that it must manage its projects and make decisions in a way which adequately identifies and mitigates risks and which reflect the potential effect on third parties.

25. ORR considers that the wider context is important. The planned volume of signalling renewals has risen threefold in four years and Network Rail plans to sustain high volumes for many years to come. Network Rail is rightly growing and developing its supply base – and the appointment of the Portsmouth contractor was part of this development programme – but it needs to manage the inherent risks in so doing, in a way which it notably failed to achieve on this project. Projects must not be allowed to get to the point where the only options are to carry on with inadequately assessed and mitigated risks, or to cancel, with all the consequences on specialist resources and the knock-on impacts to the overall renewals programme.

*(b) Whether the breach or possibility of the breach would have been apparent to a diligent licence holder*

26. ORR considers that the breach or possibility of the breach would have been apparent to a diligent licence holder. This is because Network Rail's experience

of the blockade overrun in a previous signalling scheme at Sandbach-Wilmslow should have put it on notice of the risk of serious disruption to train operators and passengers if a signalling project is poorly managed.

*(c) Culpability*

27. ORR considers that Network Rail is culpable in that it failed to carry out an adequate risk assessment to inform its decisions. Even though its contractor carrying out the work may be at fault for the delays in completing the work on time, ORR considers that Network Rail should have managed its contractor more effectively and is responsible.

*(d) The extent to which a penalty would provide additional incentives on the licence holder to remedy the breach*

28. This is a past breach and ORR considers that Network Rail is now taking all reasonable steps to mitigate its effect.

*(e) The impact the breach has had on third parties*

29. ORR considers that the breach has had an adverse impact on train operators and on passengers (although the effect on operators has been mitigated by payment of compensation), which Network Rail has accepted. ORR estimates that more than 3 million<sup>3</sup> passenger journeys may have been affected in some way by the overrun of the Project and the reduced level of train service from the beginning of January 2007 until full services are restored in October 2007, after a further full blockade affecting all services for six days. To put this into context, some 3 million passenger journeys were made on the network each day in 2006-2007.

*(f) Whether the licence holder has profited from the breach*

30. Network Rail has not profited from the breach.

*(g) The licence holder's record of compliance or non-compliance with this and other obligations and the need to provide an incentive for it to comply with its licence obligations generally*

31. Network Rail stated in its representations that this Project should be viewed taking into account its previous successful delivery of a number of major projects. ORR has considered Network Rail's record of compliance generally and also in relation to previous signalling projects.

32. In this regard, ORR considers that Network Rail's experience of the blockade overrun at Sandbach-Wilmslow is relevant, for the reasons set out in paragraph 26 above.

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<sup>3</sup> This estimate includes not only those whose direct trains have been cancelled but also those who have suffered increased journey times and reduced frequencies.



33. In addition, ORR considers that Network Rail should have understood from ORR's decision to impose a penalty in April 2006 in relation to infrastructure capability that ORR expects Network Rail to be proactive in taking all reasonable steps to achieve the purpose of Condition 7. ORR considers that an appropriate penalty would signal again to Network Rail, the industry and rail users that ORR expects Network Rail to take compliance with its licence obligations seriously.
34. Since the Sandbach-Wilmslow incident did not lead to Network Rail addressing fully weaknesses in its risk assessment of signalling projects, ORR considers it essential to provide an effective incentive for Network Rail to do so. ORR considers that the imposition of this penalty will have a strong reputational effect on Network Rail.

### **Calculation of the amount payable**

35. In calculating the amount payable, ORR has stated in its Penalties Statement that it will consider:
- (a) proportionality;
  - (b) mitigating and aggravating factors; and
  - (c) financing issues.

### **Proportionality**

36. ORR has stated, in paragraph 10 of its Penalties Statement, that its principal objective in setting a penalty or imposing a reasonable sum will be to incentivise compliance with the relevant condition or requirement.

### *Context for Network Rail*

37. When considering how to incentivise a company such as Network Rail, ORR notes that the impact of a penalty is likely to be largely reputational rather than financial. In this case ORR considers that a penalty must be sufficiently high to send a message to Network Rail that it must address the weaknesses in its risk assessment and decision making, while also being proportionate to the breach and consistent with the other factors in ORR's Penalties Statement.
38. ORR can impose a penalty of up to 10% of turnover. However, in ORR's judgement, the principles and approach set out in the Penalties Statement and ORR's duties set out in section 4 of the Act, would rarely merit a penalty approaching that level, although each case will, of course, be considered on its merits at the time.
39. To arrive at the penalty in the current case, ORR has considered, broadly, and without prejudice to future decisions, how breaches by a company such as Network Rail, with its current financial structure, might be categorised by reference to their level of seriousness. ORR considers that "seriousness" would be likely to be judged by a number of factors, depending on the facts of the individual case, including the impact of the breach on train operators and passengers.

