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Dear Lilian,

2017-18 Annual Report and Accounts

Thank you for your letter of 30 November 2018, about the Department’s Annual Report and Accounts for 2017-18. I am glad that you found the report well presented, and the information within it useful. I have set out below responses to the questions as set out in your letter.

Lower Passenger Income and Numbers

“In 2017-18 net income from passenger rail services was down 40% (a £511 million fall) compared to 2016-17. The annual report notes one factor is lower passenger number which fell by 1.4%. However, because ticket prices increased passenger revenue actually grew in 2017-18 (by 2.3%). Can you explain why you received so much less income in 2017-18 from Train Operating Companies given that overall passenger revenues were up?”

DfT’s annual income from passenger rail services represents the aggregate net position for premia (received from) and subsidies (paid to) our passenger rail franchises during the year. For an individual franchise, the premium or subsidy represents the difference between the business’s income (mostly passenger revenue) and its costs, after the deduction of a contractually agreed profit margin. In general, franchisees bear financial risk for movements in their costs.

There were three principal reasons for the fall in income in 2017-18:

i) A number of franchises saw a significant, planned increase in their cost base during 2017/18, particularly Great Western and GTR, where major new rolling stock fleets were being rolled out into service. These new trains deliver extra capacity and a range of other improvements for passengers, but can have higher lease costs than the much older trains they are replacing, especially if a ‘dual running’ period is needed (with both fleets in partial use). These cost changes were anticipated in the franchise contracts, and it was always expected that 2017/18 premium payments from the franchisees to DfT would be affected by this.
ii) The Department bears financial risk for specified factors outside the franchisee’s reasonable control. Some infrastructure upgrade projects are being delivered later than franchise contracts assumed including delays to the Great Western Electrification Programme, and the Department has made compensating adjustments to 2017/18 premia (as required under the relevant franchise contracts) to reflect the revenue and cost impacts for the franchise.

iii) While revenue from rail passengers did increase by 2.3% in nominal terms between 2016/17 and 2017/18, this represents a much weaker rate of growth than in recent years, and a real-terms fall compared to RPI which rose by 3.3% during the year. Many industry costs, notably Network Rail’s access charges, are contractually linked to RPI, and revenue growth failed to keep pace with this during the year. This weaker revenue growth had financial consequences for the Department in 2017/18, both direct (as the Department bears revenue risk on the GTR franchise) and indirect (as new franchise contracts pay lower premiums, reflecting their lower level of baseline revenue).

**Staffing**

“The Department spends a relatively high amount on consultants and temporary staff, at £62.9 million it stands at around £27k per permanent staff member. What projects are these consultants involved in and is there any reason this work couldn’t be done by in-house staff?”

The Department has a robust approvals process in place on the use of consultancy, whereby a Departmental Approvals Committee challenges the business on the use of temporary staff and consultancy and temporary resource, ensuring that all alternative resourcing options, including the use of existing in-house staff, secondment or fixed term opportunities, are considered before any approval is given.

It is normal practice for the Department to rely on in-house resource wherever possible. However, the Department also commissions external consultancy advice where it is appropriate to do so, typically where specialist or independent advice and/or assurance is required to ensure informed decisions on and effective governance of the Department’s large and complex major projects and commercial portfolio.

Projects on which specialist consultancy resource was commissioned in 2017/18 include: Crossrail, East West Rail, High Speed Rail, the Intercity Express Programme, and the East Midlands, West Midlands, West Coast and South-East franchises.

In addition, the Department makes use of short-term or interim appointments to fill skills gaps or operational requirements on a temporary basis. The Department is working to reduce its reliance on interim staff and is committed to ensuring the optimal and appropriate balance of interim and permanent staff. Where consultants are employed on an interim basis, the Department encourages the transfer of skills and knowledge to permanent staff to help build capability for the long term.

“Why is Mr Wilkinson paid around £100k more than the permanent secretary and double the FTE salary of the board members responsible for Rail?”

Membership of the Department’s Board comprises the Secretary of State and Ministers, the Non-Executive Board Members, the Permanent Secretary and the Directors General.
Mr Wilkinson is employed as the Director for Rail Passenger Services, which is not a Board-level position.

