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OFFICE OF RAIL REGULATION

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Dear Stakeholder

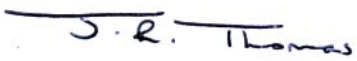
Investment framework – liabilities in Network Rail's template investment contracts

1. In May 2008[1] we published our conclusions on the changes Network Rail needed to make to its suite of investment template contracts. There were two areas in our conclusions in which we found it difficult to reach definitive views in the light of the input from received stakeholders. These areas related to the level of the Network Rail cap on liabilities and the level of liquidated damages set in certain templates. In both of these areas we found that stakeholders, whilst unhappy with the provisions of the existing templates, had not generally put forward specific alternatives to those provisions.

2. Following our publication in May 2008, some stakeholders wrote to us raising a number of concerns with the conclusions. Through our engagement with these stakeholders it became clear to us that they had additional information in connection with the two issues identified above which had not been provided to us earlier in the review. We therefore decided to conduct a focused consultation on the specific issues of the level of the Network Rail cap on liabilities and on the level of liquidated damages expressed in the templates. Our consultation document was published on 2 October 2008[2].

3. We have now reached our conclusions on these two issues, and they are summarised in the document attached, which also sets out the next steps in the process for revision, consultation on, and approval of the revised templates.

Yours sincerely



John Thomas

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1 Conclusions on the approach to third party investment. http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty_templates_090508.pdf

2 The consultation paper can be found at http://www.rail-reg.gov.uk/upload/pdf/invest-framwk-consultation-021008.pdf and responses to it at http://www.rail-reg.gov.uk/server/show/ConWebDoc.9360

Policy framework for investments – liability provisions in the template investment contracts

Context

1. In May 2008[1] we set out the changes we required Network Rail to make to its investment template contracts. There were two areas in our conclusions in which 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 provided 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.

2. In the light of concerns expressed by a number of stakeholders in response to our conclusions, we decided that we should give further consideration to both of these areas and conducted 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[2].

Network Rail cap on liabilities – consultation responses

3. In the following paragraphs we summarise the responses we received to the various questions set out in our letter of 2 October 2008. We draw our conclusions in the next section.

Should the templates include a default position on the Network Rail cap (or should the cap be negotiated for each project)?

4. Network Rail said that it was open to discussion with customers seeking bespoke terms, but believed that for most investors a requirement for individual negotiation would act as a barrier to investment.

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[1] Conclusions on approach to third party investment. http://www.rail-reg.gov.uk/upload/pdf/inv-3rdpty_templates_090508.pdf

[2] Liabilities in Network Rail's template investment contracts. http://www.rail-reg.gov.uk/upload/pdf/invest-framwk-consultation-021008.pdf

5. A number of consultees were of the opinion that no default cap should be set, because the factors that should influence its level – for example the potential loss to the customer, or the extent of the works – would vary from case to case.

6. Those consultees who thought that no default cap should be specified suggested that an appropriate cap could be set for each investment through negotiation if ORR were to issue guidance, or if there was a process through which the cap could be set by an independent party. Stanhope PLC, Hines UK and Westfield Shoppingtowns PLC (Stanhope et al.)[3] have recently provided some suggested drafting to Network Rail on a 'liability determination mechanism' with a view to implementing such a process.

7. Other consultees thought that a default cap set in the templates was helpful as a starting point for negotiation in each agreement, or that it was appropriate as a fallback position when negotiation broke down. First Group and ATOC said that a default cap was attractive for small or routine schemes (because the cost of negotiation is circumvented) but that for large or complex investments a negotiated cap was necessary.

8. The Olympic Delivery Authority, Hutchison Ports UK and Merseytravel (ODA et al.)[4] said that a default position on liabilities was essential as Network Rail was not incentivised to engage in negotiations that would increase the risks it faced.

If a default cap is established, how should it be expressed?

