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14 May 2007

Dear Jon,

Consultation on Policy Framework for Investments - Guidelines

I refer to your recent paper on the investment policy framework where you seek comments on four points in particular:

- a) The clarity of Network Rail's (NwR) templates for third-party schemes, their ability to facilitate investment and the accompanying guidance
- b) Proposals to use the RAB for small schemes
- c) Treatment of development gain; and
- d) ORR's approach to monitoring the framework

These comments reflect those of the TfL Group which includes London Underground (LUL).

NwR Template Agreements

As regards the first point, you will be aware that TfL has had concerns as to the application of the NwR template agreements, the associated risk funds and the lack of sufficient incentives upon NwR. These were listed in our responses to your consultations on the investment framework in April 2005 and May 2006 and also the associated consultation on incentives in September 2006.

In assessing progress against our responses to those consultations many of the concerns raised still apply today. In essence TfL believes that the balance of rights and obligations in the templates overly favours NwR. Furthermore, there still does not appear to be a strong enough incentive to encourage NwR to work with third-party funders to promote investment opportunities. In TfL's opinion the templates (and the associated risk funds) seem to minimise NwR's liabilities both in outlay and scope and, as a result, NwR appears to be

risk averse, although TfL recognises that this may not necessarily be the intention.

Even with relatively small projects where their role is primarily in programme management NwR often appears unwilling to commit to a fixed price despite the programme being at a high GRIP level (e.g. 4) and a considerable degree of the project's works being undertaken by an external contractor at a fixed price. This point is particularly important for small projects where it is neither convenient nor cost-effective for the promoter to take on programme, technical or risk management and where NwR inevitably would undertake a substantive role and has the necessary experience to hand.

TfL believes that the agreements do not encourage or facilitate third party investment in the way they were intended. Although we have numerous specific concerns about the drafting of the NwR template agreements there are a number of high level concerns and these are set out in Annex A to this letter.

TfL would like to see more evidence of NwR being prepared to agree bespoke agreements to reflect project complexity and the value of the investment, particularly where these exceed the investment framework ceiling of £50m. However, TfL's experience is that negotiation of bespoke agreements is difficult. TfL believes that the framework agreements are too inflexible for major enhancements but recognises that NwR does seem to be attempting to make them work. On the one hand, TfL can understand the need for some degree of standardisation for small value projects of a similar nature but on the other hand it needs to be recognised that large projects will require a measure of customisation to meet their specific requirements and that, for example, the risk funds should, in such cases, be capable of modification or suspension to reflect the degree of risk borne by each party.

In practice TfL believes a number of areas need clarity. For example, there needs to be more certainty as to when NwR is required to offer fixed price terms both for services/works contracted out to its supply chain and for its own costs and the circumstances where this could apply. On cost allocation guidelines TfL's experience is that NwR does not always apply the guidelines itself 'up front' and often the third-party has to query any high costs. Neither does NwR seem to have an obligation to apply the guidelines or to reduce costs. If the other party is not an informed buyer it is placed at a disadvantage. In addition NwR does not always act as a mediator in the market place in order that matters may progress. Virtually all contracts are with NwR but where costs and disputes occur between parties who both have contracts with NwR this is not seen as an issue for NwR to resolve and these costs are passed through to the promoter by NwR.

Turning to the risk funds, TfL believes that the application of these funds should, for large schemes at least, be at the option of the promoter. NwR needs to understand that the capacity for risk and the level of expertise for a body such as TfL are much greater than for example a local council. Therefore the process and NwR should be able to distinguish between this

order of magnitude and the agreements necessary to achieve efficient and economic delivery. There is also a need for greater clarity on risks they should cover, for example the definition 'interface risk' in Section 13 of 'Investing in the Network' could cover a multitude of issues and perhaps would benefit from examples. The universal use of the risk funds also, in our opinion, seems dubious and their application seems somewhat indiscriminate as they appear to apply to all projects. TfL would welcome guidance from the ORR as to whether participation in the funds is at the option of the promoter.

