Dear Sam,

HS1 Control Period 3 Review
Redline Report Review Headlines

Background
The Department for Transport (DfT) has requested GHD provide a high level summary of key changes that High Speed One Ltd (HS1) have made to their 31 May 2019 Stations Long Term Charge (LTC) Review for Control Period 3 document (the May Submission), since issue of the Stations Long Term Charge Review for Control Period 3 Draft for Consultation (Draft for Consultation) on 28 February 2019.

Our letter serves to highlight key changes between the two LTC Review for Control Period 3 documents as a precursor to the assurance planned, once supporting documentation has been made available by HS1 in support of their May Submission.

Limitations
GHD has utilised the redline May Submission document issued by HS1 as the basis for identifying key changes. GHD has not undertaken a separate comparison of the changes between the two documents.

Supporting documentation was not submitted by HS1 with the May Submission; when this supporting documentation is received it will be considered by GHD in the Phase Three Report together with the May Submission document.

Renewals activities and costs
Figure 9 in the May Submission has updated PR14 and PR19 costs for CP3 to CP10. We note that there have been significant changes to the figures:

- between control periods (i.e. movement of costs from one period to another); and
- to the total workbank for both the PR14 and PR19 figures (which have both reduced by circa £350m over CP3 – CP10)

The two versions of Figure 9 are outlined below to highlight the comparison. It should be noted that the scale differs between the figures, as does the colour coding and pricing indices used, creating confusion in undertaking the comparisons and introducing concerns that the information provided is incorrect:
Draft for Consultation document:

May Submission document:
**CP3 Forecast Costs**

Comparison of Section 9.4 of both documents shows that the CP3 forecast costs have reduced between the submissions by £0.5m, dropping from £18.8m to £18.3m. It has not been clearly stated why this forecast has reduced, however we note the index used has adjusted from February 2018 prices to 2018/19 prices. Removal of the 0.6% efficiency overlay and change to lifts and escalators remain stated as the key causes of the increase in costs from CP2.

**Long Term Charges**

A comparison of the movement between the CP3 LTC from the Draft for Consultation to the May Submission suggests that there are changes other than the addition of the contingency and risk provisions; identified in Table 19 of the Draft for Consultation and Table 21 of the May Submission.

After accounting for the efficiency overlay removal and applying the contingency and risk factors stated to the CP3 LTC figures from February, there remains circa £1m of difference between that calculation and the CP3 LTC in May. The reasons for the difference are unclear, for example, HS1 may have updated the LCC models between the two most recent versions. However, GHD has not been able to interrogate the LCC/LTC models that support the May Submission, and as such, are unable to comment further.

**Contingency and Risk**

In the May Submission, HS1 have included provision for contingency and risk (there was no such provision in the Draft for Consultation) reportedly based upon advice from their specialist cost advisers. Table 19 of the May Submission demonstrates the suggested provisions for contingency and risk for the period CP3 – CP10. For CP3 the table suggests provisions of 10-15% for contingency and risk applied to stations. The weighted average for the contingency and risk provision applied for the May CP3 LTCs is 13.9%.

In our Phase 2 Report we noted on page 9, section 3.4.2, that ORR’s Final Determination for Network Rail had made a 10.7% allowance for risk over a £21bn maintenance and renewals portfolio. The overall CP3 renewals expenditure for HS1 is much smaller than the Network Rail portfolio and therefore the 13.9% applied could be considered reasonable as the value of the HS1 renewals portfolio has less ability to absorb “shocks” than does Network Rail’s £21bn portfolio.

**On Costs (Indirect Costs)**

In section 3.4.2 of our Phase Two Report, we concluded that “On the basis HS1 have not made any separate allowances for contingency and risk the Reviewer considers that the on costs are reasonable.”. In section 10.3 of the May Submission, HS1 have now added into the LTC calculation, a provision for contingency and risk.

The analysis presented in our Phase Two Report was as follows:

*The total of ‘standard on costs’ used in the LCC models is circa 72%. This has been compared to the benchmarked on cost ranges adopted by Network Rail for their CP6 renewals which lie within the range 36%-75% (mid-point 55.5%).*

By adding in the new risk and contingency GHD must now conclude that HS1’s standard on costs appear high as they exceed the Network Rail benchmarks by some 16.5%. Accordingly, our previous conclusion of reasonable consideration of on costs is now withdrawn.
Alternative options considered for renewals annuity and charges

In section 10.4.1.1 of the May Submission, two alternative options have been included as alternatives to the base case LTC increase:

- **Option 1** includes direct and on-costs over 40 years and applies the risk and contingency allowance over the first 10 years only.
- **Option 2** includes direct and on-costs and the risk and contingency allowance over only 20 years (rather than the 40 years in our recommended approach).

Both alternative options reduce the forward charges, with Option 2 reducing the charges to a level similar to current contributions. It should be highlighted that HS1 state in their May Submission:

> We would expect assurance from DfT that any move away from the current approach to long term asset renewals was consistent with the HS1 Lease and Concession Agreement.

The above statement should be treated with caution by the DfT as this relates to the principles of asset stewardship and obligations of HS1 to maintain the infrastructure for handback.

**Cost Efficiency Plan**

The May Submission document retains the removal of the cost efficiency overlay, as with the February Draft Consultation document. Reference to efficiencies from CP2 and planned for CP3 are also retained, for example:

- **Reassure parties that we are motivated to achieve efficiencies and that we have the workstreams in place to deliver them** (page 9, left hand column, 2nd bullet point)
- **In CP2 we have delivered outstanding performance and significant improvements in cost efficiency** (page 12, left hand column, last paragraph, second sentence)
- **...we challenge our suppliers to improve their practices and deliver efficiently** (page 14, right hand column, fourth paragraph, last sentence)

While this is not a change, there remains a lack of evidence to support the claims of cost efficiencies from CP2 and plan for CP3.

**Consultation responses**

An addition to the May Submission is a summary of stakeholder responses, provided by HS1 in Appendix 3 of the Submission. Responses provided by stakeholders appear to be focused on Sections 9 and 10 of the submission, relating to the renewals activities and charges. The use of the stakeholder consultation responses in the preparation of the May Submission is unclear.

Kind regards,

Will Auton
Principal Consultant
07453665840