9. Network Rail said that the cap should be calculated in relation to Network Rail's fee, but proposed that it should be at least £50,000 for non-contestable services.

10. Other consultees expressed a wide range of views, from support for the current arrangements where the cap is calculated by reference to Network Rail's fee to proposals that Network Rail's liability should be unlimited.

11. Those consultees who did not support the current arrangements compared the level at which Network Rail's liability is capped unfavourably with liabilities faced (and compensation available) in other circumstances. For instance, ODA et al. said that professional indemnity insurance taken out by a design consultant would typically offer £10 million of cover, and that it was not unusual for construction contractors to face no general limit of liability for works.

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[3] The law firm White and Case responded to the consultation on behalf of these three stakeholders.

[4] The law firm DLA Piper responded to the consultation on behalf of these three stakeholders.

12. ODA et al. went beyond suggesting a level for the cap and set out a proposal that moved away from the current model to one where Network Rail was required to take out certain insurances, and that in such cases liability caps were set in line with the insurance cover. Their alternative proposal was that:

- For design & project management services, caps on liability should only apply over and above costs covered by professional indemnity insurance, which Network Rail should be obliged to take out at a level that covers customer loss in the event of breach. The level of cover should be adjusted to match individual project risks.

- For construction works there should be no general limit on liability (the expectation being that the principal contractor is best placed to manage construction risk). Only if the supply chain imposes a cap on liability, which is approved by the customer, should a cap apply.

13. Stanhope et al. were of the view that there should be no default level of cap set in the templates, but said that a default *minimum* level of cap could be included (a figure of £10 million was suggested on the basis that this would be consistent with the default minimum in track access contracts). Stanhope et al. said that the cap should in each case reflect the consequences to the customer of the breach, but that if an alternative default expression of the cap is needed it should be calculated in relation to the expenditure on works.

Should the cap on liability be calculated in the same way for contestable as for non-contestable services?

14. Most responses said that there was more need for regulatory protection for non-contestable services because Network Rail faced no competition, and so should face higher caps for non-contestable services. However, there was no consensus as to how a cap should be calculated in respect of non-contestable services.

Should the cap be set in relation to Network Rail's fee, but with a minimum value?

15. Network Rail proposed that for non-contestable services its liability cap should be the greater of £50,000 or 40% of the value of its services.

16. Several other consultees said that a minimum level of cap would be helpful for small schemes. As already described, many consultees thought that for larger schemes the cap needed to be negotiated in each case, and not directly related to Network Rail's fee.

17. Most did not suggest a value for such a minimum cap, although Stanhope et al. supported a minimum level of cap set at £10 million, but not a cap set in relation to the Network Rail fee.

Should the cap be related to any cap agreed by Network Rail with its subcontractors?

18. Network Rail said that this proposal was only relevant for contestable services. It also said that it had, and will have under the revised templates, an obligation to pass through compensation from the subcontractor if the cap on the subcontractor's liability is greater than the Network Rail cap.

19. The other consultation responses were split on this question.

20. Several said that Network Rail should retain full project liability and so caps on its liability should not be related to terms agreed with its subcontractors. ATOC said that linking the level of the Network Rail cap to any cap on its subcontractors' liability would be a problem where the customer could not appoint the subcontractor, and would make the contract negotiations more complex.

21. Other consultees said Network Rail should pass on to its customers any better terms negotiated with its subcontractors. One response said that the customer should have the right of approval of caps proposed by Works Contractors. In relation to their proposal on insurance, ODA et al. said that the cap should apply only to specified uninsured losses.

Should caps be expressed on an annual or per-breach basis?

22. Network Rail said that it was inappropriate to set caps on an annual basis because of the variable lengths of times covered by agreements.

23. Several consultees supported caps set on a per breach basis. Stanhope et al. said that per-breach caps were best, but suggested an alternative of 'refreshing' the cap every 180 days.