The role of Director for Rail Passenger Services was advertised in 2014 with a salary of up to £300k, based on benchmarks for roles that required similar skills and experience, and Mr Wilkinson was recruited on a salary of £260k. This salary has remained unchanged since 2014. Extensive experience of negotiating and delivering commercial results in rail or comparable industries was a pre-requisite for this role, which is highly specialised in nature.

"What is driving the significant increase in the numbers of high earners in the transport sector?"
"Is there any evidence that staff are moving between public sector organisations (e.g. Network Rail, HS2, TfL) and getting significant pay rises as they move?"

The Department’s Arm’s Length Bodies operate in a competitive labour market and it is not always easy to attract staff with the commercial, project delivery, procurement and other specialist skills needed in public transport sector when in competition with private sector organisations. We would expect see some degree of churn between transport bodies, however we do not have evidence to show this is a systemic issue.

All Arm’s Length Bodies operate within a framework agreement agreed with the Department that sets out what constraints and flexibilities the Board and the Executive must operate within in terms of remuneration. The Boards and their Remuneration Committees scrutinise decisions about senior pay and the Department’s shareholder team also plays an important role in ensuring that public sector pay guidelines are taken into account. All the Department’s Arm’s Length Bodies give careful consideration to how senior remuneration is utilised to recruit and retain the skills and experience needed while providing value for public money.

"What controls does the Department have in place to ensure the pay levels at HS2 are appropriate?"

There has been a small increase in HS2 Ltd’s senior population but that is commensurate with the project moving into construction and work on Phase 2 commencing. HS2 Ltd responded to an FOI request in summer 2018 that asked for details about how many people were earning over £100k, inclusive of pension contributions and other elements of remuneration; this is how the figure of 112 was calculated. Disclosures about remuneration do not normally include pension contributions; they normal incorporate base pay, benefits in kind, taxable allowances and any guaranteed payments. Each Arm’s Length Body, including HS2 Ltd, routinely publishes this information as part of Cabinet Office’s transparency reporting. This shows that 51 people earn over £150k compared to the figure of 51 provided in 2017.

Performance Information and Trends

"The Annual Report notes that “DfT’s appraised project spend assessed to be high or very high value for money” has fallen (from 95% in 2016 to 71% in 2017). What were the lower value for money projects in 2017 that caused this to fail?"
We publish a detailed breakdown of VfM annually in the VfM Indicator report; the most recent report covering 2017 can be found online (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765010/value-for-money-indicator-2017.pdf). In 2017, 78% of approved spend was expected to be High or Very High VfM. This differs from the figure published in the 2017/18 Annual Report (71%), which was a draft estimate, and subsequently revised to more accurately account for approved spending. The Indicator is likely to be an underestimate of VfM, as it does not capture schemes which deliver at least High VfM but also generate revenue for the Department. The indicator is influenced by the number, type and size of projects approved in a given year. As such, we recommend that the VfM of the Department’s expenditure is considered over a number of years to ensure a representative picture is obtained.

It should also be noted that investment decisions are informed by a broad-based assessment of their likely impact. In addition to VfM, we consider a range of factors across the five cases of a business case e.g. how well the proposed investment will support wider government objectives such as improving skills and rebalancing, and the potential for investment in transport to support jobs and business opportunities in local communities.

“One of your performance measures relates to greenhouse gas (GHG) emissions from transport which the most recent data in the annual report shows rose last year. What do you expect GHG transport emissions from transport to start falling?”

While the transport sector has seen only a 1% drop in emissions over the period 1990-2016, we are now at the beginning of a more rapid shift to cleaner transport technology, supported by Government leadership and industry investment. The Clean Growth Strategy sets out in detail a possible pathway for meeting the fifth carbon budget (i.e. 2032) through domestic action that would see emissions from transport falling by almost 30 per cent from today, largely achieved by accelerating the shift to electric and other low emission vehicles.

“Currently just under 2% of new car registrations are for ultra-low emission vehicles (ULEVs). If this total increased to, say 10%, what would be the impact upon GHG emissions?”

A shift in the level of 2017 ULEV sales to 10% could result in a reduction in new car sale GHG emissions of around 6%. However, given that the average life expectancy for a car is roughly 13-14 years, it will take time for the switch to ULEVs to feed into overall emission reductions for the entire car stock. This assumes that the proportion of the different types of ULEVs stays the same when the proportion of ULEV sales increases (e.g. the proportion of plug in hybrid electric vehicles compared to pure battery electric vehicles). A rebound effect – e.g. that people that shift to vehicles with lower running costs tend to drive further – has not been taken into account. This analysis also assumes that the people that might change vehicles to an ULEV represent the average vehicle in each group.

