



Technical note: Network Rail's approach to third party investments

Introduction

1. We published our final policy conclusions for the investment framework on 7 October 2005¹, setting out a policy framework to facilitate investment, including investments sponsored by third parties (i.e. sponsors other than Government²). A key activity in implementing the investment framework is for Network Rail to establish appropriate template agreements for third party investments, in order to provide sponsors with transparent, fair, model terms and conditions, approved by us, which should promote efficient delivery of investments.
2. This note explains our policy conclusions in this area³, which need to be reflected in the templates. The note, which should be read in conjunction with our policy conclusions document, covers the following areas:
 - general issues with Network Rail's proposed approach, such as the level of customer contributions to the proposed risk Funds⁴ and Network Rail's obligations to provide services;
 - the basis of the prices offered by Network Rail for services related to investments;
 - the Network Rail Fee Fund, the Industry Risk Fund and risk allocation more generally; and
 - the liability regime.
3. Issues relating to investments sponsored by third parties have been the subject of extensive discussion and analysis since publication of our

¹ *Policy framework for investments: conclusions*, Office of Rail Regulation, London, October 2005 may be downloaded from <http://www.rail-reg.gov.uk/upload/pdf/255.pdf>.

² That is, the Department for Transport (DfT) and the Scottish Executive.

³ A summary is also given in Chapter 3 of our policy conclusions document.

⁴ The nature and purpose of the Funds are explained in paragraph 5.



February 2005 consultation document on the policy framework for investments⁵, including:

- discussions at workshops with key industry stakeholders in April 2005;
 - a detailed review by us of Network Rail's draft templates for third party schemes; and
 - discussions on the proposed approach and on Network Rail's draft templates at two meetings of a sub-group of the DfT-led Investment Working Group (IWG).
4. Network Rail has made significant progress in developing its approach to third party schemes, and made improvements to the draft contract templates following discussions with industry stakeholders. We expect Network Rail to submit the templates to us (with accompanying explanatory notes) for approval under Part G of the Network Code by the end of 2005. We intend to adopt a staged approach to approval, which prioritises the key template agreements⁶. We also intend to publish a further version of this note once we have approved the templates, to explain how our policy conclusions have been addressed in the final templates submitted to us, and to cover any other policy issues that arise from our review of the templates.

Network Rail's proposed approach

5. Network Rail's proposed approach to third party schemes has been consulted on with stakeholders over the past two years, and is set out in more detail in Network Rail's March 2005 "Regulatory Submission"⁷. The key elements of Network Rail's proposed approach are:
- risks allocated to the party best able to manage and mitigate them but in order to address issues of risk aversion holding up projects, Network Rail is proposing that most liabilities are capped⁸ (for both

⁵ *Policy framework for investments: an initial consultation*, Office of Rail Regulation, London, February 2005 may be downloaded from <http://www.rail-reg.gov.uk/upload/pdf/223.pdf>.

⁶ In particular, the Asset Protection Agreement and Implementation Agreements.

⁷ Available at <http://www.networkrail.co.uk/Documents/ORRSubmission2005.pdf>.

⁸ In particular, industry-specific liabilities are capped.



customers⁹ and itself) and that two new funds are established as follows:

- (i) a Network Rail Fee Fund (NRFF): a ring-fenced fund, where payments from customers to cover Network Rail's own costs and contingencies for potential liabilities are put into the Fund, and the Fund is drawn on as necessary by Network Rail. Any surplus Network Rail derives from its charges to customers will be held within the Fund. Network Rail has also proposed contributing £10 million to top up this Fund to ensure it has incentives to manage effectively liabilities that may arise¹⁰; and
- (ii) an Industry Risk Fund (IRF), funded by customers' contributions based on a proportion of scheme costs, which will effectively act as insurance against low-probability, high-impact industry risks¹¹.

- a set of template agreements which provide customers with transparency on:

- (i) risk allocation;
- (ii) payments to Network Rail associated with the different services provided; and
- (iii) the company's obligations and accountability.

6. If liability caps are breached and the NRFF and IRF are both exhausted, Network Rail would finance any additional costs until the next periodic review, at which time there would be an addition to the RAB. Given that this may lead to an increased funding requirement for Government (through financial support of potentially higher access charges in future control periods), a necessary pre-requisite for our

⁹ The customer is the party contracting with Network Rail, usually the same body as the sponsor.

¹⁰ This £10 million 'top up' contribution would be drawn on if contributions from customers to the NRFF were to be exhausted.