24. Northern Rail suggested that caps should be set on a per-project basis (which is the case currently). GMPTE added that if caps apply per-breach full loss might be recoverable for many minor breaches where the cap did not apply in any instance, but full loss might not be recoverable for a single serious breach equal in impact to the many minor breaches.

Conclusions on caps on liability

Is a default cap needed at all?

25. The consultation on this subject produced a range of differing views as to the desirability or otherwise of the inclusion of a default cap on liability in the templates.

26. It is clear from the responses to the consultation that a default cap on liability is valued by some stakeholders as an efficient approach for small or simple projects where the benefit of a cap that accurately reflects the particular circumstances is outweighed by the costs of negotiation. We accept the more general concerns expressed by some stakeholders that the need for negotiation may act as a barrier to investment, and that the process of agreeing terms with Network Rail should be streamlined as far as possible by the templates. For these two related reasons we consider that it is important that a default cap on liability is retained within the templates, albeit that there should be scope for negotiation for parties that wish to agree an alternative level of cap.

27. We believe that, given the changes we are requiring Network Rail to make to the level of the cap on liabilities (see from paragraph 45 onwards), many investors will be content that the revised default liability arrangements will provide adequate incentives and remedies, and will therefore not wish to opt for more costly negotiation of bespoke terms. We believe that the alternative of having no default cap on liabilities in the contracts could itself operate as a barrier to efficient investment, particularly for the smaller and more straightforward schemes.

28. However, we accept that in some cases, customers might feel that the revised default liability arrangements will not provide adequate incentives and remedies for their particular circumstances and that those customers who require alternative arrangements will want to be assured that they have adequate protections if they perceive that Network Rail is unwilling to negotiate on reasonable terms.

29. One such protection is Network Rail's obligations under its network licence. Ultimately, if potential customers consider that Network Rail is acting unreasonably they can refer the matter to us and we would consider whether we should investigate the matter further in accordance with our enforcement policy to establish whether Network Rail was complying with the dependent persons licence condition[5].

[5] Which will become a part of a new stakeholder licence condition under proposed licence modifications.

30. As indicated in paragraph 6, a liability determination mechanism has been suggested by Stanhope et al. which they believe will be more timely and efficient in resolving disputes. Under this mechanism, the level of the cap would be referred to an independent party for dispute resolution if Network Rail and the customer could not agree.

31. Although we do not believe such a mechanism should be the default provision in the templates for the reasons set out above, we consider that the proposal has merit in principle if a number of practical issues can be resolved. These are principally:

- whether it is possible to develop criteria sufficient for an expert to be able to arrive at an objective determination on the issue of liability (and hence allocation of risk) under *bespoke individual* commercial arrangements;

- who the expert should be; and

- whether expert determination on liability arrangements can be divorced from other elements of the contract, particularly the price.

32. As to how the decision should be taken, certain general principles were suggested – for example that the limit on liability should properly incentivise both parties to perform their obligations under the contract, and that the level of protection against the default in question should be adequate. Although such principles are relevant to us in setting the default liability caps that apply generally, it is not clear to us that they would provide the appointed expert with sufficient guidance to ensure an objective and transparent mechanism for determining the cap in individual circumstances.

33. We do not believe that resolving these issues should hold up the changes we are requiring to the templates so that customers can begin to benefit from those changes. If a fair and practical liability determination mechanism can be developed, consideration can then be given to whether this should be implemented as a separate agreement or inserted as a template provision in the existing agreements.

What should be the level of the default cap, or what mechanism should be used to set it?

34. We first address two specific suggested mechanisms for establishing the level of the cap.

<u>Contractors' terms</u>

35. Several consultees said that the cap should reflect the terms agreed by Network Rail and its contractors, and that any higher caps on liabilities available from Network Rail's contractors should be available to customers.

