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OFFICE OF RAIL REGULATION

9 May 2008

Dear Stakeholder

Investment Framework - ORR conclusions on our review of the approach to third party investments

Background

1. We have established a policy framework for investments with the objective of facilitating efficient investment in the rail network. As part of that framework we have developed an approach with the aim of ensuring investments promoted by third parties[1] are delivered effectively. In our March 2007 document "Policy framework for investments - update on implementation guidelines" (our investment guidelines[2]) we said that we would carry out a comprehensive review of the arrangements for third party schemes once these arrangements had been in existence for a full financial year, i.e. around September 2007.

2. Our investment guidelines asked stakeholders for comments on certain aspects of the current arrangements for delivering third party schemes, including the suite of nine template agreements which we approved under part G of the network code (the templates).

3. Following a stakeholder workshop held on 19 April 2007 to review the current arrangements, we received 13 consultation responses[3]. We then asked Network Rail to consider the issues raised in the responses and, in the first instance, to propose appropriate changes to the template agreements (and other relevant arrangements) to address those issues. Network Rail set out its proposals in a letter to us on 12 July 2007[4].

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[1] That is, bodies other than Government

[2] Available at http://www.rail-reg.gov.uk/upload/pdf/invest-guide-let-020307.pdf

[3] Available at http://www.rail-reg.gov.uk/server/show/ConWebDoc.8746

[4] Available at http://www.rail-reg.gov.uk/upload/pdf/impgui-nr-120707.pdf

4. We subsequently received further comments from consultees on Network Rail's proposals and on a related presentation given by Network Rail in September 2007 at two further industry stakeholder workshops. Our review takes account of the views expressed by consultees. As part of our review, we circulated to stakeholders in December 2007 a copy of a high-level note addressed to Network Rail, which identified the key areas in which we had established that changes should be made to the Templates.

5. This letter and the attached paper provides our conclusions from our review of the current arrangements for third party schemes. The attached paper sets out more fully the areas where we have established that changes need to be made to the templates, or the accompanying policy framework.

Our approach to the review

6. Although we welcome the proposals made by Network Rail in July and September last year for changes to the arrangements, including the templates, our view is that they do not go far enough. As a result of our review, we have identified a number of further changes which need to be made to the templates, which we describe below and in the attached paper.

7. The aim of our review is to improve the approach to third party investments by ensuring that the risk allocation in the templates – and the associated arrangements - properly reflects our policy framework for investments. In this review we have therefore focussed upon the allocation of risk between Network Rail and third party customers, and how this risk allocation is applied in the templates. The changes we require will ensure that risks and liabilities are borne by those best able to manage and mitigate them. This is consistent with the terms upon which we approved the templates in 2006[5], when we said that we would be monitoring the use of the templates, particularly in relation to the allocation of risk. It is also consistent with our general duties under section 4 of the Railways Act 1993, and in particular, our duty to perform our statutory functions in the manner best calculated to:

- promote the development of the railway network to the fullest extent that we consider economically practicable; and

- to promote efficiency and economy on the part of persons providing railway services.

[5] Available on the "investment" section of our website, see http://www.rail-reg.gov.uk/upload/pdf/netcode_partg-3rdptyinvest.pdf

8. Our investment framework sets out the default allocation of risk for investments[6], which should reflect the following principles:

- Network operator risks should be borne by Network Rail.
- Design risk should be borne by the scheme designer
- Construction risks should be borne by Network Rail (where a promoter has required Network Rail to deliver the scheme).
- Funding / financing risks should usually be borne by Network Rail, unless a third party is arranging finance separately; and
- Output, or infrastructure capability risk: the customer may choose to bear this risk itself, but if the customer wishes to pay Network Rail to take infrastructure capability risk, it should be offered a price to do so and Network Rail should bear it.

9. We have considered how this default risk allocation should be given effect in the templates, noting that certain risks may have particular implications for third party funded schemes, given the cascade of risks for both parties (and potentially for Government) resulting from the operation of the two risk funds: the Network Rail fee fund (NRFF) and the industry risk fund (IRF).

10. Network Rail has responsibility for drafting the templates. It is therefore Network Rail's responsibility to ensure that all necessary changes are made to the templates, noting that many of our required changes apply to several templates. This review also provides an opportunity for Network Rail to address issues which, although not directly related to our policy framework, are clearly desirable to improve the templates and customer satisfaction with them - for example consistent treatment of common issues across the different templates.

11. We expect that following the satisfactory completion of this process (see the 'next steps' section below) we would not need to review the templates again until into the next control period (2009-14), with the exception of contributions into the NRFF and IRF. We will, of course, still need to deal with any complaints or disputes in an appropriate way, and will continue to monitor Network Rail's activity in this area, with assistance from one of the independent rail reporters as required.

12. The default template provisions should not constrain customers from seeking alternative terms. Customers and Network Rail have the flexibility to negotiate alternative provisions if they represent a more appropriate allocation of risk in the particular circumstances. Network Rail should not use the fact that we approve the default template provisions as a reason for refusing to agree alternative terms.

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[6] See our document "Policy Framework for Investment: Conclusions" published in October 2005, paragraph 3.9, available at http://www.rail-reg.gov.uk/upload/pdf/255.pdf

Key policy issues covered in the attached paper

Design risk

13. Network Rail will accept certain design risks for design work it undertakes. We think that this principle should apply equally to all templates under which Network Rail carry out (or procure) design work, and that Network Rail needs to go further than it originally proposed, particularly in relation to the emerging cost version of the Implementation Agreement (IA). A number of provisions will require amendment to give effect to this principle. In particular, the Network Rail standard of care provision needs to be stronger, and certain indemnities and exclusions from liability need to be removed.

Construction risk

14. The position for construction risk is very similar to that for design risk - where a customer contracts with Network Rail for construction work, the default position should be that Network Rail takes on construction risk in both the short and the long term. Similar amendments are required as in relation to design risk.

Costs of contractor's default

15. On a related issue, Network Rail has proposed that it should be liable for the costs of its contractor's default up to the Network Rail cap. While this proposal is welcome, the templates should not contain any mechanism under which the company can recover from a customer in respect of losses caused by Network Rail's own contractor's default. Also, this proposal does not in any way remove the need for Network Rail to accept liability for relevant risks, as described above.

Indemnities

16. Network Rail proposed removing indemnity provisions in some of the agreements and clarifying the remaining indemnity provisions. We welcome these changes, as the indemnity provisions were a significant source of concern amongst stakeholders.

Liquidated damages (LDs) and delay

17. The two main issues are the conditions under which LDs would be payable and the level of LDs payable by Network Rail when it misses a project completion date.

18. The templates should establish specific obligations on Network Rail in relation to timely completion to a single deadline where Network Rail is carrying out design services or procuring construction works, and should generally provide for the payment of LDs by Network Rail to the customer in the event of a failure to meet the agreed date, without the imposition of additional conditions. We have reservations in relation to the existing two-tier arrangement, in particular that this regime could be unenforceable in some

circumstances. We therefore consider that such provisions should only be used at the customer's request.

19. In relation to the level of LDs, in general, they may be quantified in two ways:

(i) as a pre-estimate of the loss a customer will suffer in the event of breach, so that the damages compensate the customer for its loss, or

(ii) as a lesser sum, in which case the imposition of liquidated damages will in practice operate as a cap on Network Rail's liability for delay.

20. For example, if it is estimated that the customer will suffer £5,000 of loss per day, and liquidated damages are payable for that amount, the damages will compensate the customer in full for its loss. Alternatively, if the customer's estimated losses are £5,000 per day, but liquidated damages are fixed at the amount of £2,500 per day, the amount of the liquidated damages will effectively cap Network Rail's daily liability for delay in the amount of £2,500.

21. When liquidated damages are intended to compensate the customer, they should be negotiated on a case by case basis to avoid the risk that the provisions will not represent a genuine pre-estimate of loss and so will be unenforceable. It is open to the customer to agree to damages which are less than compensatory if it wishes, but it is not possible for us to set in advance the damages which are payable in those cases under the templates.

22. We understand that where a customer contracts with Network Rail and Network Rail in turn engages a consultant**,** liquidated damages are already negotiated between Network Rail and its consultant. As a result, a move to negotiated LDs under the IA, and other agreements where Network Rail carries out work for the customer, should not necessarily introduce any new commercial negotiations. We recognise that it may be useful for Network Rail to publish an indicative table of values on the basis of past experience, although such guidelines are not a substitute for a genuine pre-estimation of loss in each case.

23. In general it is not clear whether this revised approach would lead to an increase in the total LDs payable to customers in the event of delay, allowing for both "pass through" damages from the contractor and Network Rail damages. However, this approach will better reflect the proper allocation of risk, which is that Network Rail is liable to its customer on terms agreed with that customer, and it is for Network Rail to negotiate suitable terms with its contractors.

24. It is appropriate for LDs effectively to operate as a limitation of liability where Network Rail is carrying out non-contestable services under an APA or a BSA as:

(a) Network Rail is obliged to carry out the services and so any negotiation would be asymmetric; and

(b) the losses which the customer may incur as a consequence of delay may be entirely out of proportion to the value of the works undertaken by Network Rail.

