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Secretary of State
Department for Transport
Great Minster House
33 Horseferry Road
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Dear Secretary of State

BROWN REVIEW OF FRANCHISING

When Richard Price and I met with you on 5 November, we explained why train franchising is critically important to the performance and efficiency of the railway as a whole. We promised to send you a copy of the advice we have sent to Richard Brown, which is attached.

Richard Brown's review and the granting of future franchises is an opportunity to drive significant efficiencies across the whole railway sector. This is in the interest of passengers and taxpayers and is consistent with Government policy as set out in the March Command paper, which called for whole industry working to reduce costs and improve service for customers.

We are bearing down on Network Rail's efficiency, recognising the challenge set by the McNulty Rail Value for Money (RVfM) Study, and will be setting NR a challenging efficiency target for CP5. However the RVfM Study asserted that Network Rail cannot achieve these savings alone and that TOCs have a significant role to play. The RVfM Study stated that, compared to 2008/09, GB rail should aim for a 30% reduction in unit costs by 2018/19. Approximately 30% of these costs (around £1 billion) need to come from TOCs, or from TOCs and Network Rail working together. However, the incentives that TOCs currently have to work together with Network Rail to achieve efficiency savings are weak. For example Network Rail is in receipt of £4bn a year of taxpayer's money through the network grant. This covers a large part of the costs of the infrastructure that TOCs use, and so TOCs are currently insulated from the true costs of using the network.

We need to incentivise TOCs to behave differently and to work with Network Rail to find efficiencies and manage down the costs that they currently impose on the network. This involves putting the industry on a more commercial footing through a move towards more cost reflective charging, and exposing franchised train operators to more of Network Rail's costs through its charges.

To achieve this requires changes in the new TOC franchise agreements. The Brown review, and your subsequent re-letting of franchises, provides the opportunity for this. If TOCs are to work with Network Rail to achieve the efficiencies which will reduce the size of the subsidy to Network Rail, this will require:

- **franchise specifications that are sufficiently flexible,** to allow and encourage TOCs to make innovations that result in efficiency savings during the lifetime of a franchise, not only when the franchise is let. This is particularly important if franchises are to be longer.

- **a franchise change mechanism to allow for changes to franchises** to deal with beneficial changes to specifications during the franchise term. This should be transparent and predictable. There may be a role for independent regulation.

- **TOCs to retain the benefits of savings achieved through route-level efficiency benefit sharing (RBES) and alliance arrangements in CP5.** This will encourage Network Rail and TOCs to work together to identify further savings by allowing TOCs to keep some of these savings. We believe it is collaboration at the route level that is likely to achieve such savings. The current franchises do not allow such benefit sharing.

- **TOCs to have an interest in the cost of the infrastructure that they use so that they are incentivised to help improve its efficiency. This means they should not be held neutral to changes in the access charges they pay** (as they are under the current franchises). TOCs should increasingly expect to meet the true costs of the infrastructure that they use (rather than funding in respect of those costs being channelled directly from government to NR, bypassing the commercial relationship between NR and TOCs). Our experience is that where TOCs are exposed to costs, e.g. their use of traction electricity on the network, they act to reduce such costs. We recognise that moving towards more cost reflective charges for TOCs would need to be implemented in stages so as not to create additional risk for taxpayers through reduction in franchise premiums.

Our preferred method of funding Network Rail is for the bulk of its income to come from TOCs and other customers. If subsidies for the use of the network continue to be required, these could be given directly to TOCs. This would have the advantage of making the government's financial support for rail more transparent and more clearly related to the specific services it is buying.

More cost reflective charges will also send better signals to TOCs on the efficient use of the network and this is crucial in driving further industry cost reductions. Again, we recognise that this change of approach would need to be phased in. We will discuss with your officials the options and scope for change.

While these are not new issues, the franchising review is a rare opportunity to make changes which could help to drive further efficiencies across the whole industry, and offer real value for money gains across the totality of your rail budget, rather than looking only for improvements from franchising in isolation.

I know that Richard Brown is considering these messages as part of his review, and hope that you will be able to seize the opportunity for change in your franchising decisions once he has reported. We are of course at your disposal if you wish to discuss these matters further.

I am copying this letter to the Minister of State for Transport, the Parliamentary Under Secretary of State for Transport, the Chief Secretary of the Treasury and Philip Rutnam and Steve Gooding at DfT.

Yours
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