40. A “trivial” breach would not usually merit a penalty, although ORR would consider the merits of a penalty in relation to each individual case. For “minor” breaches, the range of penalty, where Network Rail has not profited from the breach and before any aggravating or mitigating factors are taken into account, might be up to £2m, although ORR would consider the circumstances of each individual case.
41. In this case, ORR considers that the breach is not trivial and is more than minor. It has led to real disruption to some train operators and passengers, for a period of some months, and if repeated, the breach could have a much greater impact on third parties and on Network Rail’s signalling programme generally. However, the effect of the breach in this case has been limited to those services between Fratton and Portsmouth and there is now a service, albeit a reduced one, operating. ORR therefore considers that this breach should not be classified as one of the most serious breaches but it considers that it is more than a minor breach and is moderately serious. In exercising its judgment, ORR considers that this breach would merit a penalty somewhere in the range of £2-10 million.
42. Paragraph 10 of the Penalties Statement states that the starting point for any potential penalty or sum imposed should be an amount greater than any benefit for the licence holder from not having been compliant in the first place, such that it will be more expensive for the licence holder to have been or continue to be in breach of its licence condition than to comply. Paragraph 11 of the Penalties Statement sets out factors that ORR shall have regard to when setting the level of penalty. ORR has considered all the information made available by Network Rail. This information is considered below against the factors set out in paragraphs 10 and 11 of the Penalties Statement.

*The benefit to the licence holder from non-compliance*

43. From information provided by Network Rail, ORR understands that Network Rail has incurred substantial additional costs because of the breach. Network Rail has stated that it may be able to recoup some of its costs in compensation, but will still have incurred significant additional costs. It is therefore clear that Network Rail has not benefited from the breach.

*The cost of compliance*

44. To ensure compliance, Network Rail might have employed external project managers who would have properly assessed the risks and developed appropriate mitigation plans.<sup>4</sup> Alternatively, Network Rail might have postponed the work. Network Rail has informed ORR that if it had done so, it would have incurred costs for the planned possessions, although these costs may have been recoverable in compensation.<sup>5</sup> Deferring the possession may also have had implications for Network Rail’s wider signalling programme, but ORR does not have any information quantifying these factors and therefore does not propose to

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<sup>4</sup> ORR estimates that this may have cost between £1m and £2m for twelve months’ work.

<sup>5</sup> Network Rail has provided estimated costs in this regard but has asked ORR to regard them as confidential, which ORR has accepted.



take them into account. ORR therefore estimates that Network Rail may have incurred slightly higher costs on the Project if it had complied with its network licence but that these would be significantly less than the additional costs incurred by Network Rail.

#### *The costs to third parties*

45. These fall into two categories:

- train operators: ORR understands that train operators are being compensated under Part G of the network code and under Schedule 4 of track access contracts. The adverse net financial effect on operators is therefore unlikely to be significant; and
- passengers: ORR has formed an estimate of the cost of additional disruption to passengers. This is based on the use of industry methodology and takes account of the number of passengers affected in some way by the overrun and the impact of their journeys. ORR assessed this to be between £5-8 million, for disruption to over 3 million passenger journeys.<sup>6</sup>

#### *Desirability of deterring contraventions of relevant licence conditions*

46. ORR's primary objective in setting a penalty is to incentivise compliance and to deter contraventions of licence conditions. ORR considers that the fact that, as a result of this particular breach, Network Rail will probably have to bear significant costs does not give it the same incentive to comply with its licence conditions in future as a penalty imposed by its regulator. ORR therefore considers that a penalty is desirable in this case to deter future contraventions.

47. ORR has estimated that Network Rail may have incurred slightly higher costs on the Project if it had complied with its network licence. However, (see paragraph 44), as this figure may not be material and because Network Rail has actually incurred a far greater sum than this because of the breach, ORR does not consider this assists to a great extent in assessing what level of penalty would deter future contraventions.

48. Finally, as ORR stated above, over 3 million passenger journeys may have been affected since January 2007. ORR has estimated that the cost to passengers of the breach might amount to a sum in the region of £5-8 million. Although this sum does not directly assist ORR in calculating what penalty is appropriate to deter Network Rail from contravening its licence again, ORR considers that it assists it to assess how serious the breach is and hence what might be the appropriate level of penalty in this case.

#### *Conclusion on proportionality*

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<sup>6</sup> ORR used standard railway industry tools (MOIRA and the Passenger Demand Forecasting Handbook) to arrive at this calculation. The impact on all passengers on the routes was assessed.

49. The breach of Condition 7 covered by this notice is a past breach. Network Rail has not benefited from it; indeed it has incurred significant costs as a result. However, Network Rail's signalling programme is an important part of its renewal of the network and this breach has had an adverse impact on stakeholders in the area. ORR considers that if similar events occurred elsewhere on the network they could affect the deliverability of Network Rail's whole signalling renewal strategy and could also have a greater impact on train services and rail users.
50. Ultimately, ORR considers that the appropriate penalty, while informed by the various financial and economic calculations above, has to be a matter of judgement and not arithmetic. Taking all factors into account, ORR considers that, within the range of £2-10 million that it would normally consider appropriate for a "moderately serious" breach, a figure of £6 million is in its view proportionate.

