Dear Lilian,

2018-19 Supplementary Estimate and memorandum

I am writing in response to your letter of 29 March 2019 setting out a number of questions on the Department for Transport’s Supplementary Estimate and memorandum of 2018-19. The material below provides further clarification on each of the points that you raised, in turn.

Preparations for leaving the EU

Please note that we have provided one overall response to your questions 1 and 6.

1. The Department received EU Exit preparation funding of £80.6 million in 2018-19 (£41.6m Resource DEL and £39 million Capital DEL). Can you tell us how much of this has been spent and what is has been spent on? Has the full amount been allocated?

1.1 As the 2018-19 financial year has now concluded, we expect our total out-turn on EU Exit preparations to be £109m, although this may alter slightly as we finalise our year-end position. This has funded essential EU Exit preparations for Trailer Registration, Road Haulage Permits, International Driving Permits, DVSA Enforcement, development of alternative systems to the European Maritime Safety Agency’s systems, Civil Aviation Authority, maritime freight capacity, Kent County Council grants, additional admin, legal and communication resource and other EU Exit resilience work. It also includes the £33m settlement with Eurotunnel.

1.2 The table below shows the Department’s EU Exit spending in 2018-19:

<table>
<thead>
<tr>
<th>Area of spend</th>
<th>2018-19 Spend (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration and legal costs</td>
<td>9.5</td>
</tr>
<tr>
<td>Civil Aviation Authority</td>
<td>2.7</td>
</tr>
<tr>
<td>Communications campaigns</td>
<td>1.13</td>
</tr>
<tr>
<td>DVLA (International Driver Permits, Trailer Registrations and other)</td>
<td>12.5</td>
</tr>
<tr>
<td>DVSA (Enforcement, Road Haulage Permits and other)</td>
<td>6.8</td>
</tr>
<tr>
<td>Kent County Council grants</td>
<td>33.48</td>
</tr>
<tr>
<td>Marine Accident Investigation Branch</td>
<td>0.6</td>
</tr>
<tr>
<td>Maritime and Coastguard Agency</td>
<td>0.71</td>
</tr>
<tr>
<td>Maritime Freight Capacity</td>
<td>4.94</td>
</tr>
<tr>
<td>EU Exit Resilience</td>
<td>2.32</td>
</tr>
<tr>
<td>Vehicle Certification Agency</td>
<td>0.8</td>
</tr>
<tr>
<td>Eurotunnel</td>
<td>33.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>108.48</strong></td>
</tr>
</tbody>
</table>

1.3 In addition, Highways England has committed £30m across 2018-19 and 2019-20 for Operation Brock.

2. **Which pot did the £108m for ‘no deal’ Brexit Channel freight capacity and the £33m to Eurotunnel come from? The Secretary of State’s letter stated that the £33m for Eurotunnel will be classified as ‘part of its Brexit related funding for the 2018-19 financial year’. We further note the statement that DfT has £36.4m allocated to prepare for a ‘no deal’. Is the £33m being paid from the ‘no-deal’ pot? If not, where is the money from?**

2.1 The decision to settle with Eurotunnel reflects a collective Government decision. As the Secretary of State’s letter notes, the precise mechanics are currently a matter for discussion within Government as part of no-deal planning, but DfT will classify this settlement as part of its Brexit-related costs for the 2018-19 financial year. The settlement was agreed at the end of February, so was not part of the funding which was confirmed in the Supplementary Estimate. As this payment for cross-Government capabilities occurred too late to be considered in the Supplementary Estimate, we have agreed with HMT that it will be met from within in-year Departmental underspend.

2.2 The £108m for maritime freight has now been reduced to £88.7m mostly due to the termination of the Seaborne Freight contract. Some of these costs were incurred in 2018-19 (please refer to table above), but the majority relate to the purchase of additional capacity which falls into and will be accounted for in the 2019-20 financial year.

2.3 The £36.4m previously allocated for ‘no-deal’ planning is part of the overall funding provided by HM Treasury and this has increased to £41m as our preparations have developed. As we further our preparations for EU Exit, we may allocate additional resources for no deal contingencies.

**Income from Passenger Rail Services**

3. **Income from passenger rail services has been adjusted down by £370.5 million since the Main Estimate – the Support for Passenger Rail Services budget line does not now provide any net income for the Department.**

   a. **Could you provide a comparison between the Support for Passenger Services budget line forecast at the time of the Spending Review 2015 and the actual outturn for the years 2015-16 to 2018-19?**

   b. **What proportions of the adjustment was made because of (i) lower passenger revenues and (ii) higher than expected costs, respectively?**
c. How closely did outturn in rail demand match National Transport Model (NTM) predictions in each of the last five years and what adjustments, if any, have you made to the model?

3.1 The table below provides a comparison between the SPRS plans at the time of Spending Review 2015 and the actual outturn for the years 2016-17 to 2017-18. SR15 covered the financial years from 2016-17 onwards. Hence, I have not included figures for 2015-16, which were set as part of Spending Review 2013. The estimated outturn for 2018-19 is £167m, although this may alter slightly as we finalise our year-end position.

<table>
<thead>
<tr>
<th>Spending Review 2015</th>
<th>2016-17</th>
<th>2017-18</th>
<th>2018-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPRS Outturn</td>
<td>1.28</td>
<td>0.72</td>
<td>0.167</td>
</tr>
</tbody>
</table>

3.2 In 2016-17, the Department’s outturn was broadly in line with the Spending Review plan for that year. Thereafter, the movement is largely due to changes in the level of growth in passenger numbers, which has been weaker than the Government assumed when setting its Spending Review plans. However, it is difficult to provide an accurate apportionment between this and higher than expected costs. My letter to you on the 9th January 2019, in response to your questions regarding the 2017-18 annual accounts, provides a comprehensive explanation of the various factors that contribute to lower net income.

3.3 The Department’s forecasts of rail demand are not produced by the National Transport Model. Instead, we use an elasticity-based forecast described in our published guidance (WebTAG unit M4.8 https://www.gov.uk/government/publications/webtag-tag-unit-m4-forecasting-and-uncertainty-may-2018), which has been developed and used by both government and the rail industry over a number of years. This approach has been refined and updated regularly over the last five years. Most significantly we have incorporated the findings of the Rail Demand Forecasting Estimation study (https://www.gov.uk/government/publications/rail-demand-forecasting-estimation-study-phase-reports). This improved our forecasts by taking into account trends in the mix of the types of jobs people have (as people in certain jobs are more likely to use the train than others) in addition to improving how the traditional variables such as economic output, population and employment are used. The Department keeps its rail demand forecasting methodology constantly under review, working closely with the industry’s Passenger Demand Forecasting Council (https://www.raildeliverygroup.com/pdfc.html) which is a group made up of Train Operating Companies, Network Rail, devolved bodies and DfT.

**HS2**

4. For some time, HMRC has been reviewing HS2 Ltd’s ability to recover VAT incurred on construction activity. The memorandum notes that HS2 requires an extra £650 million to cover a potential liability to repay reclaimed VAT. This issues also affected the 2017-18 accounts.
a. What exactly is the dispute between HS2 and HMRC? What has it been going on for so long and when will it be resolved?
b. Have DfT or HS2 spent any money on getting legal or tax advice on this dispute? If so, how much has been spent?

4.1 HS2 Ltd has been registered for VAT since April 2014 and under normal VAT rules is able to recover VAT on its costs to the extent that it will use these costs to make taxable supplies in the future. Since April 2014, the company has recovered VAT it has incurred on the basis that it intends to operate as an infrastructure manager in the future. The Spending Review 2015 settlement and long-term funding envelope assumed full VAT recovery on this basis, therefore no budget was in place to cover any VAT costs.

4.2 HMRC launched a review of HS2 Ltd’s VAT recovery position in 2016 and we expect a judgment imminently.

4.3 HMRC have questioned whether the VAT incurred on track construction has a direct and immediate link to the future taxable supplies. They contend that this should not be recoverable under VAT recovery rules. Following initial discussions, HMRC invited HS2 Ltd to prepare a full case file for submission and this was completed in August 2018.

4.4 The NAO made it clear in their 2013 report on HS2 that VAT is an internal transfer within Government, so any change to HS2 Ltd’s VAT status would not change the cost of delivering HS2.

4.5 HS2 Ltd is not able to disaggregate internal costs related to dealing with this issue. The company has spent £118,543.69 on external advice relating to its intention to operate as an infrastructure manager in the future.

5 The Supplementary Estimates provide an extra £100m budget cover for HS2 in relation to non-cash inventory. Can you provide further detail on what this relates to?

5.1 The Department requested an additional £100m of non-cash budget cover in the Supplementary Estimate for land and property acquired under the following HS2 property compensation schemes: Need to Sell, Rural Support Zone, Exceptional Hardship and Statutory Blight Phase 2B. This is classified in the Department’s accounts as inventory.

5.2 The Department follows International Accounting Standard 2 for the valuation of inventories which means that the inventory portfolio will be revalued to the lower of cost and net realisable value at the balance sheet date. Any write down to net realisable value will be recognised as a non-cash expense.

Network Rail

6 From 2018-19 Network Rail spending will be included in the DEL budgets rather than the AME budgets.

a. Why were Network Rail budgets previously included in AME and what has prompted the change now?

b. What practical difference will this make to Network Rail? For example, will Network Rail find it more difficult to move budgets between years if investment plans are brought forward or delayed?
6.1 Network Rail was re-classified as a central government body during Control Period 5 (from 1 April 2013 to 31 March 2019) and the associated plans, budgets, forecasts and risk profiles were formulated prior to the re-classification. To implement a financial control framework which was aligned with other arm’s length bodies, but which was more constraining on Network Rail’s financial freedoms, would have been inconsistent with the funding settlement for that Control Period.

6.2 This position was reviewed with HM Treasury as part of the planning for Control Period 6 (CP6) with a view to aligning Network Rail with other ALBs. The planning and analysis period for agreeing and setting the Statement of Funds Available (SoFA) for CP6 has taken over two years. The additional constraints on Network Rail regarding financial management and reporting under the DEL regime (compared to working under the AME regime in CP5) have been fully considered and are reflected in their Business Plans.

6.3 Under the DEL regime Network Rail will be subject to central Government financial budgeting and reporting rules, for example:

6.3.1 Less freedom to move planned spend between major categories of expenditure, for example Network Rail now has less freedom to divert money onto unplanned track maintenance when originally that money might have been planned to be spent on longer-term capital investment; and

6.3.2 Less freedom to defer or accelerate spend between financial years. HM Treasury have however agreed budget flexibilities to help Network Rail manage this.

6.3.3 Network Rail will need to consider how to manage their projects to live within their budget each year. The Rail Network Enhancements Programme sits alongside this new financial framework and will provide a control structure over project and portfolio funding and review.

6.4 These constraints have been considered in detail and mitigations such as risk and contingency planning have been built into the 5-year plan for CP6 meaning that Network Rail are well prepared for this significant change in financial management and control.

Yours sincerely,

[Signature]

Bernadette Kelly CB
Permanent Secretary