36. However, the concern that Network Rail should not benefit from better protection than it offers to its customers must be balanced against the need to ensure that the templates determine the relationship between Network Rail and its customer, and reflect an appropriate level of protection that is not solely referable to any terms agreed by Network Rail and its contractors. These latter points are consistent with related points made in our May 2008 conclusions, particularly in connection with the discussion of design risk, construction risk and liquidated damages.

37. Under the current Implementation Agreement templates, customers contracting with Network Rail through the templates benefit from certain additional sums recovered by Network Rail from its insurers or contractors even where this amount exceeds the Network Rail cap. In our May 2008 conclusions we 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.

38. In our view, and for reasons explained in the following section, these provisions require a further modification in addition to that identified in our May 2008 conclusions, as follows: under agreements for contestable services, a customer should be 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. In our view, the current structure will, with this modification, strike a fair balance between the competing concerns discussed above, and it would not be appropriate to go further and to establish the level of the cap solely by reference to the terms agreed between Network Rail and its contractors.

Insurance

39. With regard to insurance, ODA et al. suggested that Network Rail should be obliged to take out insurance typical of a consultancy providing similar services; for example, Network Rail should be covered by professional indemnity insurance when carrying out professional services.

40. We asked Network Rail for a statement of all insurance it currently held, or usually took out, that applied to services under the templates and this has now been published

on Network Rail's website[6]. Network Rail also told us that it did not currently hold PI insurance that would apply to professional services provided under the templates.

41. We note that in the majority of cases, Network Rail does not itself deliver (for example) the design services provided under the templates, but procures them from a contractor. That contractor can be expected in the majority of cases to carry appropriate insurance.

42. The proposal made by ODA et al. would therefore require Network Rail to take out additional insurance which is likely to result in an element of "double insurance". The cost of that insurance would presumably be passed on to the customer in addition to the cost of any insurance held by the contractor, which would be reflected in its charges to Network Rail.

43. For these reasons, we were not persuaded that it was appropriate to require Network Rail to take out such insurance in connection with all contracts entered into under the templates. However, 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.

44. We also consider that, if in connection with a particular project Network Rail does not propose to use a contractor that has what a customer considers to be a sufficient level of PI cover, the customer should be entitled to require Network Rail to take out appropriate insurance. This insurance should be at the customer's cost; Network Rail should provide evidence of the costs that it passes on to the customer. The cap should be adjusted to reflect the level of cover available in connection with matters falling within the scope of the policy.

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6 http://www.networkrail.co.uk/browse%20documents/consultation%20documents/contractual%20framework/current%20consultation/correspondence%20with%20stakeholders/081231_orr%20insurance%20paper.pdf

Default level of cap

45. Returning to consider the default level of the liability cap, in our view there are two key considerations. First, the cap should be fixed at a level which, for the majority of projects, strikes a fair balance between the need to limit Network Rail's exposure to risk and the need to ensure that it is incentivised to perform its contractual obligations and that customers will be adequately compensated for any losses. It is the strong view of the stakeholders that responded to our consultation that the current level of cap is too low to strike a fair balance between these different objectives.

46. Second, the cap included in the template is intended, as are all template provisions, to operate as a default position: we expect and require Network Rail to be open to negotiation of alternative terms. However, we recognise that negotiations are likely to start with the default level of cap. Presently the cap is expressed as a multiple of the Network Rail fee, which is in turn calculated as a percentage of certain contract costs. In general terms, the cap approximates to between 30% and 40% of the contract cost, with the exception being the IA(EC), for which the cap approximates to 15% of contract costs. With a cap at these levels or similar, it is unlikely that any party will seek to negotiate the cap to a lower level. In those circumstances, if a default cap is to operate as a fair and realistic baseline, we consider it important that it should not be fixed at too low a level.

47. We are persuaded that the current level of the cap is low, for example if one compares the Implementation Agreements to the terms which one would expect to see under equivalent agreements elsewhere on the market. This is particularly true of the IA(EC), but is also true of the IA(FP). We also consider that some of the considerations which may have justified such terms in the past, in earlier phases of implementing the investment framework when such investments were uncommon, no longer apply to the same extent.