### **Mitigating and Aggravating Factors**

51. ORR considers that the applicable level of mitigation or aggravation will be a question of fact and judgement for each case.

#### *Mitigating Factors*

52. Paragraph 13 of its Penalties Statement sets out factors that ORR may consider as mitigation. In this case, ORR considers that there are two mitigating factors. These are:

*(a) any remedial steps the licence holder may have taken to rectify the breach, including whether these were initiated proactively by the licence holder or in response to ORR's actions*

Network Rail submitted in its representations that it has taken every step possible to mitigate the level of disruption. ORR considers that since January 2007 Network Rail has taken remedial steps to mitigate the effect of the breach and to complete the work, largely on a proactive basis. These have included installing temporary signalling at a cost of £6.3 million to increase the number of services running from 3 per hour to 5 per hour since April 2007. ORR considers that the extensive work which Network Rail has undertaken means mitigation should be applied under this heading.

*(b) any steps taken to minimise the risk of the breach recurring*

Network Rail has confirmed in writing that it is applying the lessons of Portsmouth to future major signalling projects, and that it will be putting additional checks and balances in position to minimise the risk of similar problems occurring again in the future. ORR therefore considers this is a mitigating factor.

53. There are two other mitigating factors listed in paragraph 13 of ORR's Penalties Statement which are co-operation with ORR's investigation and evidence that the breach was genuinely accidental or inadvertent. ORR does not consider that in this case these factors should contribute to mitigation of the level of penalty.

#### *Aggravating Factors*

54. Paragraph 15 of the Penalties Statement sets out the factors that ORR may consider as aggravating. These are: (a) whether any infringement is deliberate or reckless; (b) repeated or continuing infringement of this or other obligations, particularly if subsequent breaches occur after the licence holder becomes aware of, or is made aware of, the initial infringement; (c) the extent of involvement of directors or senior management in the action of inaction which caused the breach or their lack of involvement in action to remedy the breach; (d) the absence of internal procedures intended to prevent infringements occurring and the extent to which organisational weaknesses may result in repeated infringements of the same type by the same licence holder; and (e) evidence that the licence holder attempted to conceal the infringement from ORR.
55. ORR considers that although a number of the aggravating factors listed above are relevant to this case, they have contributed to the finding of a breach and/or the assessment of its seriousness and have therefore already been taken into account.

#### *Conclusion on Mitigating and Aggravating Factors*

56. ORR therefore considers that there are two significant mitigating factors in this case. The fact that Network Rail has been proactive in seeking to mitigate the effects of the breach and its readiness to apply the lessons from Portsmouth should, in ORR's view, result in a significant reduction in the penalty. Taking these together and, in particular, focusing on the amount of work that Network Rail has undertaken to remedy the effect of the breach, ORR has decided that the penalty should be reduced by 60% to £2,400,000.

#### *Conclusion on the amount of the penalty*

57. For the reasons set out above, and having taken account of representations duly made and not withdrawn on the notice published on 30 July 2007, ORR has decided that the amount of the penalty should be £2,400,000.

### **Financing Issues**

58. In ORR's Penalties Statement, ORR notes that it has a duty under section 4 of the Act not to make it unduly difficult for a network licence holder to finance those activities in relation to which ORR has functions. In the case of Network Rail, this duty might have a bearing on the level of penalty ORR might impose. In this case, ORR does not consider that the level of penalty would make it unduly difficult for the licence holder to finance its activities and considers it consistent with its duties under sections 4(1)(b) (to promote the use of the network for the carriage of passengers and goods), 4(1)(c) (promoting efficiency and economy) and 4(1)(g) (enabling persons providing railway services to plan their businesses with a reasonable degree of assurance).

### **Conclusion**

59. Having regard to ORR's duties in section 4 of the Act, the factors listed in paragraph 7 of ORR's Penalties Statement, representations received and for the reasons set out above, ORR has decided that it should impose a penalty in respect of Network Rail's contravention of Condition 7 as described in this notice.



60. ORR has considered Network Rail's representation that a penalty of £2,400,000 would be disproportionate. However, as Network Rail itself acknowledges, ORR has already considered the mitigating effect of the circumstances of the case in arriving at this sum and ORR does not consider that Network Rail has offered any additional reasons why it should not impose the proposed penalty or why it should reduce the amount. Therefore, for the reasons set out above and having regard to the factors listed in ORR's Penalties Statement and to Network Rail's turnover in 2006-07, which was approximately £5.5 billion, ORR has imposed a penalty of £2,400,000.

A handwritten signature in blue ink, which appears to read 'Bill Emery', is positioned above the printed name.

**Bill Emery**

**Chief Executive of the Office of Rail Regulation**