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15 March 2012



SWYDDFA RHEOLEIDDIO'R RHEILFFYRDD
OFFICE OF RAIL REGULATION

Carl Sargeant AM
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Dew Minister.

ADVICE ON NETWORK RAIL'S COSTS AND OUTPUTS IN CONTROL PERIOD 5

I am pleased to enclose a copy of our advice on Network Rail's costs and outputs which we have today submitted to the Secretary of State for Transport and published on our website. Our advice is produced to help the Secretary of State decide what she wants the railway in England & Wales to deliver in the next regulatory control period (control period 5, or CP5) and the amount of public funding she is making available for this.

The Secretary of State is planning to publish her 'High-Level Output Specification' (HLOS) and 'Statement of Funds Available' (SoFA) by the end of July 2012. These are key inputs into our 2013 periodic review (PR13) of Network Rail's access charges, regulatory outputs and the wider incentive framework for CP5, which we expect to run from 1 April 2014 to 31 March 2019.

Although the Railways Act 1993 allocates responsibility for the HLOS and SoFA for England & Wales to the Secretary of State for Transport, we recognise that the Welsh Government wishes to take a greater role in respect of rail. Given this and your continuing engagement with the Secretary of State and her department in relation to PR13, I wanted to write to you separately about issues relating to Wales in our advice and more particularly for other aspects of PR13.

Our commitment to improving value for money through PR13

As a result of previous periodic reviews, Network Rail's costs in 2013-14, at the end of the current control period, will be 40% lower than they were in 2003-04. However, we are committed to driving further improvement in Network Rail's efficiency. We estimate that, of the possible savings identified by Sir Roy McNulty's Rail Value for Money (RVfM) study (which we commissioned jointly with the Department for Transport), Network Rail is in a

position to deliver savings of £1.8-2.2bn. Network Rail has already committed in the Initial Industry Plan (IIP) for CP5 (which the industry published for England & Wales in September 2011) to achieving savings in the low end of the range identified by the RVfM study. Through PR13 we will be challenging Network Rail hard to deliver ambitious but achievable savings beyond this in CP5.

Network Rail's annual expenditure in Wales is currently in the region of £250m – a substantial amount of money. Securing greater value will therefore enable choices to be made in respect of how to use any savings.

Our commitment to industry reform through PR13

We see PR13 as an important facilitator and driver of industry reform, through:

- a clear **focus on what matters** to passengers, freight customers and taxpayers – particularly improving value for money;
- a **more disaggregated approach** – increasing transparency, facilitating greater localism, and in due course allowing a more comparative approach to regulation;
- **alignment of incentives** – improving the interfaces between different players in the industry, facilitating alliances, efficiency benefit sharing at the route level and bespoke arrangements; and
- **greater contestability** – ensuring that there is more competition in the provision of infrastructure related services where appropriate, delivering further savings.

The RVfM study identified that a significant proportion of savings (between £0.7bn and £1.2bn per year) are for train operators and the wider industry to achieve (across Great Britain). Through PR13 we will be seeking to do all we can to support the realisation of these savings. Some of these savings, however, can only be achieved in conjunction with changes that are within the control of governments. For example, whilst setting overall franchise service levels is a matter for government, providing train operators with greater flexibility in future franchises will be important to allow them to optimise delivery and achieve greater value for money. The Welsh Government, along with the Secretary of State and Scottish Government, will therefore need to take decisions on such matters.

Issues relevant to Wales

Our advice is based very much on the analysis we undertook of the IIP. The IIP was prepared at an England & Wales level and was not disaggregated into routes. Hence, our advice does not set out a route-specific analysis for Wales.

However, we are requiring Network Rail to set out in its CP5 Strategic Business Plan (SBP) (due by 7 January 2013) greater detail at route-level, including for Wales. This will then enable us to carry out a specific route-level efficient expenditure assessment in respect of Wales for our final determination.

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Nonetheless, you may be interested to note at this stage the following points relating to Wales:

Maintenance and renewals

- We have assessed Network Rail's proposed asset policies and the robustness with which these are modelled to develop route specific volume and cost forecasts. The modelling uses asset inventories and condition information specific to Wales. In some areas the asset information needs improvement. The proposed policies result in Network Rail's forecast of £257m expenditure on maintenance and £665m expenditure on renewals in Wales during CP5, making up 5.7% of total GB expenditure.
- We have identified weaknesses in Network Rail's policies, modelling, asset information, unit costs and efficiency projections which must be addressed in the SBP to ensure robust plans for Wales. In particular, we are requiring Network Rail to develop unit cost data specific to Wales and we are considering whether there should be a specific efficiency assumption for Wales. In developing the SBP, Network Rail will produce Route Asset Management Plans by route. We will scrutinise these to understand the asset policy implications for Wales in further detail.

Operations

- We have looked at Network Rail's operating strategy for Wales and it has a positive business case, with greater returns on investment compared to England.
- The operating centre in Cardiff opened in January 2010 and is currently in use. By the end of CP5 it will be approximately 60% fully operational. Along with reductions in non-signaller costs, this is expected to result in efficiency savings in operations costs of around 21%. This is higher than in both Scotland and England.

Enhancements

- We have confirmed that electrification of the Great Western route to Cardiff is a committed project that the DfT need to take account of in the HLOS/SoFA.
- Further electrification of the Cardiff valleys has been proposed in the IIP but is dependent on electrifying the Great Western route. Where further projects are funded, we will make sure that Network Rail's CP5 delivery plan sets out clear milestones with a change control mechanism that includes consultation with the Welsh Government. We are aware that DfT is working with the Welsh Government on a business case for this scheme for consideration as part of the HLOS and we are also in discussion with your officials regarding funding mechanisms.

We will of course be challenging the costs of proposed investment and encouraging Network Rail to develop innovative solutions to get the most value out of each scheme.

It is also important to note that if the HLOS for England & Wales does not include particular schemes which the Welsh Government would wish to see implemented, our investment framework provides a mechanism for you to specify and fund these schemes outside of the periodic review.

In implementing PR13 we will be looking to ensure that fixed track access charges (for Wales and elsewhere) are as cost reflective as possible.

Future engagement

We have already had useful discussions on PR13 with yourself and your officials and we very much look forward to continuing these as the review progresses. In particular, we are keen to work with you in exploring how the Welsh Government might become more involved in PR13 and in future reviews.

In the meantime, if there is anything either I or my officials can help you with, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink that reads "Richard Price". The signature is written in a cursive style with a large initial 'R'.

RICHARD PRICE

CHIEF EXECUTIVE