

5 February 2010

Dear Colleague

Improved template contracts for third party investment

I am pleased to be able to write to you having today approved¹ a revised set of template contracts, prepared by Network Rail for use by investors.

We believe that the new templates represent a very significant improvement for investors: they are clearer, and provide stronger incentives on Network Rail with a fairer and more logical balance of risk. Network Rail has responded positively to investor and ORR responses to the previous versions. We expect that the new templates will speed up transactions, reduce the cost of contract negotiation and reduce the costs of investment through greater clarity.

This letter first describes the process - why the templates have been revised, why we have approved them and what the main changes are. It then explains when they should be used, what happens if there are problems with their use, and how we will monitor their use. A list of the revised templates is at Annex 1. The agreements are available on Network Rail's website at <http://www.networkrail.co.uk/CurrentTemplatesAgreements/>

Process

The original set of investment template contracts was developed by Network Rail and approved by ORR in 2006 in order to encourage investment by third parties (that is, anyone besides central government) in the rail network. They did this by establishing default terms and conditions between investors and Network Rail. They have been very successful: over £360 million has been invested with Network Rail using over 300 contracts based on the templates since their approval in 2006.

¹ The revised templates are approved for use in England and Wales. We expect that they will be approved for use in Scotland shortly subject to agreement with Transport Scotland. In the meantime the original templates can be used in Scotland.

Once the templates had been in existence for a full year, in 2007, we initiated a review of their use in consultation with stakeholders. This review concluded in May 2008, with our publication describing how the templates needed to change.

In two areas – the capping of liability, and the specification of liquidated damages – a lack of evidence of the consequences of breach of contracts based on the templates meant we had found it difficult to reach definitive views. After representations from a number of stakeholders expressing concern with our May 2008 conclusions, we decided to conduct a further focussed consultation on these two specific issues. This further consultation concluded in March 2009. Together our two conclusions documents set out how the templates needed to change.

Network Rail has since revised the templates in the light of our conclusions (which in turn reflected investor feedback) and sought comments from stakeholders. It then asked ORR to review the redrafted agreements in order to establish whether we would be likely to approve them. In a number of areas we did not believe the drafts reflected our conclusions and so asked Network Rail to make changes, which they have now done.

In deciding whether to approve the changes made to the template agreements, we have had three broad considerations:

- do the changes comply with our conclusions?
- is the drafting clear?
- has Network Rail taken reasonable account of comments from stakeholders?

Overall we have concluded that the revised templates do comply with our conclusions. In a small number of areas, Network Rail has argued that it cannot implement our conclusions. In one material case we have accepted this argument and we explain our decisions in this case in Annex 2. The drafting is clearer and Network Rail has considered all consultation comments and taken reasonable account of them – accepting most but not all. Network Rail is writing to stakeholders who made comments on their most recent consultation, explaining how their comments have been taken into account.

The key approved changes are explained in more detail in Annex 3 but some important areas of improvement are:

- Design risk: the templates now require Network Rail to take design risk for all design work it carries out or procures;
- Liquidated damages: these are now set by the parties to the contract and so can genuinely reflect expected losses; and

- Liability caps: Network Rail's liability cap is raised significantly, and now covers negligence.

Use of the templates

The templates are intended for use as *default* terms and conditions for contracts (and are mainly designed for contract values of less than £50m). They are intended to offer a fair balance of risk between Network Rail and investors, taking into account the fact that investors in some cases face no alternative but to contract with Network Rail, and that Network Rail is obliged to perform some services if an investor requires it. Customers may have particular concerns and individual projects may have particular risks. We expect both parties to be open to negotiation of alternative provisions that suit individual circumstances, while acknowledging that they must control or manage the risks they take on.

We think that because the new templates are a significant improvement, customers will want to move to using these new agreements as a basis for contract negotiations. However, so that there is no disruption to ongoing work, we are not withdrawing our approval of the previous set of contracts at this stage.

Now the new templates have been approved for use Network Rail has updated the guidance on its website (<http://www.networkrail.co.uk/CurrentTemplatesAgreements/>), and its staff can advise on their use.

Recourse for customers during negotiation

If customers are unhappy with Network Rail's attitude in negotiating a contract for investment, and escalating the matter with Network Rail has failed or is not practical, they can refer the matter to us. We would consider whether Network Rail was complying with its stakeholder relationships licence condition. Network Rail has a code of practice (available via the link above) for its dealings with stakeholders promoting enhancements.