In relation to the issue of whether or not NwR's templates for third party schemes help to facilitate investment and how the templates could be improved, the TfL Group has identified various legal issues concerning the BSA, DSA and BAPA and these are set out in the table attached as Annex B. The list is non-exhaustive but is illustrative of the issues discussed between TfL Group's and NwR's lawyers.

TfL welcomes the fact that the ORR intends to review the arrangements for the risk funds in the future and would wish to contribute further to this. In summary, TfL believes that there is still a number of issues to be overcome in terms of the use of the template agreements and their ability to facilitate more third-party investment. In particular their application to large projects seems at odds with the specifics of the individual project delivery.

TfL would also expect to see NwR coming forward and where appropriate working with third-party funders in providing supplemental finance especially where renewals are brought forward or avoided as a result of new projects. In some cases this appears to be as a direct result of the NwR/ORR quinquennial review process whereby relevant long term renewals have no immediate visibility as they are not within the scope of the current business plan. TfL welcomes a recent decision at the ELL/NLR JPB that NwR would, for this project, now take into consideration the impact on longer term renewal costs as a result of works brought forward from CP4. However, notwithstanding this positive development, TfL would appreciate more detailed ORR guidance as to how such betterment should be dealt with where they are linked to longer term plans in order to provide a more equitable solution in such cases.

TfL would wish to see a further review of the template agreements and substantial modification of them to address the concerns we have set out in this letter and its annexes.

RAB Financing of 'small schemes'

TfL supports the principle of using the RAB to finance small schemes of less than £10m especially if this facilitates a quicker approval process. The arrangements for payment of the amortised charge on the basis of a supplemental charge to the next control period and thence novation to the following franchise appears sensible. Whilst the alternative of subsequently spreading such charges across franchises may not necessarily be appropriate

the amounts should be relatively small (unless of course a high number of such schemes are implemented).

Treatment of Development Gain

The ORR approach to development gain which recognises 'shared value' and allows NwR to take a share of the gain (e.g. enhanced RAB value and additional revenue to NwR or allows hypothecated gains so the developer carries out the investment in lieu of payments to NwR (rent or share of benefits) seems logical.

However, it appears that consideration needs to be given to developing guidance on how NwR should maximise these opportunities and the relationships it should be trying to develop in order to facilitate improvements and the implementation of such shared value schemes.

Monitoring Arrangements

TfL supports the need to keep the arrangements under review especially in the introductory phase. ORR should be prepared to take timely action to change elements of the framework especially where they are found to not be working as intended. TfL's view is that the area is still volatile and needs further fine tuning if the objective of improved third-party investment is to be achieved.

This completes TfL's comments on the consultation. If you have further questions on this response please feel free to contact me on the number below, Charles Ritchie at TfL Legal (for further detail on the matters set out in Annex A) on 020-7126-4129 or Natasha Krikorian at LUL Legal (for detail on the matters set out in Annex B) on 020-7918-4084. Please copy all parties into any follow up on these matters. Charles Ritchie is based at Windsor House, Victoria Street, London, SW1 H 0TL, Natasha Krikorian is based at 55 Broadway, London SW1H 0BD.

Yours sincerely

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Annex A to TfL comments on Consultation on Policy Framework for Investments - Guidelines

TfL high level concerns on templates.