25. In this situation, the customer may have recourse against its own construction contractor if work is delayed, so that its rights against Network Rail are not its sole remedy for delay. It may also be appropriate for LDs effectively to operate as a limitation of liability where Network Rail is carrying out development services under a DSA or FA. This is because development services are carried out at an early stage of a project, when there will be significant uncertainty as to what the possible consequences of delay might be, including as to whether the project will proceed at all.

Liability caps

26. There is no one particular level at which it is correct *ex ante* to establish a liability cap, and it is therefore difficult for us, as part of this review, to quantify what would ordinarily be a negotiated matter. However, in its September 2007 presentation, Network Rail proposed that the cap under the APA should be increased from 30% to 40%. This margin of increase in the cap should be applied to the other templates to provide a better balance of incentives for Network Rail. Also, there are some important clarifications required to the definition of the customer cap (for example, in relation to sums recovered from insurance claims) to ensure that the allocation of risks is fair and balanced.

27. Under the existing templates, claims for negligence are not limited by the Network Rail cap. Given the modifications we require to Network Rail's obligations in relation to construction and design risk, it is appropriate for liability for negligence to be brought into line with its liability for breach of contract where Network Rail is providing contestable services (i.e. under the IA, DSA and FA). We consider that this will also remove incentives on customers to present as claims for negligence those claims which should properly be brought as claims for breach of contract. We do not consider that this change puts customers in a materially less advantageous position than at present under the existing templates, as in practice we understand that any claims for negligence against Network Rail are currently rare.

Variations and Network Rail's power to change a programme of works

28. Many consultees expressed significant concerns in relation to the breadth of Network Rail's powers to make changes to a scheme. Changes to the templates are required to remove some of these discretionary powers and ensure that customers have adequate protection, such as Network Rail's power to propose variations under the IA to which the customer cannot object.

29. Similar concerns were raised at the breadth of Network Rail's powers to vary the programme under the IA. Several consultees said that such powers undermine the provisions of the contract relating to compensation for delay. The circumstances in which Network Rail is entitled to extend time under the IA should be clearly set out in the IA itself. A similar issue arises in the DSA, which requires redrafting to clarify these circumstances.

Provision of information

30. Consultees expressed concern that Network Rail's obligations[7] under the templates in respect of network information provided to customers are inadequate. We do not consider it appropriate to replicate the provisions of Part K of the network code (information) in the templates. However, given that Network Rail is the principal source of information relating to the network, it is an appropriate allocation of risk for Network Rail to have obligations to:

(a) provide any information reasonably requested by the customer in connection with the particular project and which is in Network Rail's possession; and

(b) ensure that any such information should in all material respects be the most complete and accurate information in Network Rail's possession.

Financial impact of our review

31. Although we recognise that some risks are reallocated under the changes described above, we do not believe that any of these changes will materially impact on the financial risks borne by Network Rail, or by Government (who stands behind the framework) for the reasons set out below.

32. First, the revised Templates will reflect more accurately the default allocation of risk set out in our policy framework, which reflects good practice for construction projects generally and is appropriate for Network Rail in relation to most enhancement schemes. While the revised templates will incorporate important new rights in favour of customers, we do not consider that Network Rail will, under the revised templates, accept any risks which were outside the scope or the intent of the policy framework prior to this review.

33. Second, the templates will continue to contain overall caps on liability, although we do require an increase in the level of such caps. Liability caps control the overall level of risk to which Network Rail is exposed.

34. Third, we accept that some of the changes which we require should be balanced by other changes to the templates. The key example of an additional protection for Network Rail is , as noted above, a cap on Network Rail's liability for negligence under the templates. Therefore, the additional risks accepted by Network Rail will be balanced by the introduction of other new provisions.

35. As part of our review, we have also reviewed in the next section the current level of customer contributions to the NRFF and IRF, and any drawdowns from the risk funds.

[7] See for example clause 5 of the APA

Payments into the new Risk Funds

36. Many consultees asked for more details on the quantum of payments already made into the two risk funds, the IRF and the NRFF, and in some cases expressed concerns that the current levels of contribution were too high. Having reviewed the current levels both in absolute terms and across agreements, we have considered if any changes are necessary to current levels, having due regard to the level and source of the payments.

37. We accept Network Rail's September 2007 proposals to halve (from 10% to 5% of Network Rail costs) the level of customer contributions to the Network Rail Fee Fund for those templates covering the development stage of projects. These reductions should better reflect the risk profiles of the different templates. We intend to keep the level of customer contributions to the NRFF under review.

38. The table below summarises the estimated contributions agreed for the two risk funds up to the end of September 2007[8].

Summary of contributions to fee funds agreed in the period April 2006 - September 2007 (£m 06/07 prices)

	Value of NR Services	NRFF	IRF	Total agreements	APA/ BAPAs	Feasibility (BSAs)	Design (FDA/ DSA)	IAs
Private sector (excl TOCs/FOCs)	£6.3	£0.5	£1.1	53	20	15	14	4
Public sector	£109.8	£5.9	£2.1	71	9	23	22	17
TOCs/FOCs	£6.0	£0.3	£0.2	25	9	7	6	3
Total	**£122.1**	**£6.8**	**£3.5**	**149**	**38**	**45**	**42**	**24**

39. The table shows that £6.8m of contributions were committed over the period to the NRFF and £3.5 m to the IRF. Therefore, in total, customers have paid around £10 million in contributions to the risk funds. The public sector has entered into around half the agreements with NR and is responsible for almost 90% of NRFF contributions and over 60% of IRF contributions. This high proportion is primarily because the public sector has to

[8] Note that the actual level of contributions may differ from these figures due to variations on emerging cost schemes.

date requested more implementation services from Network Rail (17 out of the 24 implementation agreements are with public sector customers), and the fee fund contributions for IAs are based on full implementation costs rather than design or asset protection services. This is also reflected in the high value of NR services for the public sector.

40. Up until September 2007, no drawdowns had been made on the two risk funds. This is primarily because the majority of agreements entered into using the new templates have covered design services, or relate to schemes where the implementation phase is at an early stage. It is too early to draw any firm conclusions from the very low level of drawdowns, as we would expect Network Rail to accrue a buffer of funds in the early stages of using the Templates. It is also possible that future claims on the funds may be relatively large and "lumpy". We would not necessarily expect the profile of such claims to be predictable or stable across time. The amounts accrued in the two risk funds therefore need to be sufficient to cover such claims. For these reasons we are not proposing any material changes to the level of contributions to the funds, other than those described above for the agreements covering the development phase of schemes.

41. We intend to review the contributions into the funds, and drawdowns from them, in early 2009, when more information should be available to inform any changes we need to make to these arrangements for control period 4 (which begins on 1 April 2009). That limited review would also consider the extent to which there is any potential for cross-subsidy due to differing risk profiles of different schemes, particularly those promoted by public and private sector bodies, and may cover whether or not major schemes (with a rail-related value above £50 million) should attract a higher level of contribution.

Next Steps

42. The next steps in this process are for Network Rail to implement the changes we require to be made to the templates. Network Rail therefore needs to:

(a) revise the templates appropriately. We understand that it has already made considerable progress on these revisions, although it now needs fully to reflect the issues described in the attached paper.

(b) issue the revised draft templates to stakeholders in a staged process starting in June 2008 with:

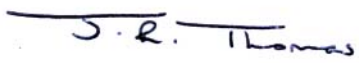
(i) document(s)[9] explaining why these changes have been made, and how the changes are consistent with the paper attached to this letter;

[9] Network Rail may choose to issue a separate supporting document for each Template

(ii) asking for comments within six weeks (from the date each revised template is issued) on whether or not the changes set out in our paper have been properly taken account of in the templates;

(c) Having taken due account of stakeholders' comments, resubmit the templates to us for approval. We expect NR to commence resubmission of the templates for approval from August 2008.

Yours sincerely



John Thomas

Policy framework for investments - Conclusions on our review of third party templates

Introduction

1. We are requiring Network Rail to revise the set of template agreements it uses for third party investment in its network (the templates). Under part G of the network code, condition GA3(b)(vi), ORR must approve the model terms and conditions used by Network Rail when contracting for the implementation of a network change (due to an investment). The templates fall within condition GA3(b)(vi). We have also considered the templates as part of our policy framework for investments[1] more generally. We have also considered certain associated issues relating to our policy framework for investments. This paper sets out our conclusions.

2. The current templates were approved by us in 2006. However, Network Rail was aware that the templates as approved in 2006 did not fully address all the issues raised by us at that time. We made clear our intention in approving the templates to keep them under review, particularly in relation to the allocation of risk between Network Rail and customers wishing to invest in the network.

3. In March 2007 we therefore initiated a further consultation on the policy framework for investments, including the templates. We received comments from stakeholders on our March 2007 consultation document. In July 2007, Network Rail issued a letter setting out its response to the consultation[2], and responding to some of the issues raised by consultees. We have received further comments from consultees on Network Rail's letter and on a related presentation given by Network Rail in September 2007 at two industry stakeholder workshops[3]. Our conclusions take account of, but are not solely the product of, the views expressed by consultees during the two consultation processes.