48. Having said this, although there is a consensus amongst customers that the current level of the cap is too low, in this and previous consultations we have been provided with little evidence as to how the cap should be calculated or as to an appropriate level for the cap. In these circumstances, we remain of the view that the most obvious point of reference in establishing the default level of the cap is the total value of the agreement (by reference to which the Network Rail fee is calculated).

49. Bearing in mind the considerations set out above, we will require Network Rail to increase the cap to 100% of the value of the agreement between the customer and Network Rail, which will comprise any Agency Costs, Consultants' Costs, Works Contractor Costs and Personnel Costs (being the costs by reference to which the Network Rail fee is calculated).

50. We do not believe that this change would subject Network Rail to a very significant increase in risk. Our comments on this issue are at paragraph 80 below.

51. The change which we have required above is intended to strike the difficult balance between protecting Network Rail against excessive risk, incentivising it to deliver its obligations under the contracts, and providing reasonable protection to customers. However, as we said in May 2008, once we have sufficient evidence from claims resulting from contracts modelled on the templates, we expect to revisit the level of the cap. We will also keep under review Network Rail's willingness to negotiate reasonable alternative terms with customers, and if necessary will consider further adjusting the balance of risk under the templates in favour of customers; or whether it is necessary to investigate whether Network Rail is complying with its licence obligations. Clearly, if a practical liability determination mechanism can be implemented, this would reduce (but not necessarily eliminate) the need for such considerations.

Minimum level of cap

52. Several consultees made the complaint that under the asset protection agreement (APA) or basic asset protection agreement (BAPA), if the Network Rail fee is low, the liability cap is correspondingly low and so the incentive on Network Rail to deliver its obligations can be inadequate. Our consultation suggested that this concern might be addressed by including in the template an alternative default cap expressed in pounds, to apply if it is higher than any cap calculated by reference to the Network Rail fee.

53. Acknowledging this concern in its consultation response Network Rail proposed that the liability cap should be the greater of £50,000 or 40% of the value of its services under APAs and BAPAs.

54. In setting a minimum level of the cap, we are mindful of the need to provide Network Rail with sufficient financial incentives to deliver its obligations, provide some financial protection to customers, whilst at the same time maintaining a reasonable balance between the value of the contract and the potential liabilities. In exercising our judgement on these issues, we have concluded that the minimum cap for all templates should be £100,000.

Aggregate or per breach caps

55. Our May 2008 conclusions said that caps should be expressed per-agreement. Responses to our 2 October consultation included a mix of views as to whether customers were better protected by per-breach, per-agreement or annual caps. The degree of protection of each of course depends on the level of the cap and the likelihood and severity of breach. However, the intention of capping liability is in order to protect

Network Rail from unlimited liability and to manage the level of risk to which it is exposed. On this basis, per-agreement caps are most logical, and we have not been presented with compelling arguments to move away from the position expressed in our May 2008 conclusions.

Liquidated damages to limit liability – consultation responses

Can and should the templates include default provisions relating to the level of liquidated damages?

56. None of the stakeholders who responded thought that it was possible to include a default level of liquidated damages in the templates that could be considered a genuine pre-estimate of loss, having regard to the considerations of legal enforceability discussed in our May 2008 conclusions. Most said that liquidated damages should be loss-reflective and negotiated on a case-by-case basis.

57. ODA et al. said that there was no reason for LDs to cap liability (that is, to be set at a level below expected loss) because this would give breaches as a result of delay a lower cap on liability than other breaches. They also said that in some circumstances it was appropriate not to set LDs, where the risks were not quantifiable in advance.

58. GMPTE said that LDs should be negotiated on a case by case basis since potential losses would vary case by case, but that customers may choose to agree to LDs at a lower level in order to cap liability.