1. The drafting of the agreements generally is confusing and difficult to follow. This causes difficulty in establishing the rights and obligations of the parties, which in turn encourages wasteful and protracted negotiations.
2. The agreements are not consistent with each other, and are frequently not internally consistent either – again, this makes it difficult to understand what the rights and obligations of the parties are.
3. The explanatory notes to the agreements are not always consistent with the agreements themselves. For example, the explanatory notes to the Implementation Agreements state clearly that the Customer's right to compensation for Relief Events is not subject to the Network Rail Cap. However, the Implementation Agreements themselves appear to apply the Cap to Relief Events. Generally, the explanatory notes are not particularly helpful.
4. When delivering projects, of paramount concern to Customers is maintaining control over programme and over costs. However, the agreements contain no real obligation on NwR to hit the target completion date, and give NR great scope to alter the programme, change the target completion date and increase the estimated works cost, in many cases unilaterally.
5. The lack of obligation on NwR highlighted in 4 above, and NwR's ability to change programme and costs, is particularly concerning in the context of the Implementation Agreements as there is also a real lack of visibility or involvement in the underlying Works Contract. The overall effect is to give the Customer insufficient certainty over programme and costs. Although there is some comfort in the form of compensation for Relief Events – of which more later – this is no substitute for meeting agreed programmes and controlling costs. (It should be noted that, for TfL Group projects, the implications of a delay in works on or near NR's network could have very serious implications for the delivery of TfL projects).
6. Although ORR has issued statements as to how the Network Rail Cap should be calculated and operated, this is not reflected in the agreements. The interaction in the agreements between the Network Rail Cap, liquidated damages and Relief Events is not at all clear or consistent and the drafting would benefit from being revisited in its entirety.
7. Although this has been the subject of earlier consultation, NR's cap on liability of 300% of the NR Fee would seem to be very low. It would be

helpful to have an understanding of how the level of NwR's cap was determined. It may be that it would be more appropriate for there to be a range of liability caps for NR depending on the service to be provided. We would propose an increase in the cap on NR's liability to incentivise NwR to meet its contractual obligations.

8. While the right to compensation for Relief Events is attractive as a concept, this is not necessarily borne out by the wording of the agreements. As referred to in 3 above, in some of the agreements – notably the Implementation Agreements - the right to compensation for Relief Events appears to be wholly or partially subject to the Network Rail Cap (which is, as stated in 7 above, a low figure). This greatly reduces the attractiveness of the concept. It is also worth pointing out that it is not clear what is and what is not a Relief Event; for example, does “a delay to the Works caused by a Network Operation Issue” include a change to the target completion date, which NwR may well be entitled to implement, or not?
9. We understand that NwR is entitled to recover compensation from the NwR Fee Fund where NwR is negligent or in breach of contract. We wish to understand how this incentivises NwR to perform. We also wish to understand how the level of the NwR Fee was calculated.
10. The concept of liquidated damages for delay is attractive, but this is not necessarily borne out by the agreements themselves. First, given the wide powers NwR have to change the target completion date, there may never in practice actually be a delay in the contractual sense. Secondly, the existence of a period of delay before liquidated damages become payable and the low figures offered (e.g. £1,000 per day) greatly reduce the value of this regime, either as a way of truly recompensing the Customer for its losses, or – more importantly – incentivising NwR to meet programmes. Thirdly, the liquidated damages may be subject to the Network Rail Cap.
11. The agreements include the concept of a “Network Operation Issue”; which in turn includes the concept of an “Operational Emergency”. This is so widely defined it could encompass almost anything, including a situation or circumstance resulting from a failure or mistake on NR's part. In the context of the Implementation Agreements, NwR can rely on such Network Operation Issues to implement variations to the scope of work without notice or consent, and also to change the target completion date.
12. The indemnity in favour of Network Rail is very wide. We would prefer to see this modified into a “third party claims” concept - NwR have been open to this suggestion in some of our negotiations – and to limit NR's ability to claim for Losses arising out of their own breach or negligence (or that of their contractors and consultants).

13. Some of NwR's costs are difficult to justify – e.g. the 50% mark-up on the costs of agency personnel. Also, there is no general obligation that costs should be reasonably incurred.
14. There is a lack of understanding on our part as to what costs (if any) we should be paying post-completion – for example, we do not understand why we should be liable indefinitely for land or noise claims, nor for additional expenses arising out of the existence of new, enhanced assets.
15. We also feel the agreements do not provide sufficient credit to the Customer for “betterment” – i.e. the enhancement of existing assets, or the replacement of existing assets which would otherwise be replaced by NwR in future.

Annex B to TfL comments on Consultation on Policy Framework for Investments - Guidelines

**TABLE OF LEGAL COMMENTS ON THE NETWORK RAIL (“NwR”)
THIRD PARTY INVESTMENT TEMPLATE AGREEMENTS**

NwR’s Liability for Liquidated Damages	It is not clear whether NwR’s liability for liquidated damages for delay is subject to NwR’s cap on liability. For example, in the BAPA, paragraph 24 states that NwR’s cap on liability is without prejudice to NwR’s liability to pay liquidated damages whereas paragraph 2.2 of Schedule 2 states that NwR’s breach of contract will be counted towards NwR’s cap on liability. In the BSA and the DSA, it would appear that NwR’s liability for liquidated damages for delay is subject to NwR’s cap on liability. The template documents should make it clear on the face of the documents that NwR’s liability for liquidated damages is <u>not</u> subject to NwR’s cap on liability. NwR should be liable to pay liquidated damages for any breach of the contract rather than only being liable to pay liquidated damages for breach of a specific clause of the contract.
NwR’s Liability for its Contractors’ Negligence, Fraud or Breach of Contract	NwR should be liable for its contractors’ negligence, fraud and breach of contract or should be under an obligation to pursue its contractors in respect of liabilities due to its contractors’ negligence, fraud or breach of contract. Under the BAPA and the BSA, NwR has no liability for its contractors’ negligence, fraud or breach of contract and is not under an obligation to pursue its contractors in respect of liabilities due to its contractors’ negligence, fraud or breach of contract.
NwR’s Liability to pay Compensation for Relief Events	There is inconsistency in NwR’s liability to pay compensation for Relief Events. In the BAPA, NwR’s obligation to the pay compensation as a result of any interference with the works caused by another contractor on an interfacing project or NwR cancelling or altering any booked possession is not subject to NwR’s cap on liability. However, in the DSA, NwR’s obligation to pay compensation as a result of any works contractor on any interfacing project preventing a contractor carrying out planned survey works or any booked possession for survey works being cancelled or altered which arises out of NwR’s breach of contract is subject to NwR’s cap on liability. The template agreements should be consistent in their treatment of Relief Events.
Customer’s Cap on Liability	In the BAPA, the Customer’s cap on liability is 10% of the estimated Project Cost. The “Project” should be defined so as only to refer to the project to the extent that it impacts upon NwR infrastructure. The calculation of the Customer’s cap on liability should only include those project costs attributable to design and implementation affecting NwR’s infrastructure and not those project costs attributable to design and implementation affecting only the Customer’s infrastructure. This is particularly relevant to abutting infrastructure

	owners.
Customer's Indemnity	The Customer is to indemnify NwR for various claims and liabilities. The Customer's obligations in respect of the project are set out in the form of the relevant template agreement and the Customer should only be required to indemnify NwR for the Customer's breach of the terms of the agreement. The Customer should also be under no obligation to indemnify NwR where NwR or its contractors are negligent or in breach of contract.
Customer's Liability for Design Services	In the BSA and the DSA, there is no cap on the Customer's liability for design services. The Customer should only be liable for those design services that have been specifically agreed to be provided by the Customer in relation to the project.
Industry Risk Fee	The "Industry Risk Fee" is defined as 2% of the total estimated costs of the Project. The "Project" should be defined so as only to refer to the project to the extent that it impacts upon NwR infrastructure. The calculation of the Industry Risk Fee should only include those project costs attributable to design and implementation affecting NwR's infrastructure and not those project costs attributable to design and implementation affecting only the Customer's infrastructure. This is particularly relevant to abutting infrastructure owners.
NwR's Costs - The Definition of "Agency Personnel"	The definition of "Agency Personnel" is incorrect. In order for NR to be able to charge the Customer an uplift of 50% in respect of the cost to NR of any Agency Personnel, NwR would need to be contracting in agency personnel to work within NR providing services exclusively to NwR in connection with the works. The definition of "Agency Personnel" should be appropriately amended in all of the template agreements.
Details of NwR's Costs	NwR should provide at the time of invoicing a schedule showing the NwR personnel who have worked on the project and details of other expenses being invoiced.
Costs Estimate	In the DSA, NwR is not under an obligation to use reasonable endeavours to carry out the services for an amount not exceeding the Costs Estimate and is entitled to revise the Costs Estimate at its discretion. In the BSA and the DSA, NwR is also not under any obligation to provide the Customer with regular reports on any changes to the estimated costs of the services.
Development Programme	The Customer should have some certainty as to timings. In the DSA, NR is entitled to revise the Development Programme at its discretion. In order to provide the Customer with certainty as to timings, NwR should only be able to revise the Development Programme under certain very limited circumstances such as agreed variations to the services or deliverables or a change in the law

