Department for
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Dear Valentina,

Office of Rail Regulation's (ORR) Draft Determination

This letter is the Department for Transport's (DfT) response to the ORR's consultation on its draft determination covering the outputs, incentives and financial framework for Network Rail from April 2014 to March 2019. The ORR has said it intends to publish its final determination on 31st October.

The Department welcomes the ORR's draft determination, which supports the principles of contestability, comparability, transparency and partnership working which are central tenets of the Government's vision for the rail industry.

In particular, given the Department's focus on efficiency and affordability, we welcome the ORR's finding that DfT's rail investment strategy (i.e. the High Level Output Specification) is affordable within the funds available. The next control period will see more than £16 billion Government funding provided for the railway, supporting economic growth and jobs, delivering a greener, more cost efficient railway that is better for freight customers and better for passengers. As the draft determination sets out, this comes against a backdrop of remarkable growth over recent years, with passenger satisfaction and train punctuality at or close to an all-time high.

The draft determination also makes significant progress in terms of efficiency, setting Network Rail a target of 20% which in turn builds on the 40% efficiencies from 2004-14. This achievement helps work towards the vision of reducing the cost of running the railway articulated in Government's March 2012 Command Paper.

The proposed efficiency target for Network Rail falls just short of the low end of efficiencies for infrastructure set out by Sir Roy McNulty. The ORR has stated that its draft determination work draws on a much deeper and robust base of studies, with newer evidence and analysis than was available to the McNulty study. The ORR also states that its review sets a strong efficiency challenge, which its plans for enhancements efficiency will develop further. The Department notes ORR's finding that if Network Rail can meet the target set for 2014-19, it will have fully responded to the efficiency challenge set by Sir Roy McNulty for the company itself.

There remains a need for train operators to pursue further efficiency, which the Government will seek to facilitate through its franchising programme, and for the whole industry to work together which is why we are strongly supporting the development of partnership working and alliances.

Financial framework

The Department welcomes ORR's adoption of the adjusted WACC methodology and also its approach to enhancement risk. DfT also supports ORR's calculation for financing costs and agrees with the approach taken in its draft determination. We recognise that there are still some issues to be resolved in relation to the terms of repayment for Crossrail and Welsh Valleys electrification, and aim to come back to you on these as early as possible.

ORR's position on financial outperformance during 2014-19 differs from that taken in control period 4. The Department supports ORR's proposal to use financial outperformance to pay down debt and welcomes that ORR will continue to allow Network Rail to make rebate payments to Government in exceptional circumstances.

The Department understands the rationale of ORR's proposal to use any surplus above the level of funding in the Statement of Funds Available to pay for "pay as you go" enhancements, and we wish to be involved in the decision making process given the potential read-across to overall levels of Government support for the railway.

We are continuing to discuss the scenarios proposed for Network Grant with ORR: it is important that we arrive at a shared view on the appropriate split between Network Grant and track access charges given that the Statement of Funds Available separately identified capital and resource funding lines.

Incentives

The Department welcomes the measures to support closer partnership working between train operators and Network Rail. While decisions will be taken on a case by case basis, the presumption is that for new franchises the franchisee will be on risk (both upside and downside) for any changes to the current CP4 mechanism, including the ORR's proposed **route-based efficiency benefit sharing (REBS)**. It is our expectation that direct awards will exclude efficiency sharing. DfT believes that in the event that Network Rail outperforms its efficiency target but misses other outputs (e.g. performance) appropriate adjustments to REBS payments need to be made, as in control period 4.

We have discussed with the ORR the scope to encourage Network Rail to enter into commercial agreements with train operators to provide these operators with a financial incentive to help Network Rail **reduce the cost of enhancements**, allowing enhancement funds to stretch further. DfT notes that this will not be a mandatory regulatory mechanism, but rather a commercial framework which Network Rail and train operators may choose to adopt. DfT is considering how it might incentivise this approach within franchises.

The Department welcomes the drive to improve the **reliability and punctuality** of the poorest-performing services towards the national target PPM level of 92.5%, so as to ensure passengers benefit from a more consistent level of performance across the network. However, we recognise that the proposed 90% minimum threshold for each train operator by the end of CP5 represents a major deliverability challenge for some long distance routes, which could have adverse consequences for other key outputs, such as journey times and cancellation levels. Without wishing to see any reduction in the overall level of PPM for the network as a whole which was specified in HLOS, the Department welcomes the initiative now being taken by the industry and ORR to review the optimal balance of performance targets for long distance operators, in line with the needs of passengers on these services.

