From the Permanent Secretary
Bernadette Kelly

Great Minster House
33 Horseferry Road
LONDON
SW1P 4DR

[redacted]

Web Site: www.gov.uk/dft

Department for Transport

Lilian Greenwood MP
Chair of the Committee
Transport Select Committee
House of Commons
London
SW1A 0AA

October 2018

Dear Chair,

I am writing in response to your letter of 13 July 2018 setting out a number of questions on the Department for Transport's Supplementary Estimate and memorandum of 2017-18, and on our Main Estimate and memorandum of 2018-19.

The material below provides further clarification on each of the points that you raised, in turn.

<u>2017-18 Supplementary Estimate and memorandum</u>

<u>National Productivity Investment Fund (NPIF)</u>

1. ***All the planned NPIF (National Productivity Investment Fund) Transport 2017-18 spending was removed as part of the Supplementary Estimate, including £210 million for local roads and £95 million for Strategic Road pinch points. Why was this decision taken and what will be the impact?***

1.1 Following agreement with HM Treasury, NPIF expenditure is no longer being reported separately and is instead being incorporated in relevant pre-existing Estimate lines instead. The change is therefore presentational only; there is no subsequent impact. NPIF spending on local roads and Strategic Roads has not ceased.

1.2 For local roads, NPIF is focused on relieving congestion and providing important upgrades to ensure our roads are fit for the future. The initial element of NPIF was allocated to Local Highway Authorities in England outside London by formula distribution in 2017-18. Of the £210m, £185m was issued in April 2017 so that works could begin quickly. £25m was targeted through the Safer Roads Fund for England's most dangerous local roads where the risk of fatal and serious collisions is greatest.

1.3 The Spring 2017 Budget announced further NPIF funding to local authorities in England for local transport networks from 2018-19 onwards. A competition was launched in spring 2017 in which 63 local highway authorities were successful in bidding for a share of funding for 2018-19 and 2019-20. In October 2017, DfT announced 76 winning projects that were awarded £244m funding. In total, with local and developer contributions, the projects are worth around £400m.

1.4 On the strategic road network £220m of NPIF is for a congestion relief programme and to improve safety at key pinch points between 2017-18 and 2019-20

Digital Signalling strategy

2. The Supplementary Estimates show spending of £212.5 million on digital signalling had been brought forward and spent in 2017-18. Was a digital signalling strategy prepared before this money was spent? Could you please provide some more detail of what this money was spent on in 2017-18?

2.1 The funding comes under the NPIF £450m allocated in the 2016 Autumn Budget for acceleration of the existing Digital Railway Programme. The Department worked closely with Network Rail to identify the most suitable schemes to take forward. The schemes were selected according to several criteria which aligned closely with the emerging Digital Railway Strategy at the time including value for money, affordability and short delivery timeframes so as to provide lessons in time for subsequent schemes in the near future. We also selected schemes which included a range of digital railway technologies and geographies.

2.2 This approach is consistent with the recently published Digital Railway Strategy, which was also developed in parallel and published in May (available on Network Rail's website). The Strategy sets out how – subject to further funding – the national programme will build on the investments currently being made with the NPIF budget and those which were made beforehand. The current investments will demonstrate the costs and benefits of digital railway technologies in a range of circumstances in the UK, provide valuable lessons, and maintain the momentum in the supply chain which previous investments have generated.

2.3 Of the £212.5m, £190m was diverted from the NPIF allocation for digital to general Network Rail budgets. This was to ensure continuity of funding for committed Network Rail activity in the light of new information about the value and accounting treatment of planned Network Rail asset sales. This approach was agreed with the Chancellor of the Exchequer in March 2017 and was sensible reprofiling given the Digital projects at the time were at too early a stage to require significant levels of funding in 2017-18. The £190m will be re-instated to the digital programme in the upcoming 2019-2024 Network Rail control period.

2.4 The remaining £22.5m in the Supplementary Estimates was the amount we had forecast for the development of the selected schemes in 2017-18 from NPIF. These forecasts have been reprofiled since then to reflect the updated cost profiles for those schemes, most of which are currently in various stages of the development and design phases. Actual spend in 2017-18 from the NPIF budget was £4.3m with the remainder of the £450m fund to be spent accelerating digital signalling between now and 2022.