	necessitating a variation of the services. In the BSA and the DSA, NwR is also not under any obligation to provide the Customer with regular reports on the progress of the services.
NwR's Obligation to Procure its Contractors' Performance of its Obligations	NwR is under an obligation to carry out the services in accordance with statutory requirements, in a timely, economic and efficient manner and using all reasonable skill and care. In the BSA and DSA, NwR should be under an obligation to carry out these obligations or, if the services are being carried out by NwR's contractors, procure the carrying out of these obligations.
NwR's General Obligations	NwR should be under an obligation in all of the template agreements to carry out the services in a timely, economic and efficient manner. For example, NwR is under no such obligation in the BSA.
CDM Regulations	The Customer is to be the sole "client" for the purposes of the CDM Regulations. This provision should be amended in all of the template agreements so that the Customer "or its contractors" are able to be the client for the purposes of the CDM Regulations.
NwR's Provision of Information	The Customer should not be responsible for verifying the accuracy and assessing the sufficiency of information provided by NwR to the Customer to the extent that such information forms part of the services or deliverables.
Intellectual Property Rights in favour of NwR	NwR should not be entitled to the grant of intellectual property rights in respect of works that have been carried out and paid for by the Customer.
Intellectual Property Rights in favour of the Customer	In the DSA, NwR's obligation to obtain an intellectual property licence in favour of the Customer from each consultant should survive the termination or expiry of the agreement.
Collateral Warranties in favour of NwR	In the BAPA, the Customer should not be under an obligation to provide NwR with a collateral warranty for any designer of the works.
Collateral Warranties in favour of the Customer	In the DSA, NwR's obligation to obtain a collateral warranty in favour of the Customer from each consultant should survive the termination or expiry of the agreement.
Confidentiality	The Customer should be entitled to disclose to any third party confidential information contained in any of the services or deliverables without NwR's consent on the basis that such third party is subject to the same obligation of confidentiality as contained in the template agreements. The Customer as well as NwR should be able to disclose confidential information required under its statutory duties. NwR as well as the Customer should be under an obligation to destroy or return confidential information on the termination of the agreement.

Customer's Design Obligations	<p>In the BSA, the Customer is under an obligation to exercise reasonable skill and care in designing the Project. The "Project" should be defined so as only to refer to the project to the extent that it impacts upon NR infrastructure. The Customer should not be liable to NR in relation to design for matters that only affect the Customer's infrastructure.</p> <p>In the BAPA, the Customer is under an obligation to design and carry out the works in accordance with NR's requirements. There should be an element of reasonableness to NR's requirements.</p>
Brief	<p>In the DSA, NR should not be entitled to vary the Brief without the Customer's consent and such consent should be in the Customer's absolute discretion rather than being qualified by being subject to such consent not to be unreasonably withheld. The outline details of the project and the objectives of the services should be determined by the Customer in its absolute discretion as it is the Customer who is paying for the services and deliverables.</p>
Termination	<p>The Customer should be entitled to terminate the template agreements at any time and with immediate effect.</p>