



Department for Transport

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Sent by email to Richard Price

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Dear Richard,

IMPROVING FINANCIAL INCENTIVES IN THE RAIL INDUSTRY TO DELIVER BETTER OUTCOMES FOR PASSENGERS, FREIGHT AND TAXPAYERS

I am writing on behalf of DfT in advance of ORR's initial consultation on the approach to charging for Control Period 6 to provide wider context about the Government's interest in the rail industry charging framework; and more detail about the proposals for changing the way money is channelled to Network Rail, as announced in the summer 2015 Budget. Our aim through this work is to improve transparency and incentives in the rail industry. Clearly, the final decision on the structure of charges is for ORR, but I hope this information will help to inform your work. I would note that the wider industry context within which work on charging is carried out remains subject to change, with the Shaw Report and the Review of the ORR.

Strategic context

Rail is vital to the health of the UK economy and to the quality of life of our citizens. The Government wants a railway that contributes to a growing and productive economy; helps to rebalance our economy; provides improved journeys for passengers and a better service for freight users; is safe, secure and sustainable; and is efficient. Delivering this is ultimately about the services that are run for passengers (which are largely reliant on the franchising process) and freight, underpinned by the day-to-day running of the network, and the development and delivery of enhancement schemes.

While Rail has been a huge success story over the last 20 years with passenger numbers doubling, there is recognition that the system could be improved. To better achieve the above objectives we believe it is crucial that all industry parties have the right incentives and that incentives are well aligned between track and train operators.

Budget announcement on money flows

The Chancellor's summer Budget announced Government's wish to channel more public money to Network Rail through train operators. Changing money flows is one of the enablers to aligning incentives between rail industry parties, and, with the right supporting measures, can help to improve financial and operational performance, and optimise use of existing infrastructure.

In this context, our preference is to remove or significantly reduce the Network Grant in England and Wales for CP6 (the position in Scotland is a matter for Scottish Ministers, in liaison with ORR). This would require an increase in the total level of income that Network Rail receives from track access charges so that it is able to meet its revenue requirement.

ORR review of charges

For the change in money flows to be effective, it is important that there is clarity and transparency about where costs are incurred and what different sources of funding are paying for. This should support better decision-making across Government and the rail industry, and help members of the public to better understand the level and purpose of Government subsidy to the rail industry.

I understand that you are considering how to make charges more cost-reflective, and will be exploring this further in your initial charging consultation. DfT is supportive of the principle of cost-reflective charging (particularly in respect of FTAC), subject to the following points:

- the work should allow for the possibility of change resulting from the Shaw Report recommendations
- DfT is concerned about the financial impact, and risk to the franchising system, from open access services which make no contribution towards the fixed costs of the network and abstract revenue from franchised services. The costs, as well as the benefits, of enhanced on-rail competition must be carefully analysed and taken into account to ensure that the railways operate in a manner to secure maximum benefits for passengers and taxpayers. We would expect all open access operators to pay at a minimum the full marginal costs of their operations, i.e. including capacity charge, and that any new open access services should make an appropriate contribution towards the fixed costs of the network
- DfT recognises that for there to be maximum transparency, fixed costs ought to be appropriately attributed to freight operators, but that this would not necessarily need to be fully reflected in charges, in light of rail freight's contribution to the environment and reducing road congestion
- if the structure of charges changes, DfT will incur significant administrative costs to negotiate and implement this in the TOC models. ORR should work with DfT to ensure that any new charging structure is implementable on a practical level and will not lead to disproportionate administrative costs, or implementation risks.

Partial exposure of train operators to changes in charges

To further the objective of aligning incentives, we are considering whether it would be practical and appropriate to partially expose franchised train operators to changes to the

rate of charges which they have the ability to influence. DfT would also be interested in any mechanisms that made the rate of charges more dynamically responsive to variations in underlying costs. We will need to ensure that DfT does not pay for transferring risk to TOCs that TOCs cannot control and **DfT will not make decisions around exposure without careful consideration and consultation with the industry**. However, the following are likely to be helpful:

- a consistent structure of charges from ORR and clear baselining to allow comparisons between control periods
- the more cost-reflective charges are, and the more TOCs can understand and influence them, the more likely it is that a degree of exposure will be possible.

We recognise that partial exposure is just one way of aligning incentives. Others include formal alliancing, partnering arrangements and collaboration. ORR has also set mechanisms in place around sharing against efficiency targets. The work that the infrastructure manager is carrying out to extend its approach to devolution, making it a more operationally focused and customer responsive organisation, is a key development to improve this alignment.

In conclusion, DfT and ORR have been collaborating at working level to share developments across our respective areas of work. The right outcomes can only be achieved if franchising, wider DfT policy and charging structures work in alignment. The Rail Executive leadership team are keen for this to continue and for this engagement to be mirrored at senior level.

Yours sincerely,



Cavendish Elithorn