Preparations for leaving the EU

3. The Supplementary Estimates memorandum states that the Department received an additional £5.6m for work to support leaving the EU - what was this money spent on in 2017-18?

3.1 In January 2018, Department's bid for use of HM Treasury's reserves related to Brexit preparation was £5.6 million (as set out in the Supplementary Estimates) including £2.5 million for admin and legal costs, £1.0 million for driving permits (reflecting the Department's decision to change its planned approach from a digital to a paper based system), £0.1m on trailer registration scheme and an additional £2 million for the Driver and Vehicle Standards Agency's (DVSA's) new road haulage scheme (paragraph 1.9 in the following link: https://www.nao.org.uk/wp-content/uploads/2018/07/Implementing-the-UKs-Exit-from-the-European-Union.pdf).

3.2 By 31 March 2018, the Department had spent £3.1 million of this funding. This included £0.6 million for work on the road haulage scheme and £43,000 for work on trailer registration, with the remaining (circa £2.5 million) on admin and legal costs.

Non-Cash Costs:

4 Depreciation of Highways England roads is £100m higher than had been expected. To what extent, if any, does the increased level of depreciation reflect lack of sufficient maintenance spending on the roads?

4.1 The increase in the level of depreciation on the Highways England (HE) network is not due to a lack of maintenance spending. HE has a 5-year funding settlement with a maintenance and renewals budget of c. £1bn per year across Resource and Capital combined. This excludes maintenance and renewals activity on the network delivered under PFI contracts, which is funded separately.

4.2 It is often difficult to predict the overall non- cash requirement due to several factors such as the level of inflation, the in-year profile of capital investment made in the HE network, the volume of traffic and the condition of the road surface (which can be influenced by factors such as extreme weather events). HE also undertakes assessments of the network throughout the year and the results of a final assessment are not be available until January, which is too late for incorporation into our Supplementary Estimate assumptions, although HE does adjust its future year depreciation forecast to take this into account separately.

4.3 Further information on the Departments Depreciation methodology can be found in our 2017/18 Annual Report & Accounts on page 228, using the following link: https://www.gov.uk/government/publications/dft-annual-report-and-accounts-2017-to-2018

5 Property purchased by HS2 has lost £75 million in value - can you please provide more detail about this property and the reason for the write down in 2017-18?

5.1 Properties held in inventories have been revalued to the lower of cost and net realisable value as per IAS 2.

5.2 IAS 2 provides guidance for determining the cost of inventories and the subsequent recognition of the cost as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories. Inventories are measured at the lower of cost and net realisable value.

Higher spending on contract administration

6 RDEL spending on central administration has increased significantly compared to the 2017-18 Main Estimate. The memorandum Annex shows that the main driver for this was a four-fold increase for spending on commercial contracts of £61.8 million (from £14.4m to £76.2m). Can you provide some more information on the reason for this increase and how this money was spent?

6.1 The increase relates to the £75m of non-cash budget, requested at the Supplementary Estimate to cover a write down on HS2 property. It therefore does not represent additional cash spending. The budget is allocated to Corporate Property (under Central Administration, outside of the department's High Speed Rail group) as this departmental business area has an oversight function regarding the Inventory and is working with the Valuation Office Agency on the matter.

Rail investment

7 Network Rail capital investment is set to fall by over £1 billion compared to 2017-18, while HS2 capital investment is increasing by a similar amount. As HS2 receives more resources, is there an expectation from the Department and HM Treasury that Network Rail will have to cut back its spending?

7.1 HS2's budgets for all years up to 2020-21 were set at the 2015 Spending Review. Network Rail's budgets for the five years to 2018/19 were initially set via the ORR-led Periodic Review for Control Period 5 (link: http://orr.gov.uk/rail/economic-regulation/regulation-of-network-rail/price-controls/periodic-review-2013/pr13-guide) although they have been amended since, most notably via the Hendy Review of enhancement plans which took place alongside the 2015 Spending Review.

7.2 Both NR and HS2 Ltd currently have considerable flexibility to adjust their annual profile of spending within a multi-year envelope, recognising the uncertain timing of spending on large-scale infrastructure schemes. Moreover, both organisations' current budgets are effectively ringfenced – there is no requirement that increased spending in one organisation to be offset by reduced spending in the other.