Monitoring

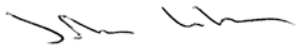
We will monitor the use of these (and the previous) templates. The independent reporter is currently reviewing a sample of enhancements promoted by third parties as a follow up to our 'obstacles to investment' conclusions of March 2009². We want to understand whether Network Rail's actions to improve customer service are having an impact.

² http://www.rail-reg.gov.uk/upload/pdf/investment_obstacles_conclusions_310309.pdf

We welcome any feedback from customers on their experience using the templates. In particular we want to understand how the variation mechanism performs in practice, and we will ask Network Rail to tell us where it uses its rights to impose variations to the contracts, or to refuse variations proposed by the customer.

We will also monitor calls on the risk funds, which are the mechanism by which Network Rail funds the extra liabilities it takes on under the templates, and both the customers' and Network Rail's exposure to industry risk (risk as a consequence of rail industry conditions rather than scheme specific conditions). If there is evidence either that the funds might be exhausted because contributions to them are low when set against the risks, or that the contributions are too high for the protection from risk that the funds provide, we will act to change the arrangements.

Yours sincerely



John Larkinson

Annex 1 – List of revised templates

Revised templates

1. Basic Services Agreement (BSA)

A simple agreement, aimed at quickly putting in place a contractual relationship following an initial promoter approach to cover pre-feasibility works to scope the scheme and develop the business case. The tasks it covers can include:

- *the provision of asset information to the promoter;*
- *attendance at meetings and workshops; and*
- *where appropriate for minor schemes, review of the promoter procured 'Approval in Principle' design.*

The agreement also permits, within particular constraints, the promoter or their representative to undertake visual inspection of the network.

It will generally be used during GRIP Stages 1 and 2 but could be used to the end of Stage 3 for simple schemes.

2. Development Services Agreement (DSA)

This agreement covers development and design work undertaken by Network Rail on behalf of a promoter. Issues covered include:

- *project and development management;*
- *contract management of consultants;*
- *management of the necessary consents and approvals; and*
- *governance and control.*

The DSA covers GRIP Stages 2 to 4 inclusive with the potential to reach stage 5 if agreed.

3. Basic Implementation Agreement (BIA)

A simple agreement for minor straightforward and low-risk works up to a typical value of £2m on or about the controlled railway infrastructure. The promoter pays for the works on an emerging cost basis and the agreement covers GRIP Stages 5 to 8 inclusive.

4. Fixed Price Basic Implementation Agreement

A simple agreement for minor straightforward low risk works up to a typical value of £2m from Stage Gate 5. It envisages that the works contractor will have provided a price based on the

specification that has been agreed between the promoter and Network Rail. The agreement covers from the end of GRIP Stage 5 up to 8 inclusive.

5. Implementation Agreement

With Network Rail acting as a construction manager, this is an emerging cost agreement establishing a clear commercial framework for enhancement work on or about the controlled railway infrastructure to provide detailed design and implementation of the promoter's scheme with the contracting strategy agreed between Network Rail and the promoter.

6. Fixed Price Implementation Agreement

This is generally intended to cover implementation of schemes up to £10m from the end of Stage Gate 5. It envisages that the works contractor will have provided a tendered price based on similar fixed price terms and against a specification which has been agreed between the promoter and Network Rail.

7. Basic Asset Protection Agreement (BAPA)

A simple agreement for straightforward, low-risk promoter led works, on the controlled railway infrastructure, where Network Rail facilitates the promoter's project through asset protection. The works will present low risks to the network, and so may take place on secondary routes and require few or no possessions. The promoter pays the costs of Network Rail's services, which generally include:

- *engineering safety management approvals;*
- *asset information;*
- *booking of possessions and necessary consents; and*
- *attendance at meetings as required.*

8. Asset Protection Agreement

An agreement for promoter led works on the controlled railway infrastructure, where Network Rail facilitates the promoter's enhancement scheme interface with the operations, maintenance and renewals business. The promoter pays the costs of Network Rail's services that include:

- *engineering safety management approvals;*
- *asset information;*
- *booking of possessions and necessary consents; and*
- *attendance at meetings as required.*

Annex 2: Approved changes not consistent with our conclusions

There is one material area – the question of recovery of costs from insurers and third party contractors, and the requirement on customers and Network Rail to pursue those costs and pass them on where appropriate – where we have reconsidered our conclusions in the light of Network Rail’s representations.

