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Bill Reeve
Director, Rail Delivery
Transport Scotland
Buchanan House
58 Port Dundas Road
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Dear Bill

Logging up overspend in Scotland in CP4 – treatment of enhancements

Further to various recent discussions, I am writing to provide you with further clarification of our approach to assessing proposals by Network Rail for logging up efficient overspend on enhancement schemes in Scotland in CP4. I will start by explaining the general approach which also covers logging down where there has been underspend. The letter does not cover the detail of project monitoring and enforcement of non-delivery of outputs.

Context – general approach to logging up and down

Chapter 15 of our determination sets out our approach to logging up efficient overspend and logging down underspend, for both renewals and enhancements. Our approach was developed in the context of the overall 'package' of our determination. Our general approach for CP4 is to add actual efficient capex to the RAB in CP4 (via an adjustment to the RAB at the beginning of CP5). This approach provides a more appropriate balance of incentives and protections for Network Rail. It provides (a) an incentive to outperform our determination since it will retain the benefits of this outperformance for five years (i.e. there should be no disincentive against outperformance later in the control period); and (b) the opportunity to log up any efficient capex overspend.

The approaches to logging up and down vary for renewals and enhancements, and differ between England & Wales and Scotland in respect of the treatment of enhancements overspend.

It is also important to note, in addition to our policy for logging up or down efficient overspend or outperformance, that where Network Rail has underspent because it has not delivered the required outputs we will, at the beginning of CP5, reduce the RAB. This reduction will reflect the value of the underspend plus the associated capitalised financing benefit received by Network Rail. Failure to deliver required outputs may also result in us taking enforcement action.

Logging up overspend on enhancements in Scotland

For enhancements in Scotland, our approach is based on a specific, ex post efficiency assessment to determine the value to be logged up, for the qualifying enhancement schemes, which are the Glasgow airport rail link, Glasgow to Kilmarnock and Borders rail schemes.[1] We expect the process to work as follows:

1. **Ongoing monitoring.** We will be monitoring delivery of the schemes and will take action if outputs are not delivered or appear likely not to be delivered from our monitoring activity.

2. **Net overspend and our assessment.** If there is any net overspend on the schemes compared to the assumptions in our determination (or the delivery plan, where this updates the determination, and which may include adjusting for bringing work forward or deferral if necessary), Network Rail will need to submit to us the justification for the overspend which it wants us to consider logging up for addition to the RAB at the start of CP5. We will examine the reasons for the net overspend, and may ask the independent rail reporters to provide an opinion. If the company cannot provide an appropriate justification for the overspend then it will not be logged up. 'Net' overspend means that we will assess any overspend in aggregate across the schemes.

3. **Logging up to the RAB.** Where the overspend is appropriately justified the full value of the overspend plus the capitalised financing costs will be logged up, less 25% of the value of the overspend, regardless of which year the overspend occurs, as set out in our determination. This is equivalent to Network Rail bearing the capitalised financing costs associated with the overspend for five years.

4. **Justification required by Network Rail.** We will expect a case from Network Rail at the end of each year in which there is overspend which it would like us to consider for logging up. Network Rail will need to provide us with a robust justification (in accordance with chapter 15 of our determination) in order for us to consider any logging up. Our assessment will be undertaken annually but if there is no net overspend then we will not undertake an assessment of the efficiency of each individual scheme.

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[1] The Airdrie to Bathgate scheme (which is subject to fixed price arrangements) and the small schemes fund are not covered by the logging up policy. Network Rail bears the risk for any overspend on these projects.

5. **Aggregate level assessment.** If presented with a case by Network Rail we would not undertake a review of each separate scheme to consider the efficiency of all the work and expenditure undertaken on the scheme, i.e. our assessment will remain focused on the reasons presented by the company for net overspend and not look for any possible areas where there could be offsetting efficiencies/underspend.

6. **Possible reasons for efficient overspend.** The reasons for efficient overspend may include, as appropriate, both additional work and unit costs (including input price impacts). (The issue of additional outputs is treated separately and discussed below.) The additional costs would need to be those that could not have been reasonably foreseen at the time of the periodic review by an efficient company. These costs may be caused by the need to address unforeseen issues in existing asset condition (where this is relevant to the enhancement), external factors and increases in input prices. We would expect Network Rail to at least demonstrate that it had properly applied its internal processes (e.g. GRIP, investment authorisation procedures and general management action) and if it could not provide evidence of this then we would not allow logging up.

7. **Renewals and enhancements.** In Scotland, the approaches to assessing renewals and enhancements overspend are broadly the same, though for renewals only additional volumes may be logged up, with overspend caused by increases in unit costs or input prices not being covered (input price inflation is covered through the separate input prices indexation mechanism). Where it presents a case for overspend on schemes with both renewals and enhancement elements Network Rail will need to set out and justify separately the overspend relating to renewals and enhancements.

8. **Additional outputs.** Where you request Network Rail to deliver additional outputs to those in our determination (which also encompasses agreed variation to the scope or timing of schemes in the determination), we will log up the full efficient cost (including capitalised financing costs) of delivering these. We will not log up overspend on enhancements to deliver additional (or varied) outputs unless this has been agreed by you.

The quarterly enhancement project review meetings that John Larkinson chairs provide a good basis to identify and discuss any emerging issues in terms of scheme progress and expenditure that will be relevant to the case for, and assessment of, potential logging up.

We will set out the technical detail of our RAB roll forward policy and how it will be applied in CP4 in updated regulatory accounting guidelines which we will publish before the end of 2009-10.

I am copying this letter to Frances Duffy, Ron McAulay, Paul Plummer and John Larkinson, and placing a copy on our website. We would be happy to discuss this issue further with you if necessary.

Yours sincerely

Paul McMahon

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