4. In December 2007, we circulated to stakeholders a high-level note, addressed to Network Rail, which identified the key areas in which we had established that changes should be made to the templates. Those areas are the subject of more detailed discussion in this paper. We also set out in this paper a number of other areas, in addition to the key areas identified in our high-level note, in which we require changes to the templates. Appendix 1 sets out a list of proposed drafting changes to the templates, many of which reflect consultee comments. Appendix 2 sets out our reasons for deciding that some areas raised by consultees do not require changes to be made to the templates.

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[1] Available on our website at http://www.rail-reg.gov.uk/upload/pdf/invest-guide-let-020307.pdf

[2] Available on our website at http://www.rail-reg.gov.uk/upload/pdf/impgui-nr-120707.pdf

[3] Available on our website at http://www.rail-reg.gov.uk/upload/pdf/inv-nr_pres_260907.pdf

5. As will be apparent from the remainder of this paper, the areas in which we require changes to the templates include certain areas which we addressed when the current templates were approved in 2006. We are satisfied that it is necessary to revisit certain aspects of the templates, such as liability caps and liquidated damages, which we considered as part of our last review.

6. We have considered Network Rail's comments and proposals as set out in its July 2007 letter and its September 2007 presentation. We have also taken into account discussions with Network Rail and further written representations. References below to Network Rail's letter of 12 July 2007 are to items in attachment 1 to that letter.

Our Approach

7. In reviewing the templates, we have focussed upon those aspects of the templates which are concerned with the allocation of risk between Network Rail and parties wishing to invest in the network. The changes which we require will ensure that risks and liabilities are borne by those best able to manage and mitigate them. This is consistent with the terms upon which we approved the templates in 2006, when we made clear that we would be monitoring the use of the templates particularly in relation to the allocation of risk. It is also consistent with our general duties under section 4 of the Railways Act 1993, and in particular, our duty to perform our statutory functions in the manner best calculated to:

(a) promote the development of the railway network to the fullest extent that it considers economically practicable; and

(b) to promote efficiency and economy on the part of persons providing railway services.

8. We remain of the view set out in paragraph 3.9 of our document “Policy framework for investment: Conclusions” published in October 2005, that the default allocation of risk in relation to investments, which should be given effect by the templates, is as follows:

(a) Network operator risks should be borne by Network Rail;

(b) Design risk should be borne by the scheme designer;

(c) Construction risks should be borne by Network Rail (where a promoter has required Network Rail to deliver the scheme);

(d) Funding / financing risks should usually be borne by Network Rail, unless a third party is arranging finance separately; and

(e) Output, or infrastructure capability risk: the customer may choose to bear this risk itself, but if the customer wishes to pay Network Rail to take infrastructure capability risk, it should be offered a price to do so and Network Rail should bear it.

9. It is however necessary to consider how this default risk allocation should be given effect in the templates, and we recognise that certain issues may have particular implications for third party funded schemes, such as the Network Rail fee fund and the Industry risk fund (see paragraphs 3.35 and following of our October 2005 document).

10. We remain of the view that responsibility for drafting and amending the templates lies with Network Rail. In many instances, the changes we have identified are required in more than one template. We do not identify every clause in every template which will have to be amended, but have referred where appropriate to examples of the clauses affected. Such examples are not exhaustive, and it is Network Rail's responsibility to ensure that all necessary changes are made. Likewise, we do not comment on the basic versions of the agreements, and it is Network Rail's responsibility to amend the basic agreements in line with the revised full agreements.

11. This review also provides an opportunity for Network Rail to address issues which, whilst not necessarily presenting a barrier to approval of the templates, are plainly desirable to improve the templates and customer satisfaction with them - for example consistent treatment of common issues across the different templates. We set out a number of such issues below.

12. Before turning to set out the areas in which we require changes to be made, we address two further preliminary issues:

(a) the intended scope of the templates; and

(b) the relationship between the changes which we require and the funding of investments.

Scope of the templates

13. The templates should provide transparency and certainty for customers wishing to contract with Network Rail for investment in the network, and for the majority of schemes, the templates should provide the starting point for any discussion on appropriate terms. We remain of the view that customers who wish to contract under terms and conditions which differ from those in the templates should be free to negotiate with Network Rail to that end. Where a customer requests a particular change to the allocation of risk under the templates, it may follow that other consequential changes are needed to ensure that the overall balance of risk is fair and appropriate.

14. Network Rail also expressed the view that although Part G of the network code requires Network Rail to make available model terms and conditions, it would not be appropriate to require Network Rail to use the templates for especially complex or high value schemes. We agree that parties should consider in these cases whether the existing template is suitable for their needs. As we said in our policy framework (see paragraph 9 of our March 2007 investment guidelines), we recognise that the templates may not be appropriate for major projects, where the rail element has a value of over £50 million. We also recognise that especially complex projects of a lower value could raise similar considerations.

Funding of investments

15. In relation to a number of the issues addressed below, Network Rail commented that the funding of changes to the templates needs to be taken into account. Network Rail did not suggest that additional funding needs to

be made available now, but noted that there is a framework in place for schemes promoted by third parties, and said that the issue of funding should be kept under review as part of monitoring activities under the investment framework.

16. Our high level note to Network Rail in December 2007 explained that the changes we require do not materially impact on the financial risks borne by Network Rail, although they do re-allocate risks to some degree. We remain of that view for a number of reasons.

17. First, the revised templates will reflect more accurately the default allocation of risk set out in our policy framework, which reflects good practice for construction projects generally and is appropriate for Network Rail in relation to most enhancement schemes. Whilst the revised templates will incorporate important new rights in favour of customers, we do not consider that Network Rail will, under the revised templates, accept any risks which were outside the scope or the intent of the policy framework prior to this review.

18. Second, the templates will continue to contain overall caps on liability, although we do require an increase in the level of such caps. Liability caps control the overall level of risk to which Network Rail is exposed.

19. Third, we have accepted an argument made by Network Rail that certain of the changes which we require should be balanced by other changes to the templates. The key example is that, whilst Network Rail will under the templates accept additional obligations where it designs and/or constructs schemes, its liability for negligence in doing so will be capped. Therefore, these additional risks accepted by Network Rail will be balanced by the introduction of other new provisions. There are also other examples of changes in Network Rail's favour, as we explain below.

20. Overall, therefore, we do not consider that the changes we require should necessarily result in the need for Network Rail to receive additional funding. However, we recognise the need for these matters to be kept under review as experience in the use of the templates develops.

Design risk

21. Consultees expressed concern in relation to the allocation of design risk for design work undertaken by Network Rail (whether through a consultant or otherwise). By design risk, we refer to the risk of defects in a design prepared by (or on behalf of) Network Rail. The central example is design work undertaken by Network Rail under an IA, but similar concerns were expressed in relation to, for example, the DSA. Consultees expressed the view that where Network Rail undertakes design work, the customer should be liable to pay the efficient cost of designing the scheme, but should not be liable for design risk.

22. We agree with the concerns expressed by consultees. We consider that the party undertaking or procuring the design is best placed to manage and mitigate design risk.

23. In its letter of 12 July (item 11), Network Rail said that, where work is undertaken under the IA(FP), it is prepared to assume design risk from the

point upon entry into the agreement. It also said that where work is carried out under the IA(EC), Network Rail is prepared to assume design risk (1) from the point at which the enhanced asset is accepted and (2) so long as variations required to deliver the design intent are not blocked by the customer. Network Rail has subsequently said that it is prepared to assume design risk at commencement of the agreement for both the IA(FP) and the IA(EC), recognising that the scope of Network Rail's power to make variations should be addressed separately.

24. Network Rail said that if it is to accept stronger obligations in relation to its design, it is appropriate for Network Rail's liability in respect of such obligations to be subject to the Network Rail cap. Liability for design work will usually involve liability for negligence. As explained further below, we have concluded that the Network Rail cap should apply to claims based on negligence as well as claims for breach of contract.

25. Network Rail's acceptance of design risk also has implications for a number of provisions of the templates, including the following:

(a) the "standard of care" provisions - for example clauses 3.1(d) and 5.1 of IA(FP). Network Rail should not simply undertake to procure the carrying out of the works with the standard of care to be expected of a project manager, but should undertake to carry out the relevant design works with the degree of skill and care to be expected of a relevant professional - see for example the different obligations imposed by DSA clause 2.3(d), and the obligations placed on the customer under APA clause 7.2.

(b) the indemnity provisions of the templates, discussed separately below. Network Rail will remove the indemnities from the IAs.

(c) IA(FP) clause 12.7, under which design risk lies with the customer save in certain circumstances. Network Rail will remove this clause.

(d) DSA clause 15.6 and FA 13.6 - it is not appropriate for Network Rail to disclaim responsibility for the performance of its consultants.

Construction risk

26. The position in relation to construction risk is the same in principle as that in relation to design risk - where a customer enters into an agreement with Network Rail for construction work, the default position ought to be that Network Rail takes on construction risk in both the short and the long term. We consider that the party undertaking or procuring the construction works is best placed to manage and mitigate that risk. Moreover, as a commercial matter, we consider that a customer ought to have the option of paying Network Rail to build an enhancement without accepting ongoing risk and responsibility in respect of construction defects. Network Rail accepted this position in principle.