The issue concerns the sections of the templates that limit the liability of each party to the other in the event of a breach of contract.

In the original templates, the position was that the Customer had to pay any sum which was *recoverable* from its contractor or insurers, even if it exceeded the cap on its own liability. By contrast, Network Rail only had to hand over such sum which it actually *recovered* from its contractor/insurer.

Our conclusions of 9 May 2008 stated (paragraph 67) that “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”.

Our further conclusions of 5 March 2009 required Network Rail to “modify these provisions so that the Network Rail cap (like the Customer Cap) is adjusted in light of any sum which is *recoverable* from its contractors or insurers. This ensures that the risks borne by Network Rail and customers are symmetrical and that Network Rail is properly incentivised to pursue claims against contractors or insurers” (paragraph 37).

Further, paragraph 43 linked this amendment to availability of insurance: “we consider that there is force in the general point made by ODA et al., that liability caps in connection with agreements for the provision of professional services should reflect the availability of PI insurance. For this reason, we require a modification to the templates so that under agreements for contestable services, a customer is able to recover from Network Rail, over and above the Network Rail cap, any additional amount which is recoverable by Network Rail from its contractor and in respect of which its contractor holds insurance. A provision of this type would be similar in approach to the existing provisions under which the cap is adjusted having regard to insurance held by Network Rail. In our view, this is a more proportionate means of dealing with the concern raised by ODA et al., than requiring Network Rail to take out further insurance.”

Rather than draft in this way, Network Rail went the other way, so that the provisions are indeed now symmetrical for itself and the customer, but the additional amount is limited to recovered rather than recoverable sums (for example, see IA(EC) clauses 12.2 and 12.6).

Our reason for agreeing with Network Rail in this departure from our conclusions is the uncertainty that surrounds “recoverable”. A recovered sum is obviously quantifiable. A

recoverable sum however may bear no relation to the amount the defendant does indeed recover from its insurer (so it could well be left out-of-pocket and paying more than its liability cap). It would appear to make claims more likely to be formally raised in court or arbitration, since that is the only way the defendant could be sure it recovers as much as it can from its insurer.

Although we want to incentivise recovery, we do not wish to cause extra litigation for parties. We do not think the templates should contain default provisions which give rise to this degree of uncertainty: as a default we want the templates to reduce uncertainty and delay for investors so far as possible. We are however mindful that adopting “recovered” instead of “recoverable” does not incentivise a defendant to recover insurance monies (or monies from its contractors) as much as would otherwise be the case. Therefore in the templates each party faces an obligation to pursue claims reasonably. We will also keep the use of this provision under review, and if we are presented with evidence that parties to the agreements are not acting reasonably to recover appropriately from their insurance or contractors, we will reconsider our conclusions here.

Annex 3: Main changes to previous version

The main areas where Network Rail was asked to improve the templates are set out in our May 2008 and March 2009 conclusions³. The areas of improvement that were of interest to most consultees are:

Design risk

The new templates require Network Rail to take design risk for all design work it carries out or procures. Previously under the templates, Network Rail did not carry this risk unless it implemented the design. The customer takes design risk for design work it carries out or provides to Network Rail.

Liquidated damages and delay

The templates used to include a default level for payment of liquidated damages. This provision risked being unenforceable since that level could exceed a genuine pre-estimate of the loss caused by that delay, and so act as a penalty. The new templates have therefore been amended so that liquidated damages will be set by the parties during the contract negotiation to genuinely reflect expected losses.

Liability caps

Customers' and Network Rail's liabilities are capped under the agreements. In order to increase the incentive on Network Rail to deliver, we have increased the level of its cap to the full value of the agreement between Network Rail and its customer, which will comprise any agency cost, consultants' costs, contractors' costs and personnel costs, or £100,000 if this amount is greater. The capping arrangements are not reciprocal, and the level of the customer's cap on liability remains unchanged; in particular the customer's liability in negligence remains uncapped.

³ ORR conclusions on our review of the approach to third party templates. http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty_templates_090508.pdf and

Liabilities in Network Rail's template investment contracts. http://www.rail-reg.gov.uk/upload/pdf/inv-tmplte_liab_cap.pdf