7.3 The HS2 Ltd increase was a presentational change only, as HS2 Ltd's budgets were shown separately for the first time in 2017-18. Prior to this these budgets were part of the Funding for Other ALB's (net) estimate line.

8 Network Rail is planning to sell off commercial property in 2018-19 - how much is this expected to raise and how has this been factored into its budgets this year?

- ***While it will provide Network Rail with cash in the short-term is there any long- term benefit for Network Rail? How can it be good value for money for the taxpayer to sell off an asset which provides a yield in excess of the cost of government borrowing?***

- ***Will the sale constrain future for the development of stations in any way?***

8.1 Network Rail has now agreed terms with Telereal Trillium and Blackstone Property Partners for the sale of its commercial estate portfolio. Proceeds from the £1.46 billion transaction will help fund the railway upgrade plan, bringing major improvements for passengers and reducing the need for taxpayers to fund the railway.

8.2 The buyer has been through a competitive auction process designed to maximise the price achieved for the business and it is this process that ensures Network Rail achieves value-for-money through the sale.

8.3 There has been extensive consultation with Network Rail's routes management to ensure that any assets included within the sale perimeter are not needed for operations (station or otherwise). Sites required for immediate or near future committed projects have been retained by Network Rail, both at stations and over the network. The consultation also sought to minimise conflict around major stations by transferring the management of specific assets out of the sale and into the property retail team. If Network Rail did require any as yet unidentified assets for future projects, it will have the right in the leasehold agreement with the buyer to repurchase these at fair value.

8.4 NR's funding settlement for Control Period 6 (covering 2019-2024) are being set via the ORR's Periodic Review process, which is now nearing its conclusion. The supporting financial assumptions recognised that a substantial part of the commercial estate was being sold and that in Control Period 6 NR would no longer have access to the revenue stream that these assets generated. NR's forward funding settlement therefore takes account of this issue and the sale will not cause a funding shortfall to NR.

<u>Rail Passenger revenues</u>

9 What will be the impact of the failure of the East Coast franchise on the Department for Transport budget for 2018-19? How will the Department fill any gap between actual revenues now likely to be received and revenues under the terms of the original Stagecoach/Virgin contract?

- ***If the Department had allowed Stagecoach/Virgin to run the franchise on a not- for-profit basis what would have the impact on its budget been?***

9.1 For franchise agreements, DfT requires all franchisees to provide a Performance Bond which in this case acted as a guarantee for the costs of early termination of the VTEC contracts.

9.2 The East Coast franchise continues to deliver revenue and provide premiums for government. LNER is being run on commercial lines using the former VTEC executive team which will support the level of premiums received. With the development of the East Coast Partnership at a very early stage, we expect the integration of track and train to provide additional benefit to both passengers and taxpayers.

9.3 The published Options Report, which compared the OLR approach taken to the Stagecoach/Virgin option included an assessment of value for money. The value for money assessment gave an estimated difference between the OLR and the Stagecoach / Virgin option ranging from £13m positive (in favour of OLR) to £19m negative (against OLR). This reflects the real uncertainties involved, which could lead to a range of outcomes. For wider value for money factors the assessment was broadly balanced, with some factors favouring VTEC and some favouring OLR.

9.4 The department continues to manage its budgets prudently and flexibly in 2018/19 to ensure that pressures are addressed.

10 Rail passenger revenues are down from previous forecasts - what is the Department spending less on to offset this lower than expected income?

- **_What are the factors driving lower passenger numbers and revenue?_**

- **_Do lower than expected passenger forecast have any impact on the cost-benefit analysis for HS2?_**

10.2 Growth in total rail passenger revenue has remained consistently positive ever since the 2008-09 financial crisis – in absolute terms revenues have not fallen. However, the rate of growth in rail passenger revenue has fallen in the last two to three years and has been lower than was assumed in DfT's budgets from the 2015 Spending Review. This has had financial consequences for the department.

10.3 The department is keeping its spending plans and income forecasts under regular review to manage these consequences. Ministers receive frequent briefings on our financial position. We are also working closely with HM Treasury, whose Ministers have confirmed that the 'risk transfer mechanism' for rail revenues – agreed between the departments at the 2015 Spending Review – will hold. This mechanism provides the department with additional budget where there is a shortfall in rail revenues due to developments in the wider economy, and is contributing to our management of this issue.