27. Like design risk, this issue has implications for a number of provisions of the templates:

(a) the "standard of care" provisions, as above - Network Rail should undertake to carry out the relevant works to a standard of workmanship

to be expected of a relevant professional. It may also be appropriate for Network Rail to give appropriate warranties in relation to fitness for purpose and any materials supplied, as is conventional under construction contracts - if for example the enhanced assets are not to be accepted back into use by Network Rail.

(b) the indemnity provisions of the templates.

(c) DSA clause 15.6 and FA 13.6, as above.

Default by Network Rail's consultants / contractors

28. On a related issue, we note Network Rail's proposal in item 1 of its 12 July letter that it should be liable for costs which it incurs as a result of its contractors' / consultants' default up to the Network Rail cap by making such costs non-recoverable up to the Network Rail cap (to be funded through the Network Rail Fee Fund).

29. There should be no mechanism under the templates by which Network Rail can recover from a customer in respect of losses caused to Network Rail by its own consultants' default. To the extent that such costs are currently recoverable at all, that is an indication that other provisions of the templates are currently cast too widely (for example, Network' Rail's entitlement to reimbursement or the indemnity provisions).

30. Network Rail also said that it may be unable to recover legitimately incurred costs arising out of managing a contractor breach because of a contractor cap or other exclusion of liability. It said that it is reasonable, if such risks arise, that they should count towards the Network Rail cap. However, the Network Rail cap is a cap on Network Rail's liability to pay the customer. Costs incurred by Network Rail at its own risk do not and should not count towards that cap.

Indemnities

31. The indemnity provisions of the templates were a significant source of concern amongst consultees. In its 12 July letter, Network Rail said that it is giving particular consideration to limiting the indemnities to third party related claims. However, Network Rail has now gone further and said it will remove the indemnities from the IAs. We welcome this proposed change, which will in part give effect to our recommendations in relation to design and construction risk as set out above.

32. Network Rail also proposed in item 10 of its 12 July letter to revise and simplify the wording to provide better clarity, and to review the various agreements for consistency. We agree that the drafting of those indemnities which will remain requires improvement. To take one example, it is not clear to us why an indemnity should be available to Network Rail simply because allegations of voidness or breach have been made, rather than because voidness or breach have in fact occurred - see clause 20.1(b) and (c) of the APA.

33. We note also that clause 9.7 of the APA contains a further indemnity provision in favour of Network Rail. Network Rail told us that this indemnity is intended to cover costs incurred by Network Rail in the event of the exercise

by Network Rail of step in rights. We consider that such an indemnity is appropriate, as long as the conditions for the exercise of the step in rights are clearly defined and appropriate. Network Rail will clarify that the conditions are as follows:

(a) the customer is unable to or does not fulfil a particular obligation contained in Clause 9 adversely impacting on Network Rail's business activities;

(b) Network Rail (acting reasonably) issues a notice stating the steps to be taken to address the issue and giving reasonable notice, so giving the customer the opportunity to remedy the situation;

(c) the customer is unable to or does not comply with the notice from Network Rail; and

(d) Network Rail 'steps in' and take appropriate action to rectify the issue.

Liquidated damages and delay

34. This section covers liquidated damages as a remedy for delay under the templates, and in particular their adequacy and effectiveness as a remedy.

Conditions on which damages payable

35. Under the IA, liquidated damages are currently payable by Network Rail in two tiers. First, Network Rail is obliged to pay the customer any liquidated damages recovered from its works contractor, and secondly it has its own liability to pay the customer liquidated damages in certain circumstances of delayed completion. As part of this regime, the customer is required to agree with Network Rail the terms required from Network Rail's works contractors as to delay and liquidated damages (for example IA(FP) clause 5.2).

36. Network Rail's own liability to pay liquidated damages under the IAs is subject to a number of conditions: it is only obliged to pay liquidated damages in so far as the delay exceeds a "contingency period", given effect by a target completion date and a "longstop" date following which liquidated damages are payable; and Network Rail is only liable to pay liquidated damages in so far as such loss is caused by Network Rail's negligence or breach of contract. Consultees objected to these restrictions.

37. Network Rail accepted that the requirements to show that it is in breach of contract or negligent should be removed. However, it considered that the existing "two tier" structure was in customers' interests, as it entitles the customers to recover both pass through liquidated damages and Network Rail liquidated damages. It said that this structure incentivises Network Rail to perform, in contrast to a "back to back" arrangement under which Network Rail would have no separate exposure. Network Rail said that the current provision for a "longstop" is also beneficial because it encourages Network Rail staff to perform to a target deadline without the need for overly conservative project planning. It said that its removal would lead to additional barriers to investment by driving a high risk of longer timescales, particularly due to the parties having to conclude negotiations in relation to the required programme, more caution and thereby higher costs. Network Rail expressed

concern that the removal of the longstop and the introduction of negotiated liquidated damages could introduce delay and complexity into the process for making investments in the network, which is contrary to its own aims and objectives.

38. We have two main concerns in relation to the two tier regime under the IA. First, we are concerned that any liquidated damages negotiated between Network Rail and its consultant which are then supplemented by a fixed amount payable under the templates are unlikely, when combined, to reflect a genuine pre-estimate of the loss which the customer will suffer as a result of the delay. If that is the case there is a risk that the liquidated damages provisions as a whole will overcompensate the customer, and so will constitute a penalty clause (which is unenforceable as a matter of law). Although we recognise that there are arguments for the current structure, having considered the matter further we have concluded that we should not approve provisions which carry this risk of unenforceability.

39. Second, a "pass through" regime does not reflect the proper allocation of risk, which is that Network Rail is responsible to the customer for completion, and the works contractor is responsible to Network Rail in turn. Thus for example, we are concerned that under the existing regime, a customer will be worse off if a delay is attributable to Network Rail rather than to Network Rail's consultants, because "pass through" liquidated damages may not be payable in those circumstances. This should not be the case.

40. As to the contingency period (the “longstop date” provision), we believe it is important that the IA should incorporate a single transparent deadline to which Network Rail is obliged to work, and to which the customer can plan. We think it unlikely that the use of two deadlines - one aspirational and one effective - allows customers realistically to plan to the earlier deadline with a reasonable degree of assurance. We are not persuaded that the points made by Network Rail justify the current “contingency period” arrangements, and consider that the current provisions do not provide adequate incentives on Network Rail to achieve standards of best practice in project planning.

41. Therefore, as a default position, the templates should establish specific obligations on Network Rail in relation to completion to a single deadline with no grace period, and should provide for the payment of liquidated damages by Network Rail to the customer in the event of delay beyond that date. This should reflect the proper allocation of risk where a customer contracts with Network Rail, and Network Rail contracts separately with a consultant. We recognise that Network Rail may offer customers a two tier arrangement if that is a customer's preference. We will consider any drafting proposed by Network Rail in this regard. However, because we have reservations in relation to the two tier arrangement more generally, we consider that such provisions should only be used at the customer's request.

42. We also note Network Rail's proposal that, where a scheme is delayed for reasons other than those allowed in the relevant agreement, the customer will not be required to accept the Network Rail staff costs implications, such costs to be funded through the Network Rail fee fund. This proposal is welcome, in that it clarifies that customers will not be liable for additional costs where the delay is at Network Rail’s risk, but it does not address the question of in what

circumstances and to what extent Network Rail should be liable to pay compensation to the customer, as to which see above.

43. The principles set out in this section are equally applicable to all of the templates. However, the principles are particularly applicable to the templates under which Network Rail undertakes work - that is the IA, the DSA, BSA, and the FSA. Thus the obligation on Network Rail to use only reasonable endeavours to meet the programme under clause 3.2 of the DSA should be removed and replaced by provisions as set out above.

Level of Damages

44. Consultees complained that the level of liquidated damages payable by Network Rail under the templates is too low. Network Rail's proposal in item 2 of its 12 July letter entailed a clarification that the liquidated damages regime is a tiered arrangement, with different rates payable under different value agreements. This proposal would have involved no substantive change to the current regime. Network Rail did however further propose in its September presentation an increase in the level of liquidated damages which it is liable to pay, and that liquidated damages should be subject to a separate cap, and so not counted towards the Network Rail cap.

45. Although consultees complained that the levels of liquidated damages are currently too low, it was not clear to us whether those complaints also took into account the "pass through" damages payable by Network Rail's consultants. Moreover, the level of liquidated damages payable under a construction contract is conventionally a matter negotiated in each individual case. For both legal and commercial reasons, it is difficult for us, as part of this review process, to establish the level at which liquidated damages should be payable. We have nevertheless considered the principles which should underlie the calculation of liquidated damages and set out our conclusions below.

46. In general, liquidated damages may be quantified in two ways:

(a) as a genuine pre-estimate of the loss a claimant will suffer in the event of breach, so that the damages are compensatory; or

(b) as a lesser sum, in which case the imposition of liquidated damages will in practice operate as a cap on Network Rail's liability for delay.

47. For example, if it is estimated that the customer will suffer £5,000 of loss per day, and liquidated damages are payable in that amount, the damages will compensate the customer in full for its loss. In so far as liquidated damages are intended to be compensatory, they should necessarily be negotiated on a case by case basis, else there is a risk that the provisions will not represent a genuine pre-estimate of loss and so will be unenforceable. Alternatively, if the customer's estimated losses are £5,000 per day, but liquidated damages are fixed in the amount of £2,500 per day, the amount of the liquidated damages will effectively cap Network Rail's daily liability for delay in the amount of £2,500.

