

13 December 2006

Ron Henderson  
Group Finance Director  
Network Rail  
40 Melton Street  
London  
NW1 2EE

Dear Ron

## **Annual Review of Network Rail Investment Activity for 2005-06**

### **Background**

1. In October 2005, we established a policy framework for investments to facilitate the development and delivery of schemes which enhance the rail network. We have implemented the framework through our investment guidelines, published in March 2006<sup>1</sup>, in which we indicated our intention to carry out an annual review of Network Rail's involvement in investments. The primary purpose of our annual review is to assess the effectiveness of your role in the development and delivery of investment schemes.
2. This is the first such annual review, carried out with advice from the independent reporter Halcrow. The review comprises:
  - (a) Halcrow's report for the year 2005-06, which is attached to this letter;
  - (b) our further analysis of the following investment programmes outside the scope of Halcrow's review:
    - (i) schemes promoted by third parties; and
    - (ii) the Network Rail discretionary fund (NRDF)<sup>2</sup>.

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<sup>1</sup> Available at <http://www.rail-reg.gov.uk/upload/pdf/277.pdf>

<sup>2</sup> The NRDF covers schemes costing below £5m identified by Network Rail using £200 million of funding provided by DfT over the four year period from 2005 to 2009.

## **Objective and scope of our annual review**

3. The primary purpose of our annual review is to assess whether in our view there are areas for improvement in your involvement in enhancement projects and, in response, for you to set out how you intend to address these.

4. Halcrow has reviewed project management procedures and analysed variances in expenditure and output delivery for major schemes delivered by you. Halcrow's report covers the following projects/ programmes:

- (a) the fixed telecom network/ GSM-R programme - to renew and upgrade your telecoms network;
- (b) the access for all programme of accessibility improvements at stations;
- (c) the national pollution prevention programme, primarily works at depots;
- (d) the southern region new trains programme (SRNTP);
- (e) the portfolio of self-financing commercial projects identified by Network Rail, such as station retail schemes; and
- (f) in outline only, the NRDF.

5. In addition, the review includes our analysis of:

- (a) your involvement in schemes promoted by third parties; and
- (b) issues relating to delivery of the NRDF.

## **Expenditure and outputs**

6. Our annual assessment<sup>3</sup> revealed an actual investment of £406m on enhancements compared with an assumption at the 2003 access charges review (ACR2003) of £429m, and compared with your own budget of £623m. This means that, once new commitments were taken into account such as the NRDF funding, your total underinvestment against your forecasts was over £200m, and this trend has continued in the first half of the current financial year with an underinvestment of £70m relative to your budget (for Q1 and Q2 of 2006-07) of £210m.

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<sup>3</sup> Published on 29 September 2006 and available at <http://www.rail-reg.gov.uk/upload/pdf/302.pdf>

7. You have delivered many of the outputs required by Government from major enhancement schemes in a satisfactory manner, including delivery of journey time improvements on the WCRM Programme and substantial completion of the southern region new trains programme (SRNTP). However, we note that costs on the WCRM continue to exceed those assumed in our ACR2003 determination, and that Halcrow has identified a number of areas for improvement in major investment schemes, as listed below.

### **Major investment programmes**

8. Halcrow's report identifies a number of underlying issues to address if the delivery of investment schemes is to be improved. In summary, it proposes that you should:

- (a) collect data on actual costs incurred on investment schemes using a consistent framework (such as your cost analysis framework) to enable structured monitoring and comparative analysis through a common data recording system;
- (b) implement a company-wide set of performance indicators which reflect actual economic value added (earned value) rather than simply variances in cost and schedule against your forecasts. These performance indicators should facilitate improved capture of cost and schedule variance information; and
- (c) roll out good practice in project management as seen on the FTN/GSM-R programme to other major programmes.

9. Halcrow has confirmed that it believes the reported information is a reasonable representation of performance, which has been properly prepared and reported in accordance with agreed procedures, except where otherwise noted in its report commentaries.

### **Small-scale schemes – the Network Rail Discretionary Fund (NRDF)**

10. We noted in our recent national rail review<sup>4</sup> that you have made a slow start in delivering NRDF schemes, and have lagged behind both your own plans and industry expectations. However, we also recognised that a ramp-up is generally to be expected for a programme of this kind (i.e. investment and delivery increasing as the process beds down). Indeed, you have confirmed that 170 schemes are currently under development.