59. Other consultees thought that default provisions were attractive for small or straightforward projects.

How should any default level of LDs be expressed, and how could one be confident that it would not act as a penalty?

60. Since most of the responses did not support the inclusion of default LDs, these questions were in most cases not applicable.

61. First Group had suggested that a default level would have to be low enough that it could not be considered a penalty.

62. Several responses said that there could be guidelines or principles drawn up which would aid the negotiation of LDs or that there needed to be some process for dispute resolution, whereby an independent party would set LDs if they could not be agreed through negotiation.

63. Northern Rail said that LDs should be capped at the higher of either the contract value or the sum recoverable from insurance.

What guidance could ORR give that would aid the setting of LDs?

64. Several consultees said that ORR could provide a summary of the types of losses that might arise from breach. ODA et al. added that because losses may depend quite heavily on the reason for the investment, such guidance could only be general; in any case they thought that LDs should reflect likely customer loss and not be 'industry standard'.

65. Some responses said that ORR could set out principles as to how LDs should be determined. For example Stanhope et al. said that the guidance should be that LDs should incentivise both parties to perform their obligations under the contract and that the party not in default has adequate protection from the consequences of the default. GMPTE said that it would be difficult for ORR to provide detailed guidance given the variety of schemes, but that the principle for setting the LDs should be a balance between potential customer loss and open ended liability for Network Rail.

What alternative method of incentivising Network Rail to deliver on time could apply?

66. Network Rail said that there were already many incentives on the company to deliver on time within the draft versions of the updated templates, and also stemming from Network Rail's wider obligations. It did not believe that the setting of milestone payments would solve the issue of establishing an appropriate level for LDs. It also said that if milestone payments lead to payments being deferred, the financing cost would have to be met by customers.

67. Network Rail also said that it would of course accept liquidated damages associated with project milestones.

68. Several consultees proposed the use of milestone payments as an incentive on Network Rail, in one case suggesting that these should be accompanied by a clause allowing the customer to retain a proportion of the payment. Another consultee suggested the payments should incorporate a pain/gain share mechanism.

69. One consultee suggested that reputational incentives on Network Rail would be more effective, for example by establishing a register of instances where it had under-delivered and publishing this information in an annual report.

Conclusions on liquidated damages

Level of LDs

70. The question as to whether and how default provisions for liquidated damages should be included in the templates is largely determined by the question of legal enforceability. As we said in our May 2008 conclusions, and as came through strongly in the consultation responses, liquidated damages set to reflect loss cannot be defined in a template: any such default provision risks exceeding loss and so being unenforceable.

71. Some consultees said that setting default LDs set at a low level was attractive for small or simple schemes because this would obviate the need for negotiation. However, it remains unclear to us that it is possible, at least at this point in time, to put forward a default level of LDs that will be both legally enforceable and will also provide a realistic and useful default level of damages for the purposes of small schemes. We have concluded that this is true of all of the templates, and that it is not possible to make different provision in relation to agreements for non-contestable services or agreements for development services, as contemplated by our May 2008 conclusions.

72. Nevertheless, we anticipate that as experience in negotiating LDs develops, Network Rail may be able to offer "benchmark" LDs which are likely to operate as capped LDs for schemes of a particular value, and that this may assist parties to lower value schemes to agree terms more quickly and efficiently.

73. Consultees have expressed concern more generally that Network Rail is not receptive to negotiation. However, for reasons explained above, we do not consider that it is possible to resolve this issue by setting a default level for LDs, in contrast (for example) to setting a default level of the Network Rail cap. We consider that the proposal that the level of LDs should be established under a dispute resolution type mechanism would need to address the same issues as identified in relation to the Network Rail cap (see paragraph 31).

74. A number of consultees asked that ORR publish a list of likely costs that should be considered in setting LDs, but we consider that the parties to the contract are best placed to understand the scope and extent of the impact of breach on their costs.