48. Where Network Rail is undertaking work for a customer, as under an IA, we have concluded that liquidated damages should be negotiated rather than set through a tariff. The customer may seek compensatory damages, or may

wish or be willing to agree damages which are less than compensatory. It is not possible for us to fix the level of damages which are payable in those cases in the templates.

49. Network Rail said that the individual negotiation of liquidated damages will slow down the process, so adding a barrier to investment. It maintained that it is appropriate for it to continue to quantify Network Rail liquidated damages by reference to a pre-determined tariff. However, this does not address the issue of enforceability, as set out above. Moreover, Network Rail told us that under the IA, liquidated damages are already negotiated between Network Rail and its contractor. A move to negotiated liquidated damages under the IA, and other agreements under which Network Rail carries out work for the customer, will not therefore necessarily introduce a new commercial negotiation. We do however recognise that the efficient negotiation of liquidated damages will require appropriate input from the customer as well as from Network Rail, and that there may be some value in Network Rail publishing an indicative table of values on the basis of past experience. Such guidelines are not however a substitute for a commercial negotiation and (where appropriate) a genuine pre-estimation of loss in each case.

50. Network Rail said that if liquidated damages are to be negotiated, there may need to be scope for changes to the fee element of the price it offered as part of that negotiation to secure a commercially reasonable balance. However, whilst we anticipate that a move to negotiated liquidated damages payable by Network Rail will lead to an increase in the level of liquidated damages payable directly by Network Rail (as opposed to those damages which are currently payable on a "pass through" basis), it is not clear that it will lead to additional cost - or risk - to Network Rail. This will depend in part on the arrangements which Network Rail concludes with its own contractors. We do not therefore accept that the negotiation of liquidated damages would necessarily affect the price payable by the customer. However, as in a case in which a customer seeks "bespoke" terms, there may be certain cases in which a customer's requirements for a particular level of liquidated damages would have consequences for the price Network Rail offers.

51. Given the restructuring of the liquidated damages provisions which we require, it is not clear whether the introduction of negotiated liquidated damages payable by Network Rail will lead to an increase in the total liquidated damages payable to customers in the event of delay, compared to the current combination of "pass through" and Network Rail tariff damages. The change will however better reflect the proper allocation of risk, which is that Network Rail is liable to its customer on terms agreed with that customer, and it is for Network Rail to negotiate suitable terms with the contractors which it engages

52. As we indicated above, there are circumstances in which liquidated damages effectively operate as a limitation of liability. In our view, it is appropriate for liquidated damages to be quantified in this way where Network Rail is carrying out non-contestable services under an APA or BSA, for two reasons. First, Network Rail is obliged to carry out the services. Second, the losses which the customer may incur as a consequence of delay may be entirely out of proportion to the value of the services provided by Network Rail.

We also note that in this situation, the customer may have recourse against its own construction contractor in the event of delay to the work, so that its rights against Network Rail are not its principal remedy for delay.

53. We have also concluded that it may be appropriate for liquidated damages effectively to operate as a limitation of liability where Network Rail is carrying out development services under a DSA or FA. This is because development services are carried out at an early stage of a project, when there will be significant uncertainty as to what the possible consequences of delay might be, including as to whether the project will proceed at all. We considered that it may be reasonable for Network Rail's liability for delay to be limited at that early stage.

54. Network Rail suggested that the revised tariff of liquidated damages proposed in its September 2007 presentation, which involves an increase over and above current levels, should be adopted under the APA, BSA and for development services. We are not yet satisfied that the level of damages proposed is appropriate and will consider further at what level any tariff should be established before we can approve the revised templates. As part of that process we will consider whether an appropriate tariff can be established for development services as well as for the APA and BSA.

Network Rail power to change programme and other issues relating to delay

55. Consultees expressed concern at the breadth of Network Rail's powers to vary the programme under the IA, and said that such power undermines the provisions of the contract relating to compensation for delay. For example, clause 3.5 of the IA(FP) is linked to extensions of time under the works contract. The circumstances in which Network Rail is entitled to extend time under the IA should be clearly set out in the IA itself. A similar problem arises with the alternative form of words in DSA clause 4.3, whereby Network Rail has a general power to revise the programme.

56. Network Rail said that drafting out these matters would introduce excessive complexity into the templates. However, we considered it right that the templates should expressly define and limit the circumstances in which Network Rail may be entitled to extend the completion date under the IA, BSA, DSA or FA. We will review the drafting proposed by Network Rail in the revised templates.

57. One consultee also suggested that the risk of delay might be mitigated if Network Rail were deemed to have given its consent to proposals if it failed to respond to those proposals by a certain time. Given the other changes we require in relation to delay, we do not consider that this change is necessary. However, we do not in any event consider it appropriate that Network Rail could be deemed to have consented to a change to the network.

Liability caps

58. The liability caps under the templates should be established at a level which allows the party making a claim (whether Network Rail or the customer) to recover for its losses at appropriate levels, but which also provides the defendant with a protection against the largest claims so as not to give rise to

a barrier to investment. At present, we have been provided with little evidence from consultees as to the level at which the caps should be established. We therefore require certain changes at this time, but anticipate the need to keep this issue under review as experience provides guidance as to the level at which the caps should be set.

Network Rail cap

59. The Network Rail cap is expressed as a percentage of fees payable under the relevant agreement. Consultees have expressed concern that the caps on Network Rail's liability are too low. One consultee suggested that the appropriate level of cap is 100% of contract value.

60. As indicated above, we have been provided with little evidence as to the level at which the caps should be fixed in order to satisfy the objectives in paragraph 58. Without that evidence any determination of what would ordinarily be a negotiated matter is a matter of judgment. However, in its September 2007 presentation, Network Rail proposed that the cap under the APA should be increased from 30% to 40%. This margin of increase needs to be applied to the other templates: Network Rail should therefore increase the cap across all relevant templates by the same margin.

61. Under the existing templates, claims for negligence are not limited by the Network Rail cap. We consider that, in light of the modifications we require to Network Rail's obligations in relation to construction and design risk, it is appropriate for liability for negligence to be brought into line with its liability for breach of contract where Network Rail is providing services other than non-contestable services (i.e. under the IA, DSA and FA). We consider that this will also remove incentives on customers to present as claims for negligence those claims which should properly be brought as claims for breach of contract. We do not consider that this change puts customers in a materially less advantageous position than at present under the existing templates, as in practice we understand that any claims for negligence against Network Rail are currently rare.

62. One consultee stated that Network Rail's liability for breach of duty or negligence in obtaining “regulated consents” (such as regulated changes including the station change process) is limited to direct costs as opposed to losses, and that there was no justification for this inconsistency between the obtaining of regulated consents and other services. However, we consider that it is reasonable for Network Rail to have more limited liability in relation to problems obtaining this type of consent (as for example for “necessary consent” under clause 3.8 of the IA(EC)) than in relation to other matters over which it should have a greater degree of control.

63. In relation to clause 19.4 of the APA, one consultee complained to us that Network Rail is not adhering to the approved form of template and is seeking to use the Network Rail cap as an aggregate cap rather than a per breach cap**.** Network Rail has told us that the approved form of template contains a mistake, and that all other Network Rail caps, including the BAPA, are expressed on an aggregate basis. We have reviewed the relevant documentation relating to our approval processes, as well as comparing the various Templates, and noted the points made by Network Rail. We accept

that the Network Rail cap should be an aggregate cap and not a per-breach cap and are content for Network Rail to correct the apparent mistake in the revised templates. If a cap is to provide Network Rail with real commercial protection, it must apply on an aggregate basis rather than a per-breach basis.

64. One consultee said that clause 19.8 of the APA excludes considerable categories of costs, meaning that Network Rail's obligations are weak, and that the remedies available to customers are “virtually worthless”. We note that clause 19.8 is a provision in common form for the exclusion of liability for what is often described as "consequential loss". It is expressed in mutual terms, although we note that it may not have entirely mutual effect because Network Rail has a right of indemnity against the customer under the APA which is excluded from the clause. Nevertheless, as set out above, we consider it reasonable that Network Rail's liability under the APA should be limited. We are not therefore persuaded that the clause requires amendment.

Customer cap

65. We note that Network Rail has proposed (see item 8 of its 12 July letter and the stakeholder presentation) that the DSA Customer cap should be reduced from 250% of Network Rail's costs estimate to 10% of the estimated project cost. Network Rail has since clarified that it will also reduce the customer cap under the BSA and the FA, which also include a customer cap on the same basis as the DSA, accordingly.

66. Consultees submitted that the customer cap should be calculated as a proportion of the cost of the project as it impacts on Network Rail's infrastructure, rather than as a proportion of total project costs. Network Rail confirmed that this is the way in which the templates are intended to work and agreed to make the point more explicit.