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<sup>4</sup> for Q2 2006/07, available at <http://www.rail-reg.gov.uk/upload/pdf/305.pdf>

11. In May 2006 you reported that, for 2005-06, you had not delivered any outputs from the NRDF and only £4m of the NRDF funding had been spent. We understand that since then, two schemes have been successfully completed and that a significant further tranche of schemes have recently been authorised by your investment panel. We also recognise and support your objective of speeding up the overall industry processes (including your GRIP process) in this area to facilitate progressing small-scale enhancement schemes more promptly. We and your customers will be looking for you to demonstrate real progress over the coming months such that we all have confidence in your ability to deliver these small schemes (and other minor and medium-sized schemes<sup>5</sup>) in a timely manner. In this context, we welcome your suggestion to publish details of NRDF schemes on your website, including a forward programme with expected delivery dates, which you have recently provided to us.

12. We will monitor your development and delivery of NRDF schemes on a quarterly basis, and report on progress in our regular national rail review.

### **Third party investment**

13. Our investment policy framework and guidelines are aimed at smoothing the way for greater third party investment by providing clarity to potential investors about your role and responsibilities, and the terms on which they can expect to invest.

14. We have analysed your involvement in schemes promoted by third parties, where you may provide design or delivery services, or facilitate schemes on behalf of others delivering schemes. The key points arising are that:

- (a) you provided services to 226 schemes in 2005-06, of which 41 used the new templates for third party schemes;
- (b) third parties committed to £644m of new rail investment in the year; and
- (c) the value of services you provided to these schemes was £228m.

15. The table below summarises our understanding of your involvement in third party schemes in 2005-06.

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<sup>5</sup> Minor schemes are those below £5m in value, medium-sized schemes are those with a value between £5m and £50m

## Network Rail involvement in third party schemes

|  | Total numbers of agreements | Total value of projects (rail-related) £M | Total forecast NR spend £M | Numbers of template agreements | Ratio of projects on schedule                                      |
|--|-----------------------------|---|----------------------------|--------------------------------|--|
| Projects in development                    | 163                         | £2,790                                    | £52                        | 36                             | 77.5% right time<br>20% customer requested delay<br>2.5% NR delay. |
| Projects in implementation NR facilitating | 51                          | £437                                      | £37                        | 2                              | 100%   |
| Projects in implementation NR implementing | 12                          | £207                                      | £190                       | 3                              | 100%   |
| Total third party projects.                | 226                         | £3,433                                    | £280                       | 41                             | 0  |

16. The table shows that you are largely providing services to stakeholders on time under the terms of the new template agreements. Also, several stakeholders have told us that you are more responsive to their requirements, partly because of your new organisation where route enhancement managers act as a single point of contact for them. However, there is still some inconsistency in your approach to third party schemes and you have acknowledged that you should go further in meeting stakeholders' requirements in a timely manner. Your recently published document "Investing in the Network"<sup>6</sup> provides further clarity on how you treat investment proposals, and the process for taking forward third party schemes.

17. One message which some stakeholders have consistently given us is that they would like the opportunity to use suppliers other than Network Rail to deliver some types of scheme (e.g. at stations, including car parks). We support competition in the delivery of enhancement schemes. We said in our investment framework that third party promoters should have the option to carry out schemes themselves because competition is a more effective spur to improved performance than regulation alone. We therefore said that you

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<sup>6</sup> The document acts as supporting material to Section 13 of the Code of Practice for Dependent Persons under Condition 25 of Network Rail's Network Licence. The document is available at: [http://www.networkrail.co.uk/documents/3802\\_section13accompanyingmaterial.pdf](http://www.networkrail.co.uk/documents/3802_section13accompanyingmaterial.pdf)

must not use your monopoly position to require third parties to buy contestable services from you. We will be seeking feedback from stakeholders on this issue.

18. We will continue to monitor your involvement in third party schemes. For the 2006-07 annual review we will assess, with assistance from David Simmons, the independent Reporter:

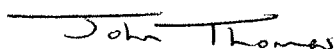
- (a) the efficiency of delivery for a sample of third party schemes implemented by you, on an *ex post* basis; and
- (b) the use of the new risk funds for third party schemes, in particular whether or not an appropriate balance exists between customer contributions and drawdowns from the funds.

### **Next steps**

19. Please could you provide us with your views on the Halcrow recommendations, whether you agree with them and if so, how and when you plan to address them. If you do not agree with any of the recommendations, could you set out your reasons and provide your alternative plans for addressing any accepted weaknesses identified.

20. I have copied this letter to members of the investment forum.

**Yours sincerely**

A handwritten signature in black ink that reads 'John Thomas'.

**John Thomas**