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2 October 2008

To: see attached list of addresses

Dear Stakeholder

## **Investment Framework – liabilities in Network Rail’s template investment contracts**

### **Context**

1. In May 2008<sup>1</sup> we set out the changes we required Network Rail to make to its investment template contracts. These are contracts which Network Rail uses when providing services to those wishing to invest in or around the railway. The required changes were aimed at ensuring a more appropriate allocation of risk between Network Rail and its customers. Since we published the required changes, Network Rail has issued revised template agreements, and is consulting with you on its proposed changes before submitting the revised agreements to us for approval. It has recently written to stakeholders extending the consultation on the revised agreements until 30 November. This is so that we can consult you further on the appropriate levels of liabilities in the contracts, an issue that we said we would keep under review.

2. There were two areas in our conclusions in which we expressed the view that we had found it difficult to reach definitive views in light of the responses received from stakeholders. These related to the level of the Network Rail cap on liabilities and the level of liquidated damages in relation to certain templates. In relation to the former, we required certain changes in our conclusions document, but anticipated the need to keep the issue under review as experience provides guidance as to the level at which the caps should be set. In relation to the latter, we were not satisfied that the level of damages proposed by Network Rail was appropriate and indicated that we would consider further at what level any tariff should be established before we could approve the revised templates.

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<sup>1</sup> Conclusions on approach to third party investment. [http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty\\_templates\\_090508.pdf](http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty_templates_090508.pdf)

3. In relation to both of these issues, we found that stakeholders, whilst unhappy with the existing templates, did not on the whole put forward specific alternatives to the current provisions (or the proposals in the conclusions document). Where alternatives were proposed, stakeholders did not put forward evidence, reasons, and practical examples or experience as to why and how the templates should be amended on these issues. There is obviously a range of levels at which a liability cap may be established or liquidated damages may be fixed, and a balance to be struck between cost and risk, and we were provided with little or no material to assist us on these issues.

4. Since our publication in May 2008, some stakeholders have written to us in respect of our conclusions and we have met with them to discuss the issues they raised. Although they raised concerns with a number of our conclusions, they confirmed that their priority concern was inadequate remedies available to investors when Network Rail fails to deliver against its contractual obligations. Through our engagement with these stakeholders it has become clear to us that they have additional information in connection with the two issues identified above which has not been provided to us so far in the context of this review. In the circumstances, we have decided that we should give further consideration to both of these areas now and have decided to conduct a short, focussed consultation on these specific issues of the level of the Network Rail cap on liabilities and on the level of liquidated damages.

### **Network Rail cap on liabilities**

5. In our conclusions we said:

*“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.*

*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.*

*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 [the first paragraph of this extract]. 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.”*

6. In order to take this issue forward now, we seek consultees answers to the following questions:

- (a) Whether the templates should include a default position in relation to the Network Rail cap at all, or whether this should be left as a matter to be negotiated?**
- (b) If a default level of Network Rail cap should be established in the templates, should it be expressed in relation to the Network Rail fee (i.e. as a percentage or multiple of the fee)?**
- (c) If not, on what alternative basis might the cap be expressed, and why should this apply? How would you typically expect caps to be set in similar contracts?**
- (d) Is it appropriate for the cap to be calculated in the same way when Network Rail carries out only non-contestable services (e.g. under an APA) as when Network Rail undertakes contestable services? The issue that has been raised here is that, for non-contestable services, the Network Rail cap can be very low in relation to the loss caused to the customer by breach because of the low value of the services being provided by Network Rail.**
- (e) Would a suitable alternative approach be that the cap was set EITHER in relation to the Network Rail fee OR at a certain minimum level, whichever is the higher? If so, what should this minimum level be, and why?**
- (f) Is it appropriate for the Network Rail cap to be set in relation to any cap agreed by Network Rail with its sub-contractors?**
- (g) Is it appropriate for caps to be set on an annual basis or on a per breach basis?**

7. We note that it has also been suggested to us by one consultee that the Network Rail cap should be established at a level that reflects the level of professional indemnity insurance cover that Network Rail might reasonably expect to have available. In the light of this we intend to explore with Network Rail what insurance cover it has in place and how this approach would work in practice.

## **Liquidated damages to limit liability**

8. In our conclusions we said:

*“...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.*

*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.*

*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.”*

9. In order to take this issue forward now, we seek consultees views on the following questions:

- (a) Whether in relation to the agreements for which we have proposed that liquidated damages should operate as a cap on liability it is practical and appropriate for the templates to include default provisions relating to the level of the damages, or whether this level should be a matter for negotiation in each case?**
- (b) If the templates should include a default level for liquidated damages, how should this be expressed?**

- (c) How could one be confident that liquidated damages expressed in this way were legally enforceable (that is, how could one be confident that they would not exceed loss and so act as a penalty)?**
- (d) If it is not possible to include a default level of liquidated damages that would be enforceable, what (if any) guidance could ORR give that would aid the setting of a level in a particular case?**
- (e) If there is difficulty in establishing the level of liquidated damages, or in providing useful guidance as to how they should be set, whether changes to other provisions in the templates would be an alternative method of incentivising Network Rail to perform on time (e.g. the establishment of milestone payments)?**

### **Next steps**

10. We invite your comments on the issues outlined above together with any other information that you think may be relevant, by 31 October 2008.

11. In view of this further consultation we have asked Network Rail to extend its deadline for consultation responses to the drafts of its template agreements to 30 November 2008.

12. Please send your responses in electronic format (or if not possible, in hard-copy format) to Chris Littlewood at:

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

E-mail: [chris.littlewood@orr.gsi.gov.uk](mailto:chris.littlewood@orr.gsi.gov.uk)  
Phone: 020 7282 2195

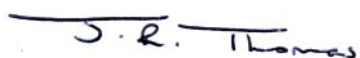
13. Please contact Chris Littlewood if you want to discuss any points we have raised in this letter.

14. In your response, you should make it clear if you want us to keep all, or part of your response, confidential. Otherwise it may be shared with Network Rail and is expected that it will be made available in our library and on our website and we may quote from it. If you want us to keep your response confidential, please provide a statement summarising your response (leaving out the confidential information) that we can treat as a non-confidential

response. We may also publish your name in future documents or on our website, unless you tell us that you do not want us to do so.

15. You can find copies of this document in our library and on our website ([www.railreg.gov.uk](http://www.railreg.gov.uk)).

Yours sincerely

A handwritten signature in blue ink, appearing to read "J. R. Thomas". The signature is written in a cursive style with a horizontal line above the first part of the name.

**John Thomas**