67. Consultees observed that the customer cap is adjusted having regard to sums which a customer may be entitled to recover, whether from third parties or an insurer (for example IA(FP) clause 12.4(iii) in relation to insurance), whereas the limit of Network Rail's liability is adjusted by reference to any sums in fact recovered from such third parties (for example, IA(FP) clause 12.2(b)). We agree with consultees that these obligations should be symmetrical and should be adjusted on both sides having regard to the existence of a liability and not sums recovered.

68. Network Rail said that the cap should not be adjusted having regard to all insurance held by Network Rail, which may or may not relate to the risks assumed by Network Rail under the templates. Rather, Network Rail said, any matters which are either party's insurable risks should be set out in the templates (or if negotiated on a case-by-case basis in the negotiated form of agreement), and the caps should only be adjusted where sums are recoverable by either party pursuant to such insurance. However, if Network Rail has third party liability insurance, we see no reason why the customer should not obtain the benefit of it where Network Rail is liable to the customer, in the same way as Network Rail benefits from any insurance held by the customer under the current templates. This change does not affect the obligations of either party to take out insurance.

69. We were initially concerned that certain matters are excluded from the customer cap - for example, liability for design services carried out by the customer or its consultant (clause 15.9(a) DSA). Network Rail explained that this provision is the mirror of provisions under which the Network Rail cap is adjusted having regard to sums recovered from consultants. We have accepted that these provisions should be retained.

70. One consultee expressed concern that the Customer cap does not apply to termination costs and "NR costs". Network Rail costs are fees for the performance of the agreement and so are properly excluded from the Customer cap. We also consider that, in the context of a cap on liability, a distinction should legitimately be drawn between termination costs and costs consequent on other breaches of the agreement.

Variations

71. Consultees expressed significant concerns in relation to the breadth of Network Rail's power to make changes. Network Rail indicated that it is revising and clarifying the variations provisions of the templates. We consider that the following particular changes to the variations provisions are required.

72. First, customers can object only on limited bases to requests by Network Rail for variations. We query whether this is the correct balance of risk given that (1) the project is in principle carried out for the customer, not for Network Rail and (2) regardless of the delivery model, the scope of works is ultimately approved by Network Rail. Network Rail should only be able to require variations if and to the extent that there is a compelling reason for it to be able to do so. Network Rail says that it has recognised this concern as part of the drafting revisions being undertaken, and that under the revised templates, its ability to insist on variations without customer agreement will be more limited.

73. Second, in certain circumstances, Network Rail is able to require variations to which the customer cannot object. An example is where Network Rail wishes to accelerate an investment. Customers should not accept the risk of delay wherever Network Rail currently has the power to insist on variations. This point should be addressed by Network Rail's proposal to limit the extent to which it can insist on variations without customer agreement. However, we accepted that where the variation is required as a result of unforeseeable circumstances, Network Rail should not necessarily carry a liability to pay liquidated damages.

74. Third, under the IAs (as opposed to under the APA), Network Rail will be paid to carry out any variations which proceed. On that basis, Network Rail should not also be indemnified for direct costs incurred in connection with the variation - see for example IA(FP) clause 6.8. This clause, and any equivalent clauses, should be deleted.

75. We note also Network Rail's proposal that a customer's exposure to regulated change costs should be capped in the amount of Network Rail's agreed estimate where Network Rail is undertaking the relevant change. This proposal is welcome.

76. One consultee said that Network Rail's proposal to cap customer liability for regulated change costs is misleading because it only applies where these

costs have already been agreed with the TOCs at the end of GRIP4, and only relates to costs incurred during the implementation stage. However, we note that the majority of these costs are generally incurred during the implementation phase, and are content that the capping arrangements proposed by NR are appropriate.

Relief events

77. We note that specific relief events, for which Network Rail accepts risk, have been singled out for separate treatment under the templates. Given that Network Rail accepts the risk of these events, we were concerned that it was not clear that Network Rail's liability to pay such compensation was not subject to the Network Rail cap. Network Rail is willing to make clear that relief events are not subject to the Network Rail Cap, save in respect of cancelled or altered possessions which amount to a breach of contract.

78. We also note that provision is not made for compensation for relief events in IA (FP). We see no reason for this inconsistency between IA(FP) and IA(EC). Although price is fixed under IA(FP), this does not mean that a customer should not be compensated for out of pocket costs which are caused by Network Rail risks. We require the two agreements to be brought into line by the inclusion of the relevant provisions in both. Network Rail said that it had already recognised this issue and had developed drafting.

Fixed prices

79. Network Rail proposed in item 13 of its letter of 12 July to cap development costs for minor schemes with any reasonable overspend being recovered through the implementation stage or by applying a fixed price to development costs. Consultees welcomed the concept of a cap on development costs but noted that the proposed approach does not give full effect to the principle of a fixed price agreement, as excess development costs may simply be deferred. The proposal may be workable where the customer expressly wishes to defer additional cost until the later stage, but note that where a scheme does not go ahead the cost will be borne by the Network Rail fee fund after 18 months. We expressed concern to Network Rail that this mechanism would be open to abuse where a customer is not committed to the project.

80. Network Rail said that its proposed approach promoted development of the railway to the fullest extent economically practicable. It said that its experience is that this is an appropriate and pragmatic way to manage projects, especially where customers have limited timescales and wish to commence work as a priority. It said that it would not undertake work where there was a real risk that the project would not proceed. Although we were initially concerned that the approach potentially involved an element of cross subsidy, we are content that this approach should be made available to customers in order to remove barriers to investment, However, we intend to keep this approach under review and note that Network Rail needs to bear in mind the risk of cross-subsidy when providing a fixed price for the development stage.

81. One consultee noted that the proposal only relates to schemes under £5m, and wished to understand the logic behind this threshold. The £5m threshold is used to differentiate minor schemes in the investment framework from others. Below this materiality threshold, the level of regulatory involvement/scrutiny is generally lower.

82. Clause 14.3 IA(FP) provides for a re-opening of the fixed contract price under certain conditions in the event of substantial cost overruns. We consider that this clause ought only to be included in relation to high value agreements (for example projects with a value of £10 million or more). Network Rail said that it generally agreed with this, but that it might also wish to propose applying the clause in relation to lower value but complex schemes. In any event, we note that the existing clause provides for ORR to resolve any dispute which may arise in relation to the revised price. This mechanism is intended to provide customers with protection against unreasonable price increases where the clause provides for a re-opening of the price.

83. Network Rail should not be free to adjust any hourly rates established in the agreement - see for example IA(FP) Schedule 2 clause 4. We expressed the view that the agreement should set out the basis for any adjustment which may fairly be made - for example indexation. Network Rail said that it will amend the templates accordingly and base this on RPI.

Information

84. Consultees expressed concern that Network Rail's obligations under the templates in respect of network information provided to customers (e.g. APA clause 5) are inadequate. Under the existing templates, Network Rail has an obligation to notify customers of the accuracy of the information. It was suggested to us that that Network Rail should have an obligation to provide information (in so far as reasonably required by the customer) which is complete and accurate in all material respects to the greatest extent reasonably practicable, which is substantially the same as its obligation under part K of the network code. It was also suggested to us that the current templates result in differential treatment of train operators and non-train operators, and that we would fail to ensure adequate regulatory protection for the latter were we to approve this aspect of the current templates.

85. Network Rail stated that such a change would not be appropriate. Network Rail said that in the current templates it is implicit that Network Rail obligations are without prejudice to any other rights the parties may have, including train operators' rights under part K of the network code. This will be made explicit in the new templates.

86. Network Rail said that the case for bringing the templates into line with part K was based on two presumptions:

(a) that Network Rail's treatment of its customers amounts to undue discrimination; and

(b) that ORR policy requires non-train operators to be offered the same protection as train operators.

87. Network Rail said that the requirement not to discriminate unduly does not require exactly the same treatment of different classes of customer. The template is drafted in order to meet the requirements of a number of different types of customer, including those which are not party to the network code. The principle of non-discrimination does not require that rights which some customers have outside the enhancement agreements should be applied to all customers entering into an enhancement agreement.

88. Network Rail also said that the provision of information under part K of the network code is part of the regulated regime with its various checks and balances between the train operators and Network Rail. It would not be appropriate simply to incorporate the same standard in a different form of agreement. Network Rail made the point that train operators pay for their rights under part K under access agreements. In contrast, a non-train operator will merely pay the cost of retrieving the information.

89. We are satisfied that it would not amount to undue discrimination for Network Rail to incorporate information provisions into the templates which differ from the standards provided for in part K. However, we have also considered what standard ought to be incorporated into the templates to ensure adequate protection for parties to template agreements. Given that Network Rail is the principal source of information relating to the network, it is appropriate on allocation of risk principles for Network Rail to have obligations

(a) to provide any information reasonably requested by the customer in connection with the particular project and which is already in Network Rail's possession; and

(b) that the information provided should in all material respects be the most complete and accurate information in Network Rail's possession at the time the information is provided.

Trespass and vandalism

90. We note Network Rail's proposal to accept the risk of trespass and vandalism where it is undertaking the design and construction works. We welcome this proposal. We agree with Network Rail that a customer carrying out works on the basis of an APA should take the risk of trespass and vandalism during the period of the works. However, once the works have reached final completion, we consider that Network Rail is best placed to manage or mitigate the risk. The customer's risk should therefore cease at that time, and clause 12.7 APA should be amended accordingly.