10.4 Work is ongoing to understand more fully the underlying causes of this passenger revenue trend and to improve forecasts for the future. This is a complex area and there is not one single dominant explanation. However, the factors driving lower rates of passenger revenue growth include:

- Road vehicle costs have been falling over the last few years (notably as cars have become more efficient) making car and coach journeys relatively more attractive compared to rail journeys.
- Income growth throughout the economy has been relatively weak by historic standards and the trend of GDP growth has been lower than

forecast by the OBR at the time of the 2015 Spending Review which set DfT budgets.

- There has been some passenger demand reaction to service reliability problems on some parts of the network.
- Changing working patterns, supported by improved technology, appear to have led to some rail commuters working certain days from home where they would previously have commuted throughout the working week. This trend may be partly influenced by relatively cheaper daily tickets in London.
- External factors have not played out as forecast – in particular a large decrease in petrol prices which was not predicted has resulted in increased competition from car and long-distance coach. Fuel costs fell by 41% between 2014 and 2017 when they were forecast to increase by 2%. The East Coast operator is one of the rail businesses which is most exposed to travel choices in the business and leisure markets, as it has a very low proportion its revenue from season ticket holders compared to most other operators

10.5 Over the last two decades long-distance rail demand (number of passenger journeys) has grown at an annual average rate of around 4.5%. Our current background forecast for long distance rail demand in a scenario without HS2 is relatively conservative by comparison at 1.9% per annum to 2037.

These long-term averages mask shorter-term volatility. Since 2010-11 annual growth rates for the franchised long-distance market have ranged between 1% to 6%, therefore it may be unwise to read too much into a single year-on-year change or even short-term trends over a few years.

The capacity, improved journey times and increased connectivity that HS2 will provide could catalyse a significant increase in long distance rail use. However, the demand forecasts used in our economic appraisal are well below the historic growth rate in long distance rail demand observed over the last 20 years.

<u>Local Authority Roads</u>

11 Funding for local authority road maintenance and investment is declining, capital funding is down over 20% compared to the prior year. Given that we have had such a cold winter and according to the AA problems from potholes are up significantly compared with the prior year, why are budgets reducing?

11.1 Local authority road maintenance budgets have been the subject of some re-profiling over the Spending Review period, including accelerating an element of funding to help authorities repair damage to the roads and other local highway infrastructure assets for which they are responsible. However, the overall total amount they are receiving for road maintenance over the years covered by the 2015 Spending Review

(2016-17 to 2020-21) has not changed. Indeed since 2015/16, Ministers have increased the Department for Transport's funding to Highway Authorities by introducing a Pothole Action Fund which totals £296 million, as well as allocating funding to help Authorities protect their roads against severe weather, such as flooding.

11.2 Therefore, in total the Department for Transport is providing Local highway authorities in England, outside London, with £6.2 billion between 2015/16 and 2020/21 which is an increase of 6% compared to what was originally announced in 2015.

11.3 The Committee will also wish to note that a number of authorities have agreed to undertake a Business Rate Retention trial which means they now receive Highways Maintenance funding via retention of this locally-raised revenue, instead of a capital grant from DfT. This trial affects both the 2017/18 and 2018/19 financial years. It was designed to be fiscally neutral, so should not create any adverse impact to the authorities in question and should not reduce the funding they have available for Highways Maintenance. However, as there is no longer a grant payment from DfT for this purpose, the department's planned expenditure reduces.

PPPs (Public Private Partnerships)

12 Highways England are considering using the PF2 private finance model (the successor of PFI and form of PPP) to finance sections of two major road projects. How much private finance does it estimate will need to be raised for these projects?

- ***What evidence does Highways England have that past PPP deals (e.g. M25 orbital) have offered, or are offering value for money for the taxpayer?***
- ***What benefits do you expect from PF2 which will offset the higher private financing costs?***
- ***How much of Highways England annual cash budget is currently spent on PFI unitary charges and what will this figure increase to if these two projects go ahead as PPPs?***

12.1 Highways Agency, the predecessor organisation to Highways England, awarded 3 PPP contracts in the last 15 years: the M25 (2009), Darrington to Dishforth (2003) and A249 Iwade (2004).

