



OFFICE OF RAIL REGULATION

Bill Emery
Chief Executive
Telephone 020 7282 2006
Fax 020 7282 2043
E-mail bill.emery@orr.gsi.gov.uk

9 May 2008

Jim Cornell Esq
Non Executive Director
Network Rail Infrastructure Limited
40 Melton Street
London
NW1 2EE

Dear Jim

ORR initial assessment of Network Rail performance to inform your remuneration committee meeting of 14 May 2008

1. I am writing to set out our initial view of Network Rail's performance on each of the three performance metrics in your management incentive plan (MIP), and to draw your attention to key safety, licence breach and other performance issues.
2. Following your remuneration committee meeting next week, we would welcome the opportunity to understand from you how the issues set out in this letter informed your decisions.

Reliability

3. Network Rail reduced its level of overall train delay minutes to around 9.5 million minutes in 2007-08. Although this was better than the trajectory specified in the access charges review 2003, Network Rail has underperformed its own reliability metric target by around 2%. We understand that this is due to passenger delay minutes being above the company's own stretch target and significant underperformance of the company's own normalised freight delay minutes target.
4. The overall industry passenger 'public performance measure' (PPM) target, agreed by the National Task Force, was exceeded. We note that this was despite underperformance by Network Rail. The reduction in delay achieved by train operators continued to be significantly greater than that achieved by Network Rail.
5. Moving from an overall level to individual routes and operators, there were considerable problems in terms of Network Rail delivery to First Great Western (where delay minute targets committed in the joint performance improvement plan were exceeded

in all 13 periods) and GNER/National Express East Coast (where a series of major incidents, many associated with overhead line equipment, were a major contributor to the PPM score falling well behind target and not improving year-on-year). Both operators have expressed concern to ORR over Network Rail delivery.

Efficiency

6. As for last year, we have undertaken an initial assessment of Network Rail's efficiency performance in 2007-08 and for the control period to date.

7. The analysis is based partially on the report from independent reporter David Simmons (of Halcrow Group Limited): Preliminary data on efficiency 2007-08, final report. We have also based some of our analysis on Network Rail period 13 data, which are also preliminary. The data may therefore be subject to some change.

8. We have compared the emerging picture on efficiency with the movement in the financial efficiency index (FEI) over the past year. We understand that the FEI is expected to be slightly below target. We believe that the FEI is likely to understate the extent of Network Rail's underperformance on operating, maintenance and renewals (OM&R) efficiency in 2007-08, driven by a significant unwinding of renewals unit cost efficiencies in year.

9. The picture across the expenditure types varies.

10. On controllable operating expenditure, Network Rail continues to remain ahead of its regulatory efficiency target for the control period to date (by 12%), realising a 4% outperformance of the target in 2007-08.

11. Network Rail's 2007-08 maintenance spend was broadly in line with our determination. Its performance on maintenance expenditure efficiency, as measured by maintenance expenditure per ETM (equated track mile), is around 4% ahead of target for the control period to date.

12. There is no straightforward methodology for assessing Network Rail's performance on renewals efficiency. The unit costs data available provide only a partial picture of the efficiency of its renewals activity. Therefore, in assessing renewals efficiency we consider both unit cost data and the company's own analysis of the variance of its expenditure relative to budget.

13. At least two years of preliminary unit cost data are available for 39 track, structures, signalling and telecoms activities. Preliminary unit cost data have not been provided for electrification & plant. We understand that this was because the work delivered in 2007-08 did not meet the requirements to constitute a repeatable work item.

14. Based on the preliminary unit cost data, if the efficiency performance observed in these areas is representative of the performance across renewals expenditure as a whole,

the data imply a reduction in renewals unit cost efficiency of around 12% in 2007-08, meaning that the company has unwound almost half of the gains achieved in earlier years. Indeed, the preliminary data suggest unit costs rose for all asset classes reported except structures, versus a regulatory target of a 5% reduction. The figures imply Network Rail is now around 10% behind our ACR2003 determination for renewals efficiency on a cumulative basis.

15. Network Rail's variance analysis (based on its internal monthly business report (MBR) which covers the majority of asset classes), suggests that activity efficiency has declined by around 1% on average for 2007-08. Again, most asset categories appear to have underperformed. This implies a material underperformance against the regulatory target, but to a considerably lesser extent than implied by the unit cost analysis.

16. We note in relation to Network Rail's variance analysis that, in his report, David Simmons stated that "[t]here was evidence of systematic errors leading to over-attribution to scope change", although we recognise that the final post-audit data are not yet available. We understand that these will be available for the annual return.

17. However, the robustness of the unit cost data is also unclear at this stage. We therefore conclude that, in 2007-08, Network Rail unwound part of the efficiency savings achieved on renewals earlier in the period and is materially below the cumulative target for CP3 to date. However, the precise scope of this is uncertain at present.

18. We also note that the preliminary analysis conducted by David Simmons suggests that Network Rail continues to be behind its original timetable to roll out robust maintenance and renewals unit costs. It is not yet clear how many of the preliminarily reported unit costs will prove to be robust. David Simmons' preliminary assessment of the data revealed systematic errors in some of the maintenance unit cost data, in particular, although we recognise that quality assured full-year's data is not yet available.

19. We will carry out our full analysis of Network Rail's 2007-08 efficiency performance once the full audited figures are available.

Asset stewardship index (ASI)

20. Through 2007-08 the ASI has continued to outperform the ACR2003 target and Network Rail's own internal stretch target. This performance is replicated in all the territories with the corresponding ASI measure.

21. Although the ASI has been performing well, it does not reflect total asset condition. Throughout 2007-08 we have challenged Network Rail about the overall level of asset failures causing delay to services. The company has been working on a number of fronts, particularly track faults, points failures and track circuit failures, which together account for approximately half of all delay due to infrastructure causes. It is encouraging to note that overall the year has ended with 10% fewer infrastructure failures than last year (just worse than Network Rail's own target) with corresponding improvements in the major components noted above. We shall continue to review ongoing initiatives related to rolling contact fatigue and some miscellaneous categories.

Safety performance

22. We consider Network Rail's management of safety during 2007-08 to have been broadly sound. The company met most of its self-imposed safety targets.

23. However, inspections and incident investigations revealed areas of weakness both in the management arrangements and in delivery of safety on the ground. The Grayrigg derailment occurred at the end of the last reporting year, 2006-07, but our follow-up of emerging findings during 2007-08 showed that track patrolling was vulnerable to failure. It was therefore necessary for us to take enforcement action to oblige Network Rail to make improvements.

24. Network Rail also began to take effective steps to address a weakness in its monitoring of ground-level safety performance, by assigning engineers independent of the maintenance function to test the safety of assets and adherence to maintenance standards. The company could not demonstrate during the year that its new competence management system was fully functional, though we found no evidence of incompetent staff working as a result. We found weaknesses in the management of some risks at user-worked level crossings.

Breaches of network licence

25. We found four breaches of licence obligations during the year. Three of these were deemed to be serious, of which two resulted in us imposing a financial penalty:

- (a) On 28 February this year, we concluded that there was a continuing breach of condition 7 in relation to the planning and execution of engineering work requiring possessions. We ordered the company to implement changes to its approach by December 2008 and to send us a plan after consultation with its customer and funders showing how it proposes to implement those changes. Network Rail will continue to be in breach until the plan is fully implemented. For this breach, we imposed a £14m penalty, reflecting the seriousness of the breach.
- (b) We also concluded at that time that Network Rail was likely to be in breach of condition 7 in that it was likely to fail to deliver the West Coast infrastructure capability to allow significant timetable improvements currently scheduled for December 2008. This conclusion was based on the fact that at the time Network Rail did not have an adequate plan to deliver the required infrastructure capability. We ordered the company to produce a plan in consultation with its stakeholders and concluded on 2 May that it had complied and was no longer likely to breach its licence in this respect.
- (c) Network Rail breached condition 7 of its licence in relation to the Portsmouth resignalling scheme. In this case, the company's planning and its assessment and mitigation of risk were at fault and we imposed a penalty of £2.4m.

Other issues

26. You will no doubt be aware that Network Rail's latest survey of its customers has revealed a deterioration in satisfaction with the company's performance. This is disappointing and needs addressing given the importance of effective partnership working in rising to the capacity, performance, safety and efficiency challenges of the future.

27. Throughout the year, we have had a number of complaints from those wishing to invest in the railway that they find it difficult doing business with Network Rail and that it takes far too long to progress and deliver small scale enhancement schemes. We are investigating further and have recently issued a consultation questionnaire to investors and potential investors in order to determine the nature and extent of the problems and whether regulatory intervention is required.

28. John Thomas or I would be very happy to clarify any points if you need this to inform your decisions.

Yours sincerely

A handwritten signature in blue ink that reads "Bill Emery". The signature is written in a cursive style with a small flourish at the end.

Bill Emery