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Dear Jon

Policy Guidelines for Investments Update on Implementation

Further to your letter of 2 March please find detailed below the PTEG response to the issues raised.

Review of ORR Approved Template Agreements for Third Party Investments

PTEs are a major Third Party investor in the rail network and have contracted with Network Rail on a number of projects using the approved Template Agreements. Following our experience of working with Network Rail in using these agreements our comments are as follows :-

Implementation Agreements

The Implementation agreements generally work well and do provide a method of capping our exposure. The main issues have been in obtaining visibility in the Network Rail hourly rates included within the schedules, the application of the liquidated damages provision, issues of design liability, the application of the Network Rail and Industry Risk Fees, and the use of Fixed Price agreements.

(i) Network Rail Hourly Rates

Network Rail provide monthly invoices detailing all the costs on each project the hours worked and the hourly rate for each member of staff. Whilst we can check timesheets and verify the hours worked for each project the hourly rates are not subject to audit so we cannot establish if these rates are a fair reflection of the actual costs incurred by Network Rail.

Our view is that the rates appear comparable with commercial consultants rates and this would imply that an element of overheads and profit are already included in the rates. Given that Network Rail are considering increasing these hourly rates there needs to be

a mechanism either locally or nationally to audit these rates to ensure that third parties are not being overcharged by Network Rail.

The other issue with hourly rates is that within the contract Network Rail can increase their rates at any time without any restrictions - as stated in Schedule 2, item 4.1 or the agreement:-

Adjustment Of Hourly Rates

Network Rail shall adjust the Hourly Rates from time to time as necessary to reflect actual changes in salary bands and other employment conditions that are made in accordance with Network Rail's personnel policies and salary plans.

The hourly rates for the contracts should be fixed for the duration of the contract or alternatively there should be an agreed rate for any increase and this should be included within the contract in order to provide cost control for each project.

(ii) Liquidated Damages

Whilst we welcome the fact that the agreements now include a clause for liquidated damages if a project is delivered late, this clause seems weak and is not a real incentive to Network Rail to deliver on time. The clause guidance is that it should apply only after delivery is delayed by some 15% later than the target Completion Date. We feel this is too long and in addition believe that the standard penalty of £1,000 per day of delay is not sufficient incentive to ensure schemes are delivered in a timely manner.

We would be interested to know how many projects incur liquidated damages and if any other Third Party has been able to negotiate a higher figure for liquidated damages on any other scheme.

(iii) Design Liability

Within the current implementation agreements under Section 12 Limit of Liability is the following clause:-

12.8 Notwithstanding any approval, consent, comment, confirmation or advice which Network Rail may provide pursuant to this Agreement or any Works Contract, the responsibility for the design of the Works shall remain solely at the risk of the Customer save to the extent such liability is assumed by any Works Contractor under the terms of any Works Contract or by any Consultant.

This clause we believe is valid in the case where the Third Party has procured the design independently of Network Rail. This clause though applies even in the case that Network Rail have been contracted to carry out the design phase. We believe that where Network Rail has previously been contracted to produce the design that when the scheme moves into the implementation phase that Network Rail should take on full responsibility for that design. This issue is detailed more fully in our comments on the DSA agreements.

(iv) Network Rail and Industry Risk Funds

1. We assume that the Network Rail and Industry Risk funds will only be drawn down once the relevant caps have been exceeded, but this is not specifically stated in the DSA. We would therefore welcome further guidance as to how these various caps and funds have been applied and used on other rail projects in order to appreciate clearly how claims are being made on these risk funds.
2. It is unclear how these agreements are to apply when schemes are jointly funded between Network Rail and the Third Party. In such situations the Network Rail and Industry Risk Fund Fees should only be levied on the Third Party contribution and not to the overall project costs.
3. Network Rail Fee industry risk fee and insurances are set as a percentage of the final cost. This means that if there is any cost increase that not only does the Third Party funder have to cover the cost increase but also the additional 7.5% fees on top. In many cases whilst projects are being developed on site opportunities arise to carry out additional enhancements or improvements. However, any additional works will also incur these 7.5% fees. We would therefore recommend that these fees are agreed at a maximum figure under the contract and that any overspend or additional works instructed should not incur any additional fees.
4. One scheme which is currently being developed by colleagues from Merseytravel with Network Rail is the re-opening of the Olive Mount Chord. This project is currently estimated at £7.6m, which would incur total fees of £570,000. These are significant costs for public authorities to fund and, given that we want to encourage further investment, we believe that for the larger schemes above £5m that there is a case for agreeing an overall maximum fee level for such projects rather than applying a fixed percentage figure.
5. With each agreement effectively being stand alone, there is no recognition to the aggregate amount paid by Third Parties into these funds. As mentioned previously PTEs are a major Third Party investor and as such will be contributing considerable funding towards these fees and insurances. We believe that where a Third Party is such a significant investor and has built up such a large contribution to these funds that we can agree to cap such contributions to further schemes or at least be able to renegotiate lower fees based upon our past record of contributions into the scheme.