91. Network Rail agreed that once the customer’s obligations are complete this liability should fall away, but said that liability should remain to the extent that the works contractor undertakes works during the defects liability period. It also said that the customer should remain liable for the consequences of any vandalism which results from a failure by the customer to build to the specification. However, in these circumstances, Network Rail's concern appears to be that the work has not been built in accordance with the agreement, rather than that the customer should take the risk of trespass and vandalism for a period after the works have been complete. Therefore we require the changes noted in the last paragraph.

Assignment

92. One consultee argued that, under the APA, a customer cannot both retain liabilities to Network Rail after completion of the Work, and also be obliged under clause 11.5 to assign the benefit of the works contract (including any claims against its consultants) to Network Rail. We agree. Network Rail said that it intends to remove this clause, and that where there are specific circumstances where its use is appropriate it will be discussed as part of the negotiation process.

Interfacing

93. One consultee said that APA customers must be protected against interference from other schemes during the construction phase.

94. We were concerned that clause 9.6 APA imposes responsibility on the customer for the identification of conflicts. Network Rail as network operator is better placed to manage and mitigate this risk. This provision should be revised accordingly. Network Rail said that it noted that the clause can be read widely and that it was reviewing this as part of the ongoing process.

Conflicts with industry codes

95. We welcome Network Rail's proposal in item 16 of its 12 July letter to clarify that the templates will not create a conflict with the network and station codes, and will review the drafting in due course.

Risk Funds and incremental OM & R Costs

96. We received various comments on the levels of fees under the risk funds. We intend to keep the level of customer contributions to the funds under review, and intend to review these levels again in early 2009, when more information should be available to inform any changes we need to make to these arrangements for control period 4 (which begins on 1 April 2009).

97. We do however welcome Network Rail's proposals[4] to halve (from 10% to 5% of Network Rail costs) the level of customer contributions to the Network Rail fee fund for those templates covering the development stage of projects. These reductions should better reflect the risk profiles of the different templates and should reduce total costs to the customer. We intend to keep the level of customer contributions to the NRFF under review, and will review these levels again in early 2009, when more information should be available to inform any changes we need to make to these arrangements for control period 4 (which begins on 1 April 2009).

98. Network Rail expressed the view that the complexity and quantum of the risks it bears for schemes above £10m generally increases such that consideration will need to be given on a case by case basis as to whether the Network Rail fee fund contribution would need to be increased. Although we accept that the relationship between scheme value and risk is often non-linear, we are not persuaded that different levels of NRFF contributions should apply for schemes above £10 million. We established the framework for

[4] Presented at the stakeholder workshops in September 2007.

schemes promoted by third parties to apply to schemes with a rail-related value up to £50 million (see paragraph 9 of our March 2007 investment guidelines). Hence for major schemes (valued at above £50 million) there is a stronger argument in principle that higher levels of NRFF contributions should apply, although no compelling argument has been made at this stage.

99. One consultee said that there was not enough clarity on the risks and liabilities covered by the NRFF. This is not a matter which can be addressed through the terms of the templates. However, further detail is given in appendix C of Network Rail's published guidance, “Investing in the network”.

100. Turning to OM&R costs, our March 2007 investment guidelines (see paragraphs 52 – 55) set out our approach to the treatment of incremental OM & R costs arising from schemes promoted by third parties. In summary, for schemes with incremental OM & R costs above the de minimis threshold of £50,000 per annum, the customer is liable for these OM & R costs for the life of the enhanced asset, net of those costs which:

(a) Network Rail has already recovered directly from beneficiaries; or

(b) the customer has recovered from beneficiaries through the proposed rebate mechanism.

101. For schemes with OM & R costs below this level, all costs below this threshold (and not already recovered) would be borne by Network Rail until the next periodic review, when these costs would be included within the periodic review settlement.

102. Network Rail needs properly to implement this policy in the template agreements by clarifying that for schemes with incremental OM & R costs below the threshold, the customer has no liability for those costs once Network Rail has taken on operation of the enhanced asset(s). This requires changes to several templates, for example clause 12.6 of the asset protection agreement.

Appendix 1: Drafting matters

1. There follows a list of drafting matters which we ask Network Rail to address in the revised templates.

2. To maximise the transparency of the templates, equivalent terms in different templates should be expressed in consistent language and presented in the same format. Slight differences between related provisions in the different templates should be eliminated in so far as possible. This is especially true of the two versions of the IA, which should differ only in relation to the payment provisions.

3. The templates include "agreements to agree". Any such provisions which are (or appear to be) legally unenforceable should, if practicable, be removed or revised.

4. The APA contains various provisions which permit Network Rail to define the requirements to which works must be carried out. Whilst these requirements are generally appropriate in principle, we consider that they are often expressed unduly widely. Examples are:

(a) clause 11.3 APA, under which Network Rail may apparently impose requirements over and above those required by the regulated change. We see no reason why this provision should be made.

(b) the definition of "Network Rail requirements", which is open ended. This provision should define the circumstances in which any additional Network Rail requirements may come into application.

5. Network Rail said that these provisions were being revised.

6. We note that the exclusion of liability provisions relating to approval (e.g. IA(FP) clause 4.1) say that Network Rail shall have no liability under this agreement "if" certain events happen or do not happen. The principle should be that Network Rail will have no liability "as a result of" the relevant events happening or not happening.

7. One consultee said that the definition of direct costs should be revised to clarify that it may include sums payable by a customer to its consultant. We agree that such costs should not be excluded from the customer's right of recovery, and invite Network Rail to clarify that they are not. Network Rail has said that it will make this change.

8. One consultee complained that the templates do not state a process for determining the necessary scope of a mandatory variation required to implement a mandatory variation. We agree that this would be a helpful clarification. Network Rail said that it intends to review the variations clause to simplify and address mandatory variations. We will review the revised wording.

9. Certain terms require definition. For example, the term "link up accreditation" should be defined in the APA as it is in the FA. Other terms are unclear, and so require new definitions: for example, the concept of "adequate

supporting information" in IA(FP) clause 9.1 and the concept of "an essential change to the nature of the works" in the variation provisions.

10. Clause 14.5 of IA(FP) requires clarification, and in particular the reference back to clause 14.2, which appears to relate to termination for material breach.

11. Similarly, we consider that clause 19.7 of the APA, and the equivalent provision in other templates, require significant clarification. First, it is not clear how the clause is intended to relate to the indemnity provisions relating to land and noise claims (for example, clause 20.1(e) of the APA). If the clause is intended to disapply the cap from the indemnity in certain circumstances, it is not clear why. Moreover, the clause contemplates that design works may not have been undertaken by the customer. However, the nature of the APA is such that design works will have been undertaken by the customer. In contrast, the "works" which Network Rail undertakes under the IA are defined to include design works, yet the equivalent of clause 19.7 in the IAs (for example clause 12.5 of IA(FP)) contemplates that the design may have been prepared by the customer.

Appendix 2: Other issues raised by consultees

1. We received a number of responses to our two consultations on the Templates, and have concluded that not all of the comments made by consultees need to be reflected in changes to the templates. In this appendix we explain why we have decided that certain points made by consultees should not result in changes to the templates.

2. Those who responded to our consultations included: National Express; Transport for London (TfL); Merseytravel; South West Trains; John Laing; Burgess Salmon on behalf of First Group; First Group; Hutchison Ports (UK), Stanhope Plc, ATOC, Arriva Trains Wales, Department for Transport (DfT), the PTE Group (PTEG), Strathclyde PTE (SPT), Victa Railfreight and Transport Scotland.

Points relating to investment generally rather than the form of the templates

3. A number of comments from consultees did not relate to the terms of the templates but to other practical aspects of the process of investing in the network through the investment framework, including behavioural aspects of Network Rail's approach. Similarly, certain of the proposals made by Network Rail in its letter of 12 July 2007 related to such matters rather than the terms of the templates (see for example items 7 and 14 in attachment 1 of the Network Rail letter).

4. The focus of this part of our review of the investment framework has been on the terms of the templates. Accordingly, we have not drawn conclusions in relation to certain points raised by consultees. We have however initiated a further consultation in which we have asked for feedback on any perceived barriers to investment in the network, and we intend to take account of comments already received from consultees when concluding on that piece of work.

Relationship between the templates and other regulatory instruments

5. We received submissions on behalf of a number of parties in similar terms which said that under part G of the network code, it is not necessary for customers to enter into a separate contract with Network Rail for a network change to be implemented. Rather, if the proposal for network change is sufficiently detailed, including details of what needs to be done, who is to pay for it and what is to happen if changes are needed or things go wrong, the work could be carried out pursuant to the network code.

6. It was submitted that the purpose of the templates, as reflected in condition GA3 of the network code, is to supplement part G and not to contradict or diminish it. A train operator should not therefore find itself in a stronger position by contracting under the network code than by using the templates. Moreover, the templates should offer the same terms and conditions to all customers. In approving the templates, ORR should not amend and weaken the change mechanism in the network code, and should ensure adequate regulatory protection by making the templates consistent with the network codes.

7. The submissions suggested that it was appropriate for the existing templates to be abandoned and replaced by new contracts which use many of the concepts and provisions of the existing access contract regime. It was submitted that ORR should not approve any revised templates if they are inconsistent with its stated policy objectives. It was also submitted in relation to certain provisions of the templates that Network Rail should comply with its licence conditions.