75. We urge customers, when seeking to agree LDs with Network Rail, to make clear and evidence based proposals to Network Rail on the basis of which a negotiation may be conducted. Network Rail should then engage with that proposal, and should only reject the proposal made on the basis of stated credible reasons. We stress that it is in the interests of both parties that enforceable and reasonable LDs are agreed as efficiently and promptly as possible. If we are presented with evidence over time that Network Rail

is unwilling to negotiate liquidated damages in this way, we would consider whether we should investigate the matter further in accordance with our enforcement policy to establish whether Network Rail was complying with its licence obligations.

Milestone payments

76. Since we are requiring, as a default position, that LDs should be negotiated to reflect anticipated loss, rather than that they should operate as a cap on liability for delay, we do not consider that it is also necessary to include in the templates other provisions to incentivise timely performance such as milestone payments or pain/gain share mechanisms.

Overall effect of these further conclusions

77. In its consultation response Network Rail said that the incentives, risk allocation and fees paid by customers under the agreements needed to be considered together. Network Rail expressed concern that the changes to the templates discussed in this paper, and in particular in connection with the Network Rail cap, would put the Network Rail Fee fund at risk, and might lead to it becoming exhausted. Network Rail suggested that there was not sufficient evidence to support the sustainability of the proposed changes, and that such changes should only be made (if at all) over the longer term.

78. Our May 2008 conclusions considered the relationship between the terms of the templates, the funding of investments, and the level of the fees payable both generally (at paragraphs 15-20) and specifically in connection with the issue of liquidated damages (see paragraph 50). We have reconsidered those issues in light of these further conclusions.

79. In particular, we have considered whether the default contribution customers make to the risk funds through fees is sufficient. It is not possible to answer this question with certainty at present because of the limited history of claims under the template agreements. However we have not been presented with evidence, based on this history of claims on the funds to date, that a change to the default level of the fees expressed in the template agreements is necessary now. As we said in May 2008 we will keep the level of the fees under review with reference to the value of the funds and the history of claims on them. If we were presented with evidence that the funds were likely to be exhausted we would review the level of fee contributions required.

80. We have also considered whether our conclusions in connection with the Network Rail cap materially increase the level of risk to which Network Rail is exposed. In this regard, it is important to consider the change we have required in context. First, in so far as the breach of which a customer complains is the responsibility of Network Rail's contractor,

Network Rail should in principle be able to recover from its contractor in respect of such breaches. Second, Network Rail also has the benefit of the Network Rail Fee Fund and the Industry Risk Fund. Third, if the funds are exhausted there is ultimately the protection that further liabilities that would have made calls on the funds can be added to Network Rail's RAB and recovered in the next periodic review. Fourth, Network Rail told us that claims to date have not exceeded the existing caps. Although we do not think that recovery up to the value of the contract should be precluded, the experience to date suggests that such substantial claims will be rare. Fifth, the increase we require starts from what is currently a low level of cap. Although we are requiring a significant margin of increase, we do not consider that the overall level of risk imposed is unreasonable, nor that it is outwith the risk allocation envisaged by our policy framework.

81. We do however emphasise that the fees provided for in the templates, as with all template provisions, are intended to operate as a default. Where project risks are unusually high or where bespoke provisions materially change the risk allocation, Network Rail could be justified in charging a higher fee. It will of course be necessary for Network Rail to justify any proposed increase in the level of the fee in any given case.

Next steps

82. In order to accommodate this focussed consultation we had asked Network Rail to extend its consultation on its proposed changes to the template agreements. We now expect Network Rail to amend its agreements to reflect our conclusions here, and to seek stakeholders' views on the amended agreements. The process through which revised agreements will be approved is:

- Network Rail will amend the five draft agreements currently available on its website, and publish for consultation by 23 April.
- Stakeholders will then have until 21 May to respond to Network Rail's consultation.
- Network Rail will then need to revise the templates in the light of the responses, so we anticipate it will begin to submit agreements to ORR for approval from June this year.