Overall, the additional financial launch of the NRFF and IRF are seen as a disincentive to use Network Rail. Such contributions could be more effectively used to fund other schemes (non-rail) in PTE Transport Plans. Has the ORR or DfT undertaken a Value for Money exercise on these two funds? The funds certainly have a role on major schemes but we question the need for schemes below £5m.

Development Services Agreement

Whilst we support the principle of these agreements to promote Third Party investment on the national rail network, we do have concerns over this particular template.

Under the terms of this DSA, there is a doubling of the Network Rail Fee compared to the Implementation Agreement template. Given that the level of risk associated with the design phase of a project is lower than for implementation, with little or no works taking place on site, we would have expected that the fees associated with the DSA to be lower than those for the Implementation Agreement, not higher. This is not value for money and is likely to frustrate the aim of encouraging future Third Party funded schemes.

Furthermore, the Customer Cap is increased by 240%, from 10% of project costs for the IA up to 250% for the DSA. In comparison, we note that the Network Rail cap remains unchanged at 300% of the Network Rail Fee for both the Implementation Agreement and DSA.

Whilst we recognise that the DSA does provide a cap on our liabilities, it does so at such a high level that the Network Rail and Industry Risk Funds would be highly unlikely to be called upon. In the case of Merseytravel's Olive Mount Chord project, which has an estimated cost for design development of £187,000, they will have to fund an additional £22,000 to contribute to both the Network Rail Fee Fund and Industry Risk Fund and also be potentially liable up to the Customer Cap of a further £522,500, a total liability of £731,500.

In this particular case, Merseytravel feel the benefits of the project outweigh the potential liabilities, as they have assessed the risks associated in developing the project to outline design Form A Stage to be low. However, it is clear that putting such high liabilities onto Third Party customers through this DSA may well become a barrier to further investment on the rail network.

The other main issue with the DSA is that of design risk. Clause 15.6 (page 16 of the contract) details that Network Rail takes no responsibility for the design whatsoever –

"Where Network Rail is required to appoint a Consultant as part of the Services, Network Rail's responsibility in respect of any Consultant shall be limited to using the degree of skill and care set out in Clause 2.3 to procure and manage an appropriate Consultant and to complying with its obligations under Clause 15.5. Subject thereto, Network Rail shall have no further liability whatsoever (whether in contract, tort (including negligence), indemnity, warranty or otherwise) for any Losses suffered by the Customer or any third party as a result of or in connection with the use of any work done or produced by such Consultant."

The risk of design error therefore rests with the customer to resolve and to take out a Collateral Warranty with the designer to provide protection in case of design error. Whilst this clause may be valid in the case when the Third Party has procured their own design independent of Network Rail, we do not believe this should be the case where the Third Party is contracting directly with Network Rail for the design services.

As Network Rail prepares the design services tender documentation, approves the list of designers to bid for the works, contracts with the designer and ultimately approves the

final design then Network Rail should take direct responsibility for what is produced. To then expect the Third Party funder to underwrite the design raises the question of what benefit Network Rail brings to the design process if they will not take ownership and responsibility of the final design they are contracted to provide.

Use of RAB to Finance Small Scale Schemes

We would be interested in exploring further whether use of the RAB offers any opportunities for PTE investment in the rail network. As this funding mechanism is designed to apply primarily to self-financing schemes, this may limit its application for PTEs as most investments do not generate a commercial return.

Treatment of Development Gains

We have not progressed any schemes under this method of funding and have no comments to make regarding the use of hypothecated gains.

ORR Approach to Monitoring Investment Framework

We welcome the ORR approach to the monitoring and the use of this consultation exercise to obtain feedback and comment as to the application and use of the agreements.

In particular, we would be interested to obtain details of the national picture with regards to the experience of other Third Party funders of rail investments and, as part of this, we believe that full visibility of the contribution to the Network Rail Fee Fund and Industry Risk fund be made available.

We also would support a regular review of the overall investment framework to be carried out, so that we can improve and adapt the current arrangements and procedures in order to ensure the efficient implementation of investment on the railway and further reduce obstacles to investment.

Investment and Maintenance Costs

One of the key issues that has frustrated a number of rail investments has been that of reaching agreement over who will pay for any additional maintenance costs. The guidance (Policy Framework for Investments, March 2006, Para 5.2, page 33) states that OM&R costs should be funded by the Third Party. This puts an additional burden on Third Parties as in many cases funding for Capital Investments cannot be easily transferred into a long-term revenue stream to cover maintenance costs.

A particular issue is that of providing step free access where the additional annual costs for lift maintenance is a real barrier to scheme development. Currently, there are a number of schemes which have “stalled” due to these issues.

We would therefore welcome confirmation that your proposal (para 53, page 19 of the update on Implementation Guidelines, March 2007) for applying a scheme specific de-minimis threshold to additional OM&R costs for £50,000 has been accepted and that Network Rail will accept these additional maintenance costs.

The application of this proposal will avoid the current impasse at many sites and allow PTEs to progress future projects more quickly and easily.

We trust these comments are helpful and demonstrate some of the barriers that still exist which are stifling Third Party investment on the rail network.

If you have any queries regarding these points please do not hesitate to contact me.

Yours sincerely,

Peter Sargent
Assistant Director Rail, Centro
On behalf of PTEG Rail Group