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Telephone: [redacted]

9 August 2019

[redacted]
Department for Transport
33 Horseferry Road
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By email: [redacted]

Dear [redacted]

Re: HS1 stations review for Control Period 3 – draft decision

Thank you for the opportunity to respond to the Department for Transport's (DfT's) draft decision on the HS1 stations review for Control Period 3 (CP3), issued on 1 July 2019. The draft decision follows our Long Term Charge (LTC) submission to DfT on 31 May 2019, our follow-up letter on stations asset management on 26 June 2019, and our response to Eurostar's feedback on our consultation provided on the same day.

The development of HS1's CP3 stations plans for London St Pancras, Stratford, Ebbsfleet and Ashford comes at a critical time for the railway. In CP2, we maintained an excellent performance standard for train operators and passengers, despite Periodic Review 14 (PR14) resulting in renewals cycles being lengthened. For Period Review 19 (PR19), the aging nature of the assets means we need to step-up renewals investment and bring renewals cycles back to agreed best practice. Under HS1's funding model, this requires setting a LTC which both provides sufficient budget for immediate CP3 renewals, and puts aside adequate provision for the longer-term workbank.

Given this growing renewals requirement, we recognise HS1 needs to continue to mature in its approach to stations asset stewardship.

HS1 welcomes DfT's draft decision, and we set out our response below under the following headings:

- Renewals volumes and costs
- LTC, including the proposed 'buffer option'
- Risk and contingency
- Efficiency overlay
- Structure of charges issues
- HS1 Lease compliance
- Business improvements during CP3

- Station enhancements

Under these headings, we have indicated where HS1 is responding directly to DfT's consultation questions in the draft decision.

Renewals volumes and costs

The foundation of our proposed LTC is the renewals workbank set out in the Life Cycle Cost (LCC) models for each of the HS1 stations. Hence, in determining the LTC, it is important that DfT has assurance over the LCCs, and specifically the proposed renewals volumes (including the frequency of interventions) and the unit costs.

As you are aware, HS1 validated its 40-year renewals workbank with external technical support and assurance from Pell Frischmann. We note that DfT's technical consultants, GHD, have now reviewed the LCCs in detail, and have concluded that HS1's renewal frequencies and the proposed unit costs are appropriate (see GHD's Phase 3 report). We welcome this independent verification of our plans. The combination of HS1's 40-year workbank build-up being based on our day-to-day asset knowledge, and the independent validation by the Pell Frischmann and GHD reviews should give the DfT confidence that the workbank is reasonable and provides a sound basis for setting the LTC.

We note concerns raised by stakeholders in relation to on-costs and overheads. HS1 recognises the issue but notes we are bound by an agreement negotiated by Government with NR(HS) which was novated to HS1 at the point of sale. This is a key part of the overall framework within which we target efficiencies. The contract expires in 2086 and HS1's plans to improve delivery under it are briefly described below. We consider DfT is a key stakeholder in this process.

LTC, including the proposed 'buffer option'
(consultation questions 2 and 4)

HS1 recognises that the growing renewals requirement, when translated into the LTC, presents an affordability challenge for operators.

Our May 2019 submission to the DfT included a core proposal which we believe sets out the costs of pre-funding ordinary renewals at HS1's stations over the 40-year period in which we must act as asset steward under the Concession Agreement and HS1 Lease.[1] This would see an overall LTC of £11.695m p.a. (2018/19 prices) over CP3, up from £6.545m p.a. in CP2.

In order to address the affordability concerns of operators, we set out an alternate approach in which the contingency allowances were applied to only the first 10 years in the 40 year workbank (the so-called 'Option 1' or 'Buffer option'). This has the effect of bringing the LTC down to £10.440m p.a., a £1.3m p.a. reduction on our core proposal.

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[1] The model does not include certain long-term costs, as we explained in our letter of 26 June 2019 on asset management.

DfT's draft decision indicates it is minded to support this buffer option, with the CP2 efficiency overlay reinstated, to arrive at an LTC of £8.959m, a £2.7m reduction on our core proposal (see below for our response on the efficiency overlay).

HS1 welcomes DfT's position on the buffer option, and in response makes three comments.

Firstly, as we indicated in our May 2019 submission, if DfT ultimately agrees to the buffer option in its final decision, we consider it must clearly set out its view that this remains consistent with HS1's obligations under the Concession Agreement and HS1 Lease.

Specifically, DfT should explain in the final decision how its acceptance of the buffer option interacts with its approach to compliance with the asset stewardship and handback obligations in the Concession Agreement and HS1 Lease. Our view is that DfT should confirm HS1 will be deemed to have met the asset stewardship and handback obligations in the Concession Agreement and HS1 Lease where DfT has scrutinised and approved our plans each 5 years as part of the periodic review process, and signed-off on delivery of our individual renewals activities (currently performed quarterly). This would also be informed by a 5-yearly update to the 100-year shadow model, setting out still longer-term renewals requirements, which HS1 intends to provide to the DfT.