8. We recognise that in principle, a customer which is a party to the network code may be able to carry out an investment project pursuant to part G rather than pursuant to a separate contract. However, we also note that the network code does not contain or impose detailed provisions of the sort included in construction contracts generally and which form part of the templates. Rather, part G (condition G3) provides that the sponsor of an investment proposal may, as part of its proposal, set out the terms and conditions which it proposes should apply to a network change, and provides for Network Rail to make its own proposals in response, explaining the reasons for any differences. In the event of disagreement, part G contains further provisions for the resolution of any differences between the parties.

9. Part G therefore provides a process by which a network change may be implemented, but it does not remove the need for consideration of the particular terms on which a change should be implemented. Our view is that, other than in relation to the simplest projects, additional terms of the types included in the templates will have to be established. In this regard, condition GA3(b)(vi)(C) provides that the templates "shall, so far as reasonably practicable, form the basis of any terms and conditions relating to the implementation of a network change" proposed either by Network Rail or by a TOC.

10. The purpose of the templates is to offer a number of standard forms of contract, based on a default allocation of risk, on the basis of which investments may be carried out. In this way, the templates supplement part G, which does not set out the detailed terms on which particular projects may be carried out. Given that the templates fulfil a purpose which differs from that of the network code and other regulated contracts, we do not consider the terms of the templates to contradict or diminish any such codes or contracts.

11. We also recognise that, although we have a role in approving the templates under part G, the templates provide a standard form of contract which may in practice be used by a customer who is not a party to the network code. Such investments also fall within our policy framework for investments. A customer who is not a party to the network code will stand in a different commercial relationship with Network Rail, and it may be appropriate for Network Rail to offer that customer terms which differ from the provisions of the network code or the model clauses for use in track access contracts. We do not therefore consider that the templates should necessarily replicate equivalent provisions of the network code or other regulated contracts. We have nevertheless required Network Rail to amend the templates so that it is clear that a customer can exercise its rights under the network code rather than the templates if it so wishes. We do not consider that differences

between the templates and the network code contradict or weaken the regulatory regime.

12. It has also been suggested that the templates are not consistent with ORR's policies. The policy that is of most direct relevance is the third party investment framework and we consider that our approach to the templates is consistent with this policy. However, it was also suggested that to ensure adequate regulatory protection, we should ensure that the templates reflected the policies adopted by ORR in other areas, such as track access contract reform.

13. We consider that our role and policy in relation to the templates needs to be considered in context. Our role in relation to the templates differs from our role in relation to other regulated contracts. The approach taken in the network code is for us to approve the templates as model terms and conditions. There is no requirement for customers to use those terms and conditions for particular schemes, nor do we have the same role, whether under statute or otherwise, in approving particular contracts entered into on the basis of the templates as we do with regulated access contracts.

14. We have considered what constitutes adequate regulatory protection in the particular context of the templates, and our paper reflects our conclusions. In so far as there may remain differences of approach as between the templates and other regulated contracts, that reflects the differences between the different contracts, and our different role.

15. For similar reasons, we are not persuaded that the templates should be replaced by new contracts modelled on the model clauses or the network code. Having regard to the regulatory status of the templates, we remain of the view that they should be "owned" by Network Rail, subject to our approval. We do not consider it necessary to require Network Rail to remodel the templates on other regulated contracts. We also thought that it would not necessarily be appropriate to model the templates on the equivalent provisions of an agreement with a quite different purpose and character.

16. Network Rail should of course comply with its obligations under its network licence, and the templates should be consistent with those obligations. However, we do not think that the templates, which are particular forms of commercial agreements, should necessarily be modelled on Network Rail's licence obligations, which are of a different and more general character. For example, one suggestion was that the templates should reflect Network Rail's obligation under condition 25.1 of its licence to act with "that degree of skill, diligence, prudence and foresight which should be exercised by a skilled and experienced network facility owner and operator". However, condition 25.2 states "*Condition 25.1 does not apply to the performance by the licence holder of a contract or the exercise of any discretion conferred by a contract*."

17. Similarly, we have explained in detail in our policy framework for investments how we have interpreted Network Rail's general stewardship obligation under condition 7 of its licence in relation to enhancements (see our October 2005 policy conclusions, Chapters 2 and 3, available at ttp://www.rail-reg.gov.uk/upload/pdf/255.pdf). We do not however think that the templates should be modelled on condition 7 of its licence. Rather, the changes we

require, for example in relation to design and construction risk, will ensure that Network Rail's general licence obligations are supplemented by further appropriate obligations in the context of an agreement for the execution of design or construction woks. In this way, the templates will continue to supplement other regulatory instruments, whilst remaining consistent with such instruments.

Externalisation

18. It was submitted to us that the templates, like track access contracts, should not cross-refer to other unregulated documents. In this regard, we refer to our comments above. We also considered whether the documents referred to in the templates raise particular concerns in this regard and concluded that they do not. Therefore, although we recognise this concern in principle, we do not consider that amendments to the templates are needed in practice.

19. We considered whether Network Rail might nevertheless ensure that all documents cross-referred to in the templates are published on its website, so as to ensure full transparency of the obligations imposed. Network Rail said that copies of the Standards and GRIP are readily available. It did not consider that it was appropriate for it to publish other unregulated documents, such as British Standards, on its own website. We therefore conclude that this is not a straightforward solution.

Commercial issues

20. Consultees suggested a variety of alternative commercial terms and structures which might be used in or instead of the templates. Examples included:

(a) incentive arrangements, such as pain gain mechanisms;

(b) alternative termination provisions, such as termination at will provisions in favour of the customer, and the cancellation of any outstanding obligation on the customer to pay in the event of Network Rail default;

(c) alternative payment structures, such as payment on milestones;

(d) provision for the pass through of warranties from Network Rail's consultants, or the giving of collateral warranties by such consultants;

(e) alternative provisions relating to intellectual property rights;

(f) rights for the customer to participate further in Network Rail's project management (in relation to which we note paragraph 18 of attachment 1 to Network Rail's letter of 12 July 2007); and

(g) the suggestion that simplified versions of the templates should be created specifically for TOCs.

21. The purpose of the templates is to establish standard form of agreement based on a default allocation of risk. There are inevitably alternatives to the approach taken in the templates, and customers who wish to contract on alternative terms are free to do so. However, we are not persuaded in relation to the variety of alternative approaches proposed that they would necessarily result in a better or more appropriate default position.

Cost Estimation

22. We received a variety of comments relating to cost estimation. We anticipate that some of these matters, such as Network Rail's methodology in estimating costs, will be addressed in our consultation on obstacles to investment. Concern was also expressed that customers should be given additional protection against situations where Network Rail exceeds its cost estimate. In our view, the revised templates will provide a degree of additional protection by strengthening Network Rail's obligation to act in all relevant respects to the standard to be expected of an appropriate professional.

Advice and Assistance

23. One consultee said that that Network Rail has in the past committed to obligations to provide reasonable degrees of advice and assistance to companies seeking to carry out enhancements, and such provisions have been adopted in the draft model contract for vehicle and route acceptance. We consider that the provisions referred to had now been supplemented and superseded by the investment framework, which establishes a clear policy and new processes which are designed to facilitate investments.

Disputes

24. We received various comments in connection with the dispute resolution provisions of the templates, including in connection with Network Rail's proposal to include an escalation mechanism (paragraph 19 in Attachment 1 to the letter of 12 July 2007). There are a variety of possible approaches to commercial dispute resolution and we are not persuaded that we should require further changes in relation to these provisions.

Hierarchy of Obligations

25. One consultee questioned why it was considered necessary for the templates to specify a hierarchy of obligations, with compliance with the contract coming last. It was suggested that such a provision would be unnecessary if the contract were consistent (as it ought to be) with other relevant obligations, such as the law, necessary consents and so on. We consider that hierarchy of obligation clauses are a common and appropriate mechanism for resolving the conflicts which may arise where a contract operates in a complex legal environment, and noted that no practical problems were identified as following from the clause.

26. Another consultee expressed concern that Network Rail's obligation to complete the works in a timely, economic and efficient manner "having regard to its obligations as network operator (APA clause 5.4) arguably made the former obligation "subject to" the latter. We do not agree with this interpretation, and thought that (1) the obligation to complete in a timely manner would in any event be addressed through our changes to the provisions relating to delay.

Land and Noise Claims

27. One consultee expressed concern about potentially open-ended liabilities relating to land and noise claims. We remain of the view that it is appropriate

for the funder of the scheme to bear the risk of such claims arising out of the design or implementation of the scheme (rather than the operation of the enhanced assets). We have however required Network Rail to clarify certain provisions relating to land and noise claims

Completion and Taking Into Use

28. One consultee suggested that the standard for taking works into use under the APA is too high. We consider that this is principally a matter of engineering judgment for Network Rail.

29. One consultee also expressed concern that a number of aspects of the completion process need clarification, in particular the definition of completion in the Implementation Agreement, and whether works must be commissioned, tested and brought into use before they are complete. Network Rail in any event said that it intends to review these provisions as part of the templates update.