“What will be the impact on GHG emissions of the new runway at Heathrow airport?”

The Government has considered the carbon impacts of the construction and operation of the Heathrow Northwest Runway scheme and agrees with the Airports Commission’s assessment that it can be delivered within the UK’s climate change commitments. The
Airports National Policy Statement is clear that a project would not receive development consent if it causes an increase in carbon emissions that materially impact the ability of Government to meet its carbon reduction targets. While it is true that expansion at Heathrow could increase overall CO₂ emissions at the UK level, the Appraisal of Sustainability accompanying the Airports National Policy Statement sets out how these emissions would either be controlled through an international carbon traded scheme (carbon traded scenario) or reduced through a number of measures to meet the CCC’s planning assumption of 37.5 MtCO₂ (carbon capped scenario). The Aviation Strategy published on the 17th December provides further information on carbon reduction measures in the aviation sector (https://aviationstrategy.campaign.gov.uk).

Your recent report, published on 23 March 2018, at figure 55 of Annex I (Carbon) noted the emissions presented in the Appraisal of Sustainability – Additional emissions, at the UK level, by expansion option, MtCO₂ https://publications.parliament.uk/pa/cm201719/cmselect/cmtrans/548/54818.htm#_idText Anchor071. We do note that the figures in figure 55 relate to the whole 60 year appraisal period, and only for flights. The latest estimates for airport operations, surface access and construction are given in the appendix to the following report:

"The number of serious road accidents and fatalities rose in 2017, particularly amongst pedestrians (up 680, +18%) and pedal cyclists (up 260, +9.6%). Do you know what caused these increases?"


Overall, there were 1,793 reported road deaths in 2017, similar to the level seen since 2012. There were 39% fewer fatalities in 2017 compared with 2007. Specifically on pedestrian fatalities, it is too early to say whether the increase in 2017 data is a sign of an increase from this trend or is a result of natural variation.

Regarding pedal cyclist fatalities, although the number of pedal cyclists killed on the roads in 2017 was slightly lower than in 2016, the 101 fatalities is very similar to the level seen since 2008. Any changes since that point are most likely to be as a result of natural variation and cannot be attributed to underlying causes.

In relation to serious injuries, the report sets out details on the changes in the way severity is recorded for some police forces, particularly in 2016 and 2017. Due to these changes, we cannot comment further at this stage on trends for serious injuries by road user type and have presented a high level adjustment from a methodology we are currently developing with the Office for National Statistics. Further details on the methodology change are provided on pages 3-4 (high level) and pages 31-33 (detail) of the report.

You will also want to be aware of the Road Collision Investigation Project (RCIP), which has been funded by the Department for Transport. The RCIP will be used to develop and trial, in a number of police force areas, a different approach to identifying and understanding common themes and patterns that result in death and injury on the public highway. The insight could then help shape the Government’s future policy making in this vitally important area. Further details on this project can be found at https://www.racfoundation.org/collaborations/road-collision-investigation-project
Network Rail property sale

"The accounts note the sale of a Network Rail property portfolio for £1.46 billion. What proportion of the properties were being let and what was the annual profit and yield (gross and net) that Network Rail were receiving from these properties before they were sold?"

This sale was a key element of the post-Hendy financial settlement for CP5 and ensures that increases in costs in NR’s enhancements portfolio are funded in part from sale of NR assets. The portfolio included a significant number of properties not in a lettable condition, or not let as they were being refurbished. In total, just under 75% of the estate sold was let at the time contracts were exchanged. The new owners have a business plan to invest in several hundred unlet properties, so they can make space for more local businesses. In 2017/18, Network Rail received £80.853 million in income from the commercial estate portfolio being sold. In 2017/18, Network Rail generated £63.760 million in profit from the commercial estate portfolio being sold.

"Do tenants have any legal protections against significant rent rises?"

Future discussions about rents will be between tenants and the new owners. The new owners have agreed to adopt a ‘tenants first’ approach, cemented in a tenants’ charter, which commits the new owner to engage with all tenants and communities in an open and honest manner. The charter includes initiatives such as establishing an engagement team to interact with tenants and encourage input on development proposals; committing to best practice to make prompt payments; and developing a protocol to provide financial support for SMEs. The charter also pledges to provide an improved environment for businesses to flourish, bringing several hundred currently unlettable spaces into use. The charter is included in the legal agreements with the new owner.

"What effect will the sale have on Network Rail’s operations and its ability to develop land around stations or above railway lines?"

The sites have been sold on a 150-year leasehold basis and Network Rail will retain access rights for the future maintenance and operation of the railway. The right to buy-back assets as required for future railway schemes will also be included in the Terms of the Lease, so that enhancement plans over the course of the long lease term are not impeded. The sale will not affect the safe and efficient running of the rail network, train operating companies, freight operating companies or other operational partners. In addition to this several sites that did not meet the criteria for inclusion in the sale e.g. where they support the running of the railway, are being retained by NR.

The sale does not fetter in any way NR’s ability to develop land around stations, or take forward over site development. NR is currently undertaking station development in several places such as York which involves developing under-utilised land around stations. Network Rail is also expecting to deliver land for around 10,000 new homes by 2020, and the sale will not impact on this programme.

"Within the terms of the sale has Network Rail retained any rights over the properties?"

The sites have been sold on a 150-year leasehold basis and Network Rail will retain access rights for the future maintenance and operation of the railway.

Intercity Express Trains (IEP) Loss
"The annual report notes that the delay to electrification on the Great Western line means the Department is making a loss of £42 million a year on the privately financed Intercity Express trains – paying for trains that are not ready or cannot be used. Can you provide more detail, beyond that contained in the annual report, about the reason for this loss and if these costs were factored in when the decision to delay the electrification was taken?"

Under the IEP agreements, a test track was required to be delivered by Network Rail a number of months prior to introduction of the fleet into service to enable the test of the train design on the Great Western network. The £42m payment resulted from delays to the provision of this test infrastructure by Network Rail for which the Secretary of State was liable under the contracts. The nature of the indemnity provided under the IEP agreements required the SoS to provide compensation to Agility where HMG is responsible for delay to the acceptance of units. The reasons for delays to the Great Western Electrification Programme have been subject to a number of reviews.

"Is the Department receiving a discount of any kind on its lease payments given that the trains will not have to be serviced and maintained?"

A commercial agreement was reached with Agility Trains West to cap the total number of days delay. A discount on the delay cost payable for the trains was also agreed consistent with the terms of the contract. This discount was approximately 20% of the daily set availability payment.

"The 2014 NAO report, procuring new trains, estimated that the total contract payments per carriage for the Intercity Express Great Western (IEGW) would amount to £4.1 billion (present value), amounting to £11.1 million per carriage. What do you currently estimate the contract payments for the IEGW trains will be in total and per carriage? (Please provide answers in both nominal cash terms and present value terms)."

The contract payments over the next 27.5 years have a net present value (at 2010 prices) of £3.4bn, and a nominal cash value of £12.5bn. Per carriage, this gives a net present value (at 2010 prices) of £9.2m, and a nominal cash value of £33.9m. These payment calculations have been undertaken using the NAO methodology. However, these calculations are not reflective of the financing, performance, maintenance and risk regimes priced into the programme’s underlying PFI agreement.

"How does this compare to the cost per carriage of the publicly financed Crossrail rolling stock?"

The Department does not hold details of the costs of Crossrail’s Class 345 fleet, as this was procured under a separate contract by Transport for London. However, based on available information, the Department would note that the costs of the two fleets are not directly comparable due to contrasting lease and contractual arrangements.

**Budget Announcements**

"The Chancellor announced that there will be an £500 million for local authority road maintenance in 2018-19. How do you expect local authorities to get value for money from these additional funds given they have been announced so late in the financial year? What proportion of these funds do
you expect will be used in 2019-19? If the funds are not used will local authorities be able to use them next year?”

Last winter's harsh weather took its toll on the local road network. The additional funding announced in the Budget for 2018-19 will allow highway authorities to accelerate works in their asset management plans to improve the condition of the highway network for which they are responsible. Local authorities can use funding quickly for repairs and improvements to local roads through their framework contracts and suppliers. This additional money means authorities can undertake further works to put right damage and consider new plant and machinery for tackling the problem in the future. The Department does not profile expected spend on highways maintenance by local authorities, but the funding has been provided to local authorities for use in this financial year and we expect authorities to do that.

“The Budget announced that all English Vehicle Excise Duty (VED) will be allocated for a new National Roads Fund. What is the benefit of hypothecating VED as opposed to HM Treasury providing a long-term budget settlement for roads in England?”

The Government’s roads reform programme in 2014 established the Road Investment Strategy (RIS) cycle through which the Government confirms a five-year funding settlement for the strategic road network. This approach has enabled Highways England to more efficiently plan and manage its work of operating, maintaining and enhancing the network.

The Government’s decision to go further and provide a continuing commitment to match the money raised through Vehicle Excise Duty (VED) in England to form a National Roads Fund (NRF) provides much longer-term security of funding. This means that the Department and Highways England can develop a strong strategic vision for the future of the strategic road network and a clear pipeline of schemes over multiple RIS periods, confident that the resources will be available to deliver them.

With the decision to use the NRF to cover enhancements on the most important local roads too, we are enabling sub-national transport bodies to work with local highway authorities to develop plans for their area with more certainty. By enabling a confident planning process, the NRF also provides the roads supply chain with assurance of continuing work, with clear visibility of a long-term investment plan. This allows it to plan more effectively, building skills and capacity and lowering the costs and risks to delivery. Road users also gain from this clarity, assuring them that the payment of VED corresponds to investment in the roads they use and enabling them to benefit from continuous improvement in the road network.

“How will average annual spending on roads from the new Fund compare with current levels of spending?”

The Government has made £17.58bn available for Highways England during the first Road Period (RP1), from 2015 to 2020. The funding the Government intends to make available in the second Road Period (RP2, from 2020 to 2025) is £25.3bn. However, the profile of spending in RP1 has seen a steady increase across the five years and we expect that annual expenditure in RP2 will not be significantly different from the final year of RP1. The remaining £3.5bn available through the NRF between 2020 and 2025 has been allocated to fund the Major Road Network (MRN) and large local major road schemes. The MRN does not currently exist so there is no direct comparison with current expenditure,
but £475m has been available for large local major schemes in the current spending review period.

"Will Highways England have any influence over the annual VED increases and the amount levied on different vehicles? Will Highways England be allowed to borrow against the VED revenue stream?"

HM Treasury will continue to set VED, and control the amounts levied on different vehicle types. The Department has worked closely with HM Treasury to understand the forecast income from VED and will continue to do so in future years, for example to understand how changes in the vehicle fleet may impact on total receipts. Highways England will not be able to leverage the VED revenue stream to borrow money.

"The Chancellor abolished the use of PFI and PF2 for new projects given the poor value for money and lack of genuine risk transfer in these deals. Does this mean that the Department will not use private finance to procure new trains in the future?"

The majority of rolling stock procurements are made through the franchise programme, by franchise operators. These trains are financed by the private sector who lease them to the operators for the term of their franchise.

"Were the Intercity Express Trains procured using a PFI type contract? If not what sort of contract was this and how did it differ from PFI?"

The funding arrangement used for the Intercity Express Programme (IEP) was a form of public-private partnership and represented, at the time, the best financial deal the market could support during the difficult post-2010 economic climate and represented the best value option for the taxpayer to replace a rolling stock nearing the end of its passenger service. This secured an unprecedented long-term investment commitment of £5.7bn over 27.5 years. The Department continues to work to maximise the best value from this existing contract while delivering the promised benefits to passengers as soon as possible and into the future on these key intercity routes. When DfT or its arm’s length bodies are procuring new trains, alternative structures that include private finance would be considered and evaluated alongside other forms of commercial arrangements when deciding upon the most suitable way to deliver the trains.

"Highways England were planning to finance two road projects using PF2 – this would have resulted in Highways England having to commit a significant proportion of its annual Resource DEL budget to these 25-year contracts, leaving less for other work. Will HM Treasury now be providing Highways England with additional capital funding for these projects? If not, how will these projects be financed?"

The Department remains committed to progressing the Lower Thames Crossing (LTC) and A303 at Stonehenge; we have submitted the Development Consent Order on A303 and the LTC is being consulted on. The business cases will be considered in 2019 as planned and the Department is working with HM Treasury to determine the funding route for these schemes as part of this process, but my Department’s expectation is that public funding will need to be agreed as part of the Spending Review.

I hope that you find this response helpful. If you require any further clarification on any of the answers to your questions, please let me know.
Yours sincerely,

Bernadette Kelly CB
Permanent Secretary