Secondly, it is likely that in adopting the buffer option there will be increased LTC charges in the future as subsequent high value five-year workbanks become eligible to have the contingency applied.

Thirdly, we encourage both the DfT and ORR to work together to arrive at an approach to HS1 stations and route renewals annuities that is consistent and can continue to be applied in subsequent control periods. This will give HS1 and operators as much certainty as possible about how the funding model will function in practice over the life of the Concession.

Risk and contingency
(consultation question 4)

Given DfT's position that it is minded to support the buffer option for calculating the LTC, we consider we also need to demonstrate appropriate validation and assurance over the proposed project contingency amounts in HS1's plans.

To reiterate our May 2019 submission, the contingency levels HS1 has proposed are based on the independent advice of our technical advisors, driven by risk factors associated with the renewal of station assets. The contingency levels are weighted according to the actual work planned at each station – that is, they are specific to the mix of assets being renewed at each station over successive 10 year periods.

GHD, in its Phase 3 report, concludes the proposed risk allowances (13.9% on a weighted average basis) are in line with those of Network Rail in its CP6 plans (10.7%). We note HS1's stations portfolio is markedly different to Network Rail's. Around 65% of HS1's LTC charge is for renewals at St Pancras, a Grade 1 listed building, which is highly unique and therefore requires greater sensitivity in planning and conducting building works and presents specific project risks. By comparison, Grade 1 listed buildings form a comparatively very small part of Network Rail's overall station portfolio.

Nevertheless, we agree with GHD's view that the Network Rail's significantly larger renewals portfolio makes it better able to absorb shocks, driving a lower overall contingency percentage.

Our view is the evidence points towards our proposed contingency levels being appropriate, and that these should be factored in to LTC calculation.

We also note GHD has suggested HS1 adopts a Quantitative Cost Risk Assessment (QCRA) approach to calculating portfolio risk. It may be suitable to undertake a QCRA for future control periods, and we will reassess this in the development of our CP4 plans.

In practice, we consider the CP3 contingency values should be applied to each project budget for agreed renewals projects, to deal with the specific project risks that may materialise. Access to contingency would need to be agreed by DfT as part of the quarterly renewals governance meetings. For the contingency applied to forecast works in years 5-10, the funds should remain in escrow given they are tagged to CP4 renewals projects. In CP4 and beyond, the same approach would be adopted, whereby project budgets in the first control period of the 40-year workbank would include contingency values, and the subsequent 5 years of the buffer would remain in escrow. We would be pleased to work with DfT and operators to refine these arrangements.

Efficiency overlay
(consultation question 7)

As noted above, DfT's draft decision anticipates reinstating the 0.6% efficiency overlay applied in CP2.

Our May 2019 submission removed this efficiency overlay, as we do not consider it to be evidence-based, nor derived from benchmarks of similar renewals workbanks at stations comparable to the HS1 stations. Recognising the need to drive efficiencies, we highlighted how the competitive tendering of renewals activities ensures we achieve market prices, and DfT can further challenge our approach in the quarterly renewals governance meetings (see also our letter of 26 June 2019).

GHD has highlighted that competitive tendering applies only to the direct costs (i.e. the purchasing of replacement station assets such as lifts and escalators) and not on-costs and overheads. As noted above, a key part of the framework within which we target efficiencies is an agreement with NR(HS), which HS1 inherited on sale of the Concession. This agreement extends to 2086, and we agree it should be revisited so that it better supports improved service delivery, efficiency and outcomes for passengers. As noted above, DfT will be an important stakeholder in that process.

To that end, we are working with NR(HS) to progress these improvements through the framework in the contract, but we have not included any assumption about the outturn of this work in our CP3 plans (again, because we would seek to base an assumption of this kind on evidence, and none exists at present).

For these reasons, we consider reinstating the 0.6% efficiency overlay is an unhelpful development which lacks an evidentiary basis, particularly in relation to the efficiencies that

are realisable given the contractual framework within which HS1 operates. Our preference is that the 0.6% efficiency overlay is not applied in CP3, but that we are held to efficiency improvements realisable through improvements to the SCA. These efficiencies would flow through to operators in two ways – in more efficient overall renewals costs, overseen by DfT in the quarterly renewals governance meetings, and in the pass-through of Qualifying Expenditure (Qx) for operations and maintenance activities.

We are concerned that DfT's position on the 0.6% efficiency overlay could result in deferral of renewals activity. In turn, this might produce corresponding uplifts in Qx due to an increased need to conduct reactive maintenance as assets fail.