¹¹ Such as discriminatory changes of law or the impact of an operational emergency elsewhere on the network on a scheme.



approval of the model terms and conditions is Government support for these arrangements.

7. Following recent discussion between Network Rail and Government, DfT is content to accept the potential RAB addition arising from the two Funds, subject to our approval of the terms of the template agreements. The Scottish Executive is currently considering the precise form that its support for the Funds should take, and what transitional arrangements it should put in place, in advance of the creation of the new Scottish Transport Agency.
8. We expect that Network Rail will manage risks within its control and manage these Funds so as to ensure as far as possible that the Funds are not exhausted. We would need to be satisfied that this was the case before considering making any addition to the RAB, by reference to the monitoring arrangements described in Chapter 4 of our policy conclusions.

General issues with the proposed approach

Level of customer contributions to the Funds and liability caps

9. Network Rail proposed in its March 2005 Submission:
 - that customer contributions to the IRF are set at 2% of the cost of the scheme;
 - a range of customer contributions to the NRFF, depending on the service provided; and
 - a range of liability caps for itself and the customer, depending on the service provided.
10. We believe that the level of liability caps for both customers and Network Rail contained within the templates should be set at a level which provides a reasonable balance between providing:
 - appropriate incentives on all parties to meet contractual obligations; and
 - reasonable protection for both Network Rail and customers, in order not to discourage appropriate investment.



11. The Association of Train Operating Companies (ATOC) questioned whether or not it was appropriate for Network Rail to charge mark-ups on its fees for providing services to third party schemes. However, these mark-ups are put in place to cover potential liabilities arising (rather than any expected profit element for Network Rail) and any surplus on individual schemes is used to cover liabilities arising on other schemes, through the application of the NRFF.

12. Given the innovative nature of the approach put forward by Network Rail, it is difficult to estimate accurately in advance an efficient level of customer contribution to the two funds (NRFF and IRF) and appropriate liability caps. Through monitoring actual use of the two Funds, we will be able to assess whether or not the levels are appropriate, by examining how claims on the funds arise.

13. The initial levels of contribution and caps on customer liability will therefore generally be as stated in Network Rail's March 2005 Submission to ORR. However, we have proposed an increase in the cap on Network Rail's liability, for reasons set out in paragraph 43.

Customer contributions to the cost of industry risks

14. In addition, Network Rail initially proposed that the customer would share any liabilities (up to a cap) arising due to industry risks: this would effectively mean that the contribution to the industry risk fund would be more than 2% if liabilities arose. Network Rail proposed this so that customers had appropriate incentives to manage industry risks, where it is possible for them to do so, and so avoid a "claims culture".

15. However, we believe that it is unreasonable for customers to bear liabilities for industry risks which are beyond their control and that a combination of the following alternative mechanisms should avoid inappropriate claims:

- a requirement for the customer to mitigate losses - for example, in the template Asset Protection Agreement; and
- a *de minimis* threshold on claims¹².

¹² The threshold will initially be set at £10,000, consistent with the Stations Code.



16. We therefore have concluded that customers should not bear additional liabilities arising due to industry risks and should not be required to share the costs of any industry risks which arise.

17. Network Rail has stated that it is content with this approach and that this was more a matter for DfT, as DfT was supporting the contingent exposure for the IRF. Stakeholders who attended the IWG sub-group meetings (including DfT) also said they were content with this approach. Following recent discussions, Network Rail has amended its draft templates accordingly, for our review.

Network Rail's obligations to provide services

18. ATOC and other consultees expressed concern over the apparent weakness of Network Rail's contractual commitment to provide services according to a pre-defined programme of work, as drafted in the templates.

19. We recognise that there may be some external factors impacting on scheme timescales which are beyond Network Rail's control, such as delays in obtaining external consents, and therefore that it may not be desirable - or possible - to fix a programme rigidly in all circumstances.

20. However, we believe that Network Rail should give binding contractual commitments (i.e. not just "reasonable endeavours") to provide the services a customer requires when designing or delivering a scheme and to do so by a pre-defined end date, agreed up front with the customer. Following discussion, Network Rail has accepted this principle and has made consequent changes to its draft templates for our review.

21. We have considered what form of contractual compensation mechanism would be appropriate for failure to adhere to an agreed end date, and believe that the use of liquidated damages should provide appropriate compensation for customers, where liquidated damages would be triggered by failure to meet a specified "longstop" date (beyond the agreed end date). We continue to discuss with Network Rail the precise mechanism and conditions for contractualising this policy.



Availability of Resources

22. Previous versions of the templates contained references to obligations being subject to the availability of Network Rail resources, so that if resources were not available, the IRF might be drawn upon or Network Rail would be excused from its contractual commitments. ATOC and other consultees (including Hutchison Ports) have expressed concern over the effect of this provision.

23. We consider that, once Network Rail enters into a contract with a customer, it should not seek to avoid its contractual commitments due to inadequacy of resources. Network Rail is required under Condition 12 of its Network Licence to ensure that it has sufficient resources to comply with its relevant obligations.

24. We recognise that exceptional circumstances (such as a safety-critical event, classified as a Network Operation Issue (NOI)) may on occasion raise resourcing issues. We consider that, as a general rule, adequacy of resources should only affect contractual commitments as a consequence of such a NOI. Following recent discussions, Network Rail has accepted this principle and has amended its draft templates accordingly, for our review.

Commitments to operate, maintain and renew the network

25. The draft templates originally contained various mechanisms that made Network Rail's commitments to deliver enhancements appear secondary to its commitments to operate, maintain and renew the network (OM & R commitments). Again, ATOC and Hutchison Ports expressed concerns over these provisions. Network Rail has explained to us that the original wording was intended to recognise existing obligations e.g. under current access agreements.

26. Under Condition 7, Network Rail is required to satisfy the reasonable requirements of customers and funders in respect of enhancements, and this requirement is not secondary to its OM & R commitments. Following recent discussions, Network Rail has amended its draft templates accordingly, for our review.



Basis of Price

27. The February consultation document stated that Network Rail should generally offer the customer a fixed price or a target price for delivery of the required outputs in order to ensure that appropriate incentives are in place to deliver the required outputs efficiently.

28. Several stakeholders have pointed out that in many cases, it may not be efficient for Network Rail to offer a fixed price for providing services due to the nature of the service being provided. We accept this but believe that, as discussed in Chapter 3 of our policy conclusions, Network Rail should generally offer customers prices on a fixed or target price basis if customers wish them to do so. Generally, where Network Rail is implementing a scheme, it will offer a fixed or target price (where required) for implementation at GRIP Stage 5¹³.

29. The previous version of the “fixed price” implementation agreement, which contained a variation mechanism, did not actually provide customers with a firm fixed price. Although we accept that there will generally be some exclusions to any fixed price, the templates need to reflect the fact that, where they require it, customers expect to be offered a firm fixed price for delivery under these agreements.

30. Our conclusion is that Network Rail should offer customers a fixed price for providing implementation services where the customer requires it, excluding only risks outside of Network Rail's control (which will generally be borne by the customer or the IRF). We have suggested appropriate revisions to be made to the templates to reflect this policy, which Network Rail has now incorporated, for our review¹⁴.

¹³ The stage in Network Rail's scheme development process (set out in the Network Rail manual *Guide to Rail Investment Projects*, or GRIP) where design work is complete and it can go out to tender for construction.

¹⁴ We are also discussing with Network Rail possible mechanisms for addressing exceptional circumstances.



Emerging costs contracts

31. Emerging cost arrangements are quick to set up and may be preferred by some customers in selected circumstances, but, we believe, generally provide weaker incentives on parties to control costs.

32. Generally we prefer suitable variable cost arrangements where risk allocation is clear and Network Rail has incentives to deliver, such as “target cost” arrangements with pain/gain share. We believe that any emerging cost arrangements which are put in place should usually be subject to a pre-defined cap, but we accept that the preferred basis of price is ultimately a matter for the customer.

Network Rail Fee Fund, Industry Risk Fund and risk allocation

33. We are supportive of the objective of the IRF to alleviate some of the barriers to investment, related to risk aversion or risk avoidance and to the management and funding of low-probability, high-impact industry risks. The categories of risks proposed for inclusion within the IRF primarily relate to:

- events elsewhere on the network (such as an operational emergency) which affect the delivery or facilitation of the scheme;
- risks that arise as a result of industry processes which are beyond the direct control of the customer e.g. certain changes in standards or the consent process during the scheme; and
- certain Governmental risks which cannot be funded by other means e.g. discriminatory changes in law.

Coverage of IRF

34. Network Rail's March 2005 submission set out a schedule of all industry risks covered by the IRF. The draft templates do not currently contain a comparable schedule, because several industry risks such as non-discriminatory change of law do not need to be explicitly referenced in the templates, as this risk remains with each of the parties and is therefore not included in the risk allocation under the templates. However, Network Rail will provide guidance notes for customers using the templates, setting out precisely which risks are covered by the two funds.



35. Discussions with stakeholders identified two categories of industry risk where further clarity on risk allocation was required:

- risks arising from land and noise claims (covered in the next section); and
- force majeure risks.

36. We believe that when a force majeure event occurs all parties should receive relief from liability for performance of their obligations. However, following discussion with stakeholders, we have concluded that generally each party should bear its own force majeure risks and take out adequate insurance where possible. Network Rail has amended its draft templates accordingly for our review. We will also monitor the impact of these arrangements going forward to ensure that this allocation of risk is appropriate.

Land and noise claims

37. Land and noise claims may arise:

- against Network Rail or the customer during the construction phase of a scheme; and/or
- against Network Rail or the relevant operator further downstream, once assets have been taken in use and transferred to Network Rail. Claims can arise up to seven years from the date when the works are first open for use. For example, a scheme in a built-up area might incur claims several years hence.

38. We accept that the customer, who requires the enhancement, should be responsible for land and noise claims during construction (in particular where Network Rail is merely providing asset protection services).

39. We are concerned though that some customers may be unwilling (or unable) to take the risk of claims that could arise several years after the enhancement works are completed, and that this may be a disincentive to invest in the rail network. Customers have expressed concern that they are unable to bear this downstream risk and that investments may be stymied if they are asked to do so.

40. We agree that customers should not be expected to bear any unforeseeable downstream risk and consider that the IRF should generally



cover such risks resulting from land and noise claims. This is just the kind of risk which is largely outside the direct control of customers that the IRF was designed to cover.

41. Network Rail has proposed that the customer takes risks on land and noise claims up to a negotiated limit, to reflect the fact that the customer should allow for claims that may arise in its business case, as customers should be able to quantify the probability of foreseeable claims arising. Because of the nature of land and noise claims this limit would need to be considered on a case by case basis. If land and noise claims exceeded this limit then all other claims would be funded by the IRF.

42. We continue to consider appropriate contractual provisions with Network Rail, in discussion with other stakeholders. We intend to finalise the appropriate risk allocation for this category of risk before approving the template agreements, and to set out the risk allocation in the further version of this note.

Liabilities under the template agreements

Liability regime

43. We considered that the liability regime throughout the templates would benefit from restructuring, particularly the way in which limitations on liability are defined. We have proposed that the structure from the model clauses regime could be used as a suitable framework, e.g. to include mitigation obligations in relation to indemnities and *de minimis* levels. For consistency with the model clauses regime, Network Rail's liability cap would then increase to 300% of its fees (from the current proposed level of 200%). Following discussion, Network Rail has amended its draft templates accordingly, for our review.

44. We have reviewed the liability and compensation mechanisms available through the draft templates with reference to similar contracts used elsewhere in the construction industry. We consider that Network Rail and customers should not be liable for indirect losses (such as a customer's loss of profit in another part of its business as a result of delays in a rail scheme), as:

- this type of compensation is not generally available through contracts used elsewhere for similar services;



- this liability may in practice be difficult to mitigate; and
- we have been provided with no evidence that this approach would create barriers to efficient delivery of investments.

However, we will keep this issue under review and, if our monitoring shows that this limitation was preventing efficient delivery of schemes, we would re-examine this issue.

Remedies for not providing design services

45. Customers have expressed concern over the proposed enforcement route for them if Network Rail does not provide appropriate design services, which in the current templates appears to limit unacceptably Network Rail's accountability when it is providing design services (usually through a contract with a designer).

46. We have sought clarification of the intention and effect of the collateral warranties in place in this case. Network Rail has explained that it takes responsibility for management of designers. In addition, Network Rail as the manager of the design process may separately be liable to the extent it fails to manage that process or if it is in breach of its standard of care. The designers remain responsible for their designs.

47. This is an area where Network Rail's explanatory notes will be particularly useful to provide clarity to customers on the remedies available to them, including the remedy of specific performance to require provision of design services, where this is available.

Information warranties

48. Currently the templates give the customer no protection in relation to sub-standard information, and both ATOC and the Rail Freight Group (RFG) have argued that the current contractual position is unacceptable.

49. While we do not consider that Network Rail should warrant all information, we consider that where it is the sole source of information (e.g. on maintenance), it should have a stronger obligation than that in the current templates. We have provided detailed drafting suggestions to Network Rail which recognise the limitations of information which may be provided but strengthen the obligations on Network Rail, which should incentivise Network



Rail to provide accurate information. Following discussion, Network Rail has amended its draft templates accordingly, for our review.

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