The Department remains concerned that **payment rates for schedule 8** may not be set at the right level. Setting these rates accurately is crucial in order to generate the appropriate behaviours in the rail industry and to ensure that adequate compensation is available in the event of underperformance. Separately, DfT notes that work on the interfaces between schedule 8, the capacity charge and volume incentive is still under way and will seek to engage closely before the settlement is finalised.

For the **capacity charge,** the Department supports arrangements that provide clear signals to the industry around maximising the use of network capacity, avoid perverse incentives and avoid complexity for the control period 5 negotiations that DfT and existing franchised operators must carry out to unwind the impact of regulatory changes. DfT welcomes the Rail Delivery Group's work to form a single industry view on capacity incentives, noting that the final decision on the capacity charge will be for the ORR and subject to its regulatory policy and legal consideration, including with regard to affordability for open access operators. DfT also supports a bespoke and affordable arrangement for rail freight operators given these operators represent a different market segment.

DfT welcomes the funds provided for **innovation** in the draft determination, in order to bring the rail industry closer to the levels of innovation investment in other sectors. In addition to the £50 million fund provided for in the rail investment strategy, we welcome ORR's proposal to provide further matched funding up to a ceiling of £45m. Further clarity is needed, however, around how this matched funding mechanism will work in practice, the governance arrangements required and how it can best support innovation across the entire rail system.

Rail freight charging

The Department welcomes the ORR's interim conclusions on **rail freight**, recognising the risks around the cumulative impact of its previous proposals, and the need to provide affordability and business certainty for a sector that generates significant economic and environmental benefits through the sustainable transportation of goods. DfT supports the ORR's intentions in future control periods to set up a rail freight customer panel, and to start work on freight charges earlier in the control period cycle.

Rail safety

On **safety**, the GB rail network is amongst the best performing in the world. The principle of pursuing the highest standards of safety is embedded in the ORR's thinking, as illustrated by the funding made available for reducing risk at level crossings and for those working on the railway. We also note that the ORR's decision on maintenance funding allows Network Rail more time to make efficiencies in a way that is safe and effective.

Rail enhancements

The Department continues to take forward work on enhancements to ensure that the projects specified in the rail investment strategy (HLOS) are delivered as required.

The **Northern Hub** is a programme of individual projects announced by Government at different times, with the final set of projects confirmed in the July 2012 rail investment strategy. At the March 2012 budget statement, Government announced a £130m budget for capacity enhancements on the Hope Valley line and line speed improvements on the Hope Valley, Calder Valley and Manchester to Bolton lines. The ORR's draft determination, drawing on the Nicholls report, found £20m savings, reducing the budget to £110m. However, the final scope of all interventions has yet to be determined and the Department's original specification envisaged any savings being reinvested in line speed improvements elsewhere within the Northern Hub area, subject to value for money. This element of the Northern Hub programme should, therefore be treated as a budget and remain at £130m with a notional £20m unallocated pending finalisation of the overall scope.

Further, the Castlefield Corridor - one of the most significant and expensive schemes in the Northern Hub - has yet to reach GRIP3 stage. The Department believes it should therefore be treated in the same way as the early stage electrification schemes, being subject to a budget review concluding in March 2014.

To date the ORR has not included the construction of **depot facilities and other ancillary works linked to electrification** in Network Rail's obligations for 2014-19, nor is there provision within RAB funding, on the basis that it was possible a third party might lead the work more efficiently. However, over the past months electrification work has evolved to a point where we believe there is better value in the work being delivered through Network Rail. Accordingly, we believe that both the funding and the obligation should be added to the NR-required enhancements in the ORR's determination.

Finally, some enhancement projects and schemes funded and expected to be completed in control period 4 (2009-14, CP4) have been delayed to complete in control period 5 (2014-19, CP5). Similarly some funded projects have been significantly modified and CP4 funding requirements have changed. We would like to clarify the extent to which provision has been made for the CP4 funding to 'rollover' to CP5 and whether any CP4 funding agreed is now not expected to be called upon.

We look forward to continuing to work with the ORR and other industry partners on finalising the determination for 2014-19.

Yours sincerely,

Nick Bisson

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