The Highways Agency undertook a value for money analysis on each of these projects prior to contract award and compared the cost estimate to a publicly financed alternative. Along with a qualitative analysis, at the time, these demonstrated value for money.

Post-contract award, each of these 3 projects completed construction in line with the requirements of the contract and are performing as intended.

12.2 Highways England's Value for Money analysis for the A303 Amesbury to Berwick Down and Lower Thames Crossing link roads identified that the main benefits relating to the use of PF2 are:

- The greater level of risk transfer and innovation in a complex engineering environment that are expected to lead to a reduced risk-adjusted capital cost and quicker construction phase;
- A greater focus on whole life costs, which is expected to reduce both the maintenance costs and interventions. This should allow for a better service to road users;
- Potential for better contract management and control of risks; and
- Greater cost certainty.

In addition, spreading the cost over the 25-year operating period means that overall there may be more capital available to spend on road improvement projects in the near term, and the economic benefits associated with the improvements could be realised earlier than may otherwise have been the case.

12.3 In 2017-18 Highways England spent £442m on PFI unitary charges.

The payment mechanisms of each PFI contract differ but generally there are annual uplifts for inflation and uplifts for traffic volume increases where relevant. Some contracts also have sculpted payment profiles.

The annual unitary charges on the two new PF2 contracts are estimated to be between £120m and £130m for A303 starting in 2026-27 and between £160m and £170m for Lower Thames Crossing link roads, starting in 2027-28. It is also worth noting in this context that user charges are expected to be operated on the Lower Thames Crossing tunnel scheme which, whilst separate from the privately financed link roads, will generate an additional income to Highways England.

13 In March 2018 the Secretary of State announced plans for the potential use of private finance for a new southern rail link to Heathrow - will this be a PF2 contract?

- ***How much private investment does the Department expect to obtain and who will repay this investment (taxpayers or passengers)?***

13.1 Although work on this is at an early stage, the Department is currently undertaking market-sounding engagement for the proposed Southern

Rail Link to Heathrow (SRLtH), to explore options to bring this opportunity forward through private sector involvement.

13.2 The route could be sufficiently commercially viable and as such no government funding would be required. It is also possible that a blend of public and private funding may be needed or a combination of the two so the private firm/consortium may bring forward capital, but not design or build the scheme. All options are currently being looked at to ensure best value for money and, through the market-sounding process, we want to understand the level of involvement we can expect from private firms, and their appetite for taking risk on this type of project from an early development stage.

This is just the first step in the development of SRLtH and will inform the further work required before any decision on how this scheme will be progressed. The intention is to publish a summary report in the Autumn, followed by further work to develop advice on options for how to take this forward.

14. In his statement on the East Coast Main Line in May, the Secretary of State said that the Department will be preparing for a new public private partnership on the line. What do the plans for increased use of private finance entail and how will this affect the Department for Transport's budgets in future?

- ***What does the Department consider to be the main risks and benefits of this approach?***

14.1 The Secretary of State has made clear that he wants a new public and private partnership on the East Coast Mainline that will transform services in a sustainable way with reliable and high-quality rail services for passengers.

The plans will be for a public-private partnership but in a different form than has taken place up to now. An example of what it would entail would be bringing in private capital to invest in digital signalling as part of the partnership, and an employee stake in the business.

The Partnership will evolve over time to develop proposals that will support the achievement of its objective of delivering a good service at an affordable cost to passengers and value for money for the taxpayer.

Any proposals would, where required, be subject to a full analysis and a business case, including of the financial impacts once the preferred model has been identified.

14.2 The East Coast Partnership is the first of a new generation of long-term regional partnerships building on the best of the public and private sectors, with private sector involvement bringing innovation and investment.

The Partnership will bring together the operation of track and train under a single leader and a unified brand. This will make it easier to meet the challenges today's network faces as both the infrastructure manager and train operator would work together with a shared vision.

The Partnership will evolve over time and develop proposals that will support the achievement of its objectives. The proposals will be subject, where required, to a full analysis and business case, including an assessment of the main risks and benefits.

Yours sincerely,

Bernadette Kelly CB
Permanent Secretary