However, if DfT ultimately concludes the efficiency overlay should be applied, HS1 considers it should not be set at the individual CP3 project budget level, but on the overall LTC charge (i.e. recognising that efficiency improvements being targeted in CP3 through improvements to the SCA are to be determined). This will provide sufficient time for HS1 to realise the improvements outlined above.

Clearly, HS1 will seek to manage costs as best we are able, and will set out our approach to efficient delivery of renewals in our CP3 delivery plan, following DfT's final decision (as recommended by GHD in its Phase 3 report).

Structure of charges issues
(consultation question 7)

HS1 welcomes DfT's position, expressed in the draft decision, that HS1's retail and other commercial income is not subject to the regulatory process to determine LTC, given this income is unregulated. As we explained in our letter of 26 June 2019 in response to Eurostar's feedback on our formal consultation, this in our view is the correct interpretation of the Concession Agreement and HS1 Lease, and reflects the basis on which Government conceived and sold the Concession to the private sector.

We note the positive discussions that have taken place to date on the other key structure of charges issue relevant to the LTC, namely requiring a contribution to LTC from the Thameslink franchise. As we have stated previously, HS1 supports the views of operators that this change is necessary, and looks forward to working with DfT to implement necessary adjustments to the contractual framework to give effect to it.

That said, we accept DfT's position that correcting this anomaly will not be possible for the commencement of CP3, due to the dependency on re-franchising of the Thameslink, Southern and Great Northern franchise in coming years, and we agree it may be necessary to deal with the change in an interim review of the CP3 settlement during the control period.

HS1 Lease compliance
(consultation questions 1 and 6)

HS1 notes that DfT's draft decision did not reflect the detailed response we provided on 26 June 2019 to GHD's Phase 2 report, which highlighted what it saw as non-compliance with certain HS1 Lease obligations.

Our 26 June 2019 letter set out HS1's view that we have met our obligations, and that many of the claimed non-compliances were technical in nature – for example, information appearing in our LTC submission, which we consider to be the primary regulatory document, rather than then Life Cycle Reports (LCRs).

We consider DfT should regulate HS1 for outputs and outcomes, including improving our asset management systems consistent with best practice in future. This is in contrast to an approach based on driving compliance with a dated Lease document that has not kept pace with current practice, including ways of operating the Concession that have been agreed with DfT. For example, many of the Lease obligations pertaining to deferral of renewals are addressed in the quarterly renewals governance meetings, rather than simply reported in the LCRs each 5 years, but this approach has been treated as a technical non-compliance.

In GHD's Phase 3 report, written in view of our 26 June 2019 letter, it acknowledges that the remaining non-compliances are non-material and would not prevent DfT formally approving the LCRs. DfT observed at the stakeholder forum on 24 July 2019 that it accepted this conclusion. HS1 welcomes these findings, and would expect they are appropriately reflected in the final decision.

To ensure similar technical non-compliances are not encountered in subsequent regulatory reviews, GHD also helpfully recommends that the DfT should provide guidance about compliance with the HS1 Lease. We agree with this recommendation, and consider DfT should provide a clear direction of travel for how it will assess compliance in the future. This would be a pragmatic means of DfT appropriately scrutinising HS1 against the benchmark of asset management best practice, while ensuring the outcomes anticipated in the HS1 Lease are met.

Business improvements during CP3
(consultation question 8)

DfT has indicated it wishes to more closely monitor agreed outcomes from the periodic review process over the course of CP3, including tracking these through regular bilateral meetings. HS1 supports this view, and looks forward to working with DfT to agree these commitments and develop plans for meeting them.

As we noted in the May 2019 submission, we would expect these commitments to include: development of a CP3 delivery and efficiency plan; implementing a rolling 40-year look ahead in the LCC models; providing the 100-year shadow model, setting out still longer-term renewals requirements; further improving our asset management maturity towards best practice; improving the robustness of 5 year Qx forecasts; and more fully integrating Qx and LTC decision-making.

Stations enhancements
(consultation question 3)

Finally, on stations enhancements, as noted previously, HS1 intends to develop the stations enhancement policy as an Annex to HS1's Network Statement, in consultation with stakeholders later in the year.

In the draft decision, DfT highlights that its Rail Network Enhancements Pipeline (RNEP) and Market-Led Proposals guideline should be considered in the development of the HS1 stations enhancement framework. We observe the RNEP specifically does not apply to HS1, but acknowledge there are similarities in the stage-gate approach in the RNEP and our own project governance process, which we intend to explain further in the framework.

We would be pleased to discuss the contents of this letter further with you. In the first instance, please contact [redacted] with any follow-up queries you may have.

Yours faithfully

Dyan Crowther
Chief Executive Officer