HS1 Limited
5th Floor
Kings Place
90 York Way
London
N1 9AG

Telephone: [redacted]

[redacted]
HS1 Concession Manager
Department for Transport
33 Horseferry Road
London SW1P 4DR

2 October 2019

By email: [redacted]

Dear [redacted]

Consultation – HS1 Stations Periodic Review 2019

1. Thank you for the opportunity to respond to the Department for Transport's (DfT's) consultation letter on the HS1 Stations Period Review 2019, issued on 13 September 2019. This consultation follows DfT's draft decision on 1 July 2019, and specifically relates to the design of the stations renewals annuity, and the efficiency overlay. Resolution of these two key areas of concern will be a critical input into DfT's final decision, which is scheduled to be published on 9 October 2019. We set out our response below to the consultation questions on the design of the stations renewals annuity and efficiency overlay. In summary, HS1 has serious concerns as to the procedural fairness of the process adopted by DfT, that DfT has misunderstood HS1's approach to the 40-year indicative plan, and as to the evidence and reasoning underlying DfT's proposed conclusions on efficiency overlay in particular.

Process Adopted by DfT

2. HS1 has engaged openly and transparently with stakeholders on our plans for CP3 over the past two years. Our Stations LTC submission to DfT on 31 May 2019 was the product of this engagement and detailed technical analysis carried out over the same period.

3. In this time, there has been ample opportunity for stakeholders to articulate their priorities, respond to our proposals, and suggest alternative approaches where they have identified areas of concern.

4. We welcome this challenge. As a business, HS1 fundamentally believes we can only succeed where our train operator partners succeed, having benefitted from the excellent levels of safety and performance on our network that they have rightly come to expect, at the lowest possible whole-life cost.

5. In this context, HS1 is extremely concerned with the proposals outlined in DfT's consultation, coming as they do in the last month of a two-year Periodic Review process, and constituting a significant departure from DfT's draft decision, issued just 10 weeks earlier. In our estimation, this does not represent the 'no surprises' approach we thought we had agreed with you and the principles of better regulation.

6. We question the procedural fairness of this consultation, as first explained in our letter of 16 September. Specifically, providing 7 business days to respond the consultation is not in our view consistent with the Government's own Consultation Principles. While we note the consultation was subsequently extended by 6 business days, given the provision of supporting benchmarking analysis produced by GHD, overall the consultation period still falls well short of established norms of 6 or 12 weeks. This raises concerns about the compliance of the consultation process with the principles of natural justice, in particular the opportunity for all stakeholders to be provided with sufficient information and time to properly respond to the consultation. It also raises concerns as to the robustness of DfT's decision-making process as this proposed decision will seriously underfund the stations renewal programme.

7. As DfT is aware, the Government Representative (GR) has worked openly and transparently with HS1 throughout CP2. The GR has been provided with detailed evidence on the renewals portfolio, its delivery and relevant change controls every quarter. DfT has signed off on this process, it is well documented and gives a clear line of sight in relation to portfolio expenditure and change control. At no stage has the GR raised concerns about the evidence received. It is telling that GHD has provided no comment on the evidence that drives the quarterly process, the decisions that have been taken and how this drives efficiency and the role of DfT as regulator.

8. We have previously also noted that DfT made key factual errors in its consultation letter pertaining to HS1's application of contingency and our efficiency performance during CP2, which were clearly relevant to the proposals to revisit the design of the annuity and efficiency overlay set out in the consultation. Although DfT has clarified and corrected its advice in relation to risk and contingency we do not accept DfT has had insufficient evidence to demonstrate that HS1 delivered the efficiency overlay in CP2. We have set out clear inaccuracies in DFT's approach above and set out below why DfT is incorrect in paragraphs 18 – 20.

9. The effect of DfT's proposals will be to underfund long-term renewals, as we explain further in this letter. We note that while DfT must balance its duties as regulator with those as the ultimate owner and landlord of HS1, HS1 does not believe the right balance has been struck – in short, perceived short-term savings are being prioritised over the longer-term financial sustainability of HS1 as a high-performing railway.

10. We set out our response below to the consultation questions on the design of the stations renewals annuity and the efficiency overlay, respectively. In summary, HS1 is concerned that:

    - in respect of the design of the stations renewals annuity, DfT has misunderstood HS1's approach to the 40-year indicative plan; and

- in respect of the efficiency overlay, HS1 remains concerned that DfT's proposal to substantially increase the overlay from 0.6% to 2% p.a. compounded over 40 years is not a sustainable basis on which to fund the long-term renewal of HS1 station infrastructure. If implemented, such an approach would not be rationale or proportionate and would not, in HS1's view, be based on sound evidence as it would fail to take account of the efficiencies achieved in CP2 and those built into the approach to CP3. Further, HS1 considers the comparison with efficiency targets in other regulated sectors to be unsound comparators for the reasons explained below.

Design of the station renewals annuity

11. DfT has stated it wishes to retain a 40-year 'look ahead and pay ahead' model for the stations Long Term Charge (LTC) annuity. In doing so, DfT suggests the 'buffer' option, which HS1 proposed to address stakeholder affordability concerns, would represent a departure from this model.

12. HS1 emphasises the intent behind the buffer option was not to depart from the 40-year model, which is a fundamental pillar of the HS1 Concession, ensuring we execute our asset stewardship duties with an appropriately long-term view. The buffer option was proposed in recognition that of all the forecast costs in the indicative 40-year plan, contingency represented the element most difficult to predict beyond the very short term. For that reason, we excluded contingency from years 11-40 in the LTC calculation. The intention was that this would be rolled-forward each 5 years to ensure an adequate buffer existed in the station escrow accounts to deal with project-specific costs shocks within a given control period.

13. Nevertheless, we welcome DfT's clarification that it considers the 40-year indicative plan should represent the expected full costs over that period, including contingency. We would encourage DfT to include in its final decision that it now expects HS1 to build its plans in future periodic reviews on this basis, which will provide certainty both to HS1 and operators.

Efficiency overlay

14. We recognise that DfT, having established that the 40-year indicative plan should be built on a 'full cost' basis, wishes to significantly increase the efficiency overlay in response to operator affordability concerns. Specifically, DfT wishes to increase the overlay from 0.6% p.a. compounded over 40 years, as proposed in the draft decision, to 2% p.a. compounded over 40 years.

15. If not adjusted in subsequent periodic reviews, the draft decision's 0.6% p.a. efficiency overlay would remove 21% of costs from the indicative 40-year renewals plan. As we have noted throughout the periodic review process, we do not accept that this provides a sustainable basis on which to fund the long-term renewal of HS1 station infrastructure. By now proposing a 2% p.a. compound efficiency overlay, DfT is indicating its desire to remove 55% of costs from the indicative 40-year renewals plan. DfT have noted if there is a need for adjustment this will be dealt with either by reopening the determination or in 2025 when it is reset. DfT note in paragraph B16 of the consultation that the approach will incentivise HS1 to move towards asset

stewardship best practice and improve the evidence it provides. While HS1 has agreed it is moving towards asset stewardship best practice we disagree that this approach will in some way accelerate our approach. If the requirement is to achieve certification with an approach, or there is a need for a new evidentiary requirement that should be set by DfT, as regulator to spell out exactly what it requires. As we have noted above DfT has not done that, and worse has been fully engaged in a process to oversee the portfolio on a periodic basis throughout CP2. All DfT is doing is underfunding future renewals, the cost of which will either lead to increased charges on operators in the future, or reduced asset quality and performance if insufficient funds are available to renew the asset.

16. The evidence presented to support such swingeing cuts to renewals capital budgets are a series of proposed efficiency targets of dubious relevance to HS1, including those drawn from opex budgets set by regulators in other industries (as we explain below). There is no evidence that the targets are achievable in practice; indeed, the only outturn efficiency benchmarking provided (in GHD's report) confirms that Network Rail Infrastructure Limited (NRIL), which DfT suggests is broadly comparable to HS1, responded to a 19.4% cumulative efficiency target set by the ORR in CP5 with a cumulative *inefficiency* of 7.4%.

17. Before turning to our concerns with the benchmarking evidence presented in support of the 2% efficiency, we think it important to re-state what we have achieved on efficiency over the course of CP2, the evidence DfT has before it demonstrating efficiency and the efficiencies built into our plans and procurement approach in CP3.

HS1's CP2 outturn efficiency

18. As we noted in our letter of 16 September 2019, HS1 disputes DfT's assertion in the consultation letter than there is a lack of evidence that we have delivered efficiencies in CP2. This is a critical point because DfT go onto suggest this is one of the main reasons they require an efficiency overlay to incentivise HS1. At Periodic Review 14, DfT set HS1 an efficiency overlay of 0.6%, which was then applied to the renewals budget for CP2. Of the funding envelope of £16.12m, we are on track to deliver the portfolio at £16.03m (2013/14 prices). While there have been changes to required outputs during CP2, which must be considered in any robust efficiency analysis, these were at the margins and agreed with DfT through the established renewals governance process. Portfolio changes have gone through change control and the evidence has been provided to DfT before sign-off before being accepted. In short – DfT has had a clear line of sight over the last 5 years and raised no concerns with the approach.

19. HS1 also note that DfT, as regulator has provided no guidance as to its expectations in assessing capital efficiency. In the absence of DfT guidance HS1 as followed generally accepted practice. This has helpfully been set out by CEPA in its support of the Civil Aviation Authorities future *ex post* assessments of project efficiency[1] including:

[1] https://publicapps.caa.co.uk/docs/33/1563e_H7_Capex_Governance_report_by_CEPA.pdf

- **the procurement approach and timing in particular to consider whether competitive tension was maintained throughout.** HS1 procures its renewals projects through competitive tender processes, and its overall approach to procurement is open to scrutiny on an ongoing basis by DfT, as part of the overall governance of the renewals portfolio.

- **whether fixed price components were contracted before work began and delivered as planned within the fixed cost.** HS1 has a number of contracting strategies (including the use of fixed price contracts that have been competed through open tender) and provides detailed project budget information to DfT regularly, as part of the overall governance of the renewals portfolio.

- **whether and for what reason target costs moved**; and

- **The management of variations.** DfT endorses the portfolio at the start of each control period, any changes to the scope/budget of the portfolio within the control period, and cash drawdowns from the escrow accounts to authorise projects. The detail of changes within CP2, as authorised by DfT, are provided again for information at **Annex A**.

20. To reiterate, against every reasonable measure DfT has been engaged, has been provided detailed evidence and has signed off on key decisions. DfT set the portfolio in CP2 and applied the efficiency overlay. DfT and its consultants have accepted the volume of work and unit rates applied were efficient in CP2. DfT has been provided with detailed change control papers setting out portfolio changes throughout the control period. HS1 delivered below the budget set by DfT in CP2. At no stage in the last 5 years has DfT raised concerns over the evidence before it. It is factually incorrect for DfT to say *ex post* that there isn't enough evidence to suggest the overall budget was delivered efficiently and then use that as a justification for the approach in CP3.

HS1's CP3 approach and the 40-year workbank

21. For CP3, given our concerns with the effect of a compounding 0.6% p.a. efficiency overlay on the long-term renewals budget, we proposed a different approach. This did not include an efficiency overlay, relying instead on three key levels of assurance:

- First, the inputs into the indicative 40-year plan were peer reviewed by technical expert advisors, who confirmed both the unit rates and intervention frequencies (renewal cycles) were reasonable. We note that DfT's technical advisors, GHD, have not raised concerns with this approach or the resulting proposed costs.

- Second, HS1 has strengthened renewals governance arrangements, to improve decision-making on renewals interventions within the control period. Crucially, DfT is central to this decision-making process, and can challenge us on cost and any other aspect of our proposed renewals interventions, up to and including the ability to refuse to authorise investment where it is not satisfied. DfT can interrogate portfolio change control and can clearly set out the evidence it requires at the point of decision.

- Third, proposed renewals are subject to competitive procurement processes, ensuring we secure the appropriate market price at the time the intervention is required.

22. Given the approach to efficiency we have outlined above, and that both our proposed unit rates and renewals cycles have been validated by HS1's and DfT's technical advisers[2] there is strong evidence around the robustness of our plans. We also need to then consider the efficiencies built into the 40-year workbank itself.

23. This includes where we have efficiently brought forward work aspects of renewals work to respond to observed accelerated rates of degradation whilst continuing to meet operator and customer needs. The most obvious example DfT would be aware of is the approach to lift and escalators which account for 18% of the cost of the 40-year renewals portfolio. Following discussions with NR(HS), Mitie and specialist subcontractors (Schindler and Coney) we changed our approach from full lift renewal every 25-35 years (depending on asset type) to in-truss renewal every 15 years and full renewal every 60 years. We consider this is the lowest whole life cost approach to managing these critical assets.

24. Another example relates to stations communications systems which accounts for 21% of the 40-year renewals portfolio. HS1 has implemented a design for stations communications systems that will minimise ongoing maintenance costs, and to facilitate moves to a single CCTV hub across stations which would further reduce operations and maintenance costs. Again this approach is based on delivering lowest whole life cost in the long term but critically, these are efficiencies that are being delivered now and are already built into the renewals portfolio, not in some future hypothetical state which could be reached through application of an efficiency overlay or other similar incentives. There is clearly no catch-up efficiency required as seems to be implied by DfT in their use of technical analysis provided by GHD.

25. Overall, we are therefore confident our CP3 proposals represent good value for train operators and taxpayers, and are based on a robust evidence base. We reject DfT's statement, on page 4 of the consultation letter, that our plans are based on an "an absence of strong underlying supporting data and models from HS1 Ltd". The evidence demonstrates that the approach adopted by DfT of a 2.0% year on year efficiency will significantly underfund the renewals requirements moving forward.

Use of efficiency benchmarks

26. As a starting point to the consideration of relevant efficiency benchmarks, it is important to define precisely what is meant by 'efficiency', in the context of HS1's stations renewals workbank. To date, neither DfT nor its technical advisors GHD have clearly spelt out the application of the concept of efficiency in the periodic review. While GHD's most recent report includes a small statement that efficiencies are defined as producing "the same for less", this does little to set the parameters for the

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/819319/hs1-asset-management-station-periodic-review-determination-report.pdf.pdf Page 18 - 19 - endorses unit rates and frequencies (based on scope set by DfT)

comparison with other businesses and industries that follows and gets further confused when GHD and DfT talk of frontier shift and catch-up efficiencies.

27. We question the utility of a broad-brush efficiency target as proposed. Specifically, DfT's conclusion that a 'prudent land owner' would include an efficiency target in the way proposed does not appear to be evidence-based, nor does it indicate that DfT has meaningfully engaged with the ongoing evidence provided to it over the last 5 years, responded to the actual efficiency proposals HS1 has put forward, the constraints we face and the risk of underfunding of future asset requirements.

28. In our view, any efficiency benchmarking analysis needs to be sensitive to:

- **The comparability of the industries in question.** For example, is the water industry a valid comparator to the railway industry, given the nature of the infrastructure and services provided?

- **Whether the benchmarks relate to operating or capital expenditure, or both**. The efficiencies realisable in an opex or totex budget are materially different in nature to those possible in a capex budget.

- **Where capex budgets are being compared, the asset mix in each budget**. For example, in the rail industry, is it valid to compare potential efficiencies in track and signalling infrastructure with those for lifts and furnishings within stations?

- **The 'starting' efficiency of the businesses or industries being compared.** Comparing the efficiency targets of two business with profoundly different levels of existing efficiency relative to the frontier in their respective industries has significant potential to be misleading.

- **The scale of the businesses or industries being compared.** Larger businesses benefit from economies of scale and purchasing power which are not available to smaller businesses. This is particularly relevant to HS1's stations renewals portfolio, which we value at £20.7m over CP3, including contingency (2018/19 prices). This is very small relative to the capital budgets of other regulated businesses.

29. Turning to the specific benchmarks proposed by GHD, and used by DfT to support its proposed 2% p.a. compound efficiency overlay, HS1 considers GHD's methodology to be seriously flawed, leading to conclusions which are unreasonable, irrational and undeliverable in practice. This presents considerable risks to HS1 assets in the longer term, affecting HS1's ability to deliver the renewals volumes required during the Concession. This is particularly an issue because although the efficiency is being applied to HS1 we are significantly constrained by the commercial contracts DfT negotiated with NR(HS) that offers no opportunity to test the market or to terminate and does not expire until 2086. Until DfT addresses that issue and gives HS1 the levers it needs to drive efficiency all the proposed approach will do is underfund renewals in the longer term.

30. As the DfT would also be aware the ORR has recently set out its position to the route annuity. That analysis includes a principle that the escrow account should not

forecast a negative balance over the 40-year period. In considering overall efficiency ORR has has included an uplift to take this into account and noted 'a strong emphasis on HS1 Lt building an escrow balance in each control period, which smooths the renewals annuity and avoids negative escrow balances in the future'[3]. DfT is adopting the opposite approach - although there is a minor escrow balance forecast in HS1's proposals the application of an efficiency overlay increases the funding shortfall from £200,000 to over £18 million in CP8. For every year DfT underfunds the annuity gap it will be creating a problem for the future.

Cross industry comparison

31. Firstly, HS1 considers the comparison with efficiency targets in other regulated sectors, including the water, energy, aviation, and highways industries, to be irrelevant.

32. As GHD's technical paper to DfT explains, the comparisons with aviation, water and energy industry opex benchmarks specifically are unreliable. GHD makes it clear that it "(does) not believe that this dataset (is) a reliable source of benchmarking for HS1's capex (renewals) efficiency target". We agree with GHD's statement and reject DfT's use of these benchmarks, as they have no relevance to HS1's stations renewals programme.

33. By way of example, we have considered DfT's claims that "Gatwick Airport (is) considered to provide useful insight as it is similar to St Pancras International Station in having a large associated retail business". While it is true that both Gatwick Airport and St Pancras provide a significant retail offering to customers, the validity of the comparison stops there. Operating expenditure efficiency targets for an airport provide no meaningful insights into the efficiency realisable in a capex programme at a railway station. As DfT would be aware the operating costs of an airport typically include significant staffing costs associated with security screening, heating and ventilation and activities such as cleaning. As DfT would be aware this is equivalent to qualifying expenditure (Qx) in a station. Comparing these types of costs in Gatwick Airport to the costs of purchasing lifts and installing them in a Grade I listed railway building is irrational. For these reasons, we do not believe DfT should give any weight to these benchmarks.

34. The Highways England benchmarks may be viewed as being more relevant, given they relate to a large capital programme in the transport industry. Unfortunately, again, the comparability with HS1's stations renewals programme stops at this superficial level. GHD claims that Highways England's "asset base and type of work shares a lot of similarities to the mainline rail network, comprising c.4300 miles of aging linear assets with limited access to carry out renewals or improvement projects". How the linearity of assets and the ability to access highways and railways to conduct renewals is relevant to HS1's stations are not made clear.

35. The ORR has recently set out its views in relation to cross industry comparison including the use of NRIL benchmarks[4]. ORR clearly set out that such analysis,

[3] ORR PR19 Supplementary Document: Financial Framework – page 25
[4] ORR PR19 Supplementary Document: Financial Framework – page 20

including their own analysis of NRIL 'are difficult to translate to HS1'. ORR do note however, drawing on work from Ofgem, that it is useful to compare frontier shift efficiencies and that an level of 0.7% is appropriate for capital and replacement expenditure. This is the evidence used to support the 0.5% proposed by ORR on HS1 route assets.

Comparison with Network Rail

36. The main basis for DfT's proposed 2.0% p.a. compound efficiency overlay is the 2.5% p.a. target set by the ORR for NRIL in CP6. DfT notes that it has:

    a. *"…made use of available benchmarks from within the rail sector and in reasonably comparable regulated sectors and consider the most relevant to be the 2.5% efficiency overlay for NRIL in CP6. However, the GRs also consider this to be too high for HS1 given its substantial smaller asset base and newer assets. Lacking a granular analysis of the NRIL assets and associated efficiencies, the GRs have assessed a reasonable reduction to be 20% giving an efficiency overlay of 2.0%.This is slightly above the 1.9% for Ofwat Totex in 2015-2020 and 1.65% for Gatwick reflecting a greater perceived scope for catch up efficiency given the lack of evidence provided by HS1 for efficiencies in CP2"*

37. Thus, DfT acknowledges it lacks the evidence to meaningfully compare HS1 to NRIL, including considering the sensitivities in making comparisons highlighted above. This is further reflected in ORR's recent comments on HS1 benchmarking set out in paragraph 35 above.

38. We have highlighted above the unreliability of other sector opex and totex comparisons and that we have met our CP2 efficiency targets. Further, as noted above DfT and GHD appear confused between the applicability of frontier and catch-up efficiency **(as set out in Attachment B)** so the main points of remaining contention in applying NRIL's targets to HS1 are, in our view:

    - The comparability of the existing efficiency between NRIL and HS1;

    - The comparability of the scale between NRIL and HS1;

    - The comparability of the asset mix between NRIL and HS1;

    - The different approaches taken by NRIL and HS1 to building up their stations renewals workbanks;

    - The concept of catch up efficiencies and wage inflation; and

    - The reasonableness of using a 5-year efficiency overlay for NRIL as the basis for setting a 40-year efficiency overlay for HS1.

39. Each of these factors require their own detailed consideration and demonstrate a 2.0% efficiency overlay is too high and not sustainable. I deal with each in turn.

40. A fundamental flaw in GHD's and DfT's comparison between NRIL and HS1 is that no evidence is provided as to how each business differs in existing levels of efficiency. Without this as a firm foundation, the analysis of efficiency overlays between the two business is almost certainly misleading and inaccurate. For example, if it is assumed that NRIL is less efficient than HS1, it would be more appropriate to apply a higher efficiency overlay to NRIL than HS1, with the objective of pushing both firms towards optimal efficiency.

41. On scale, DfT acknowledges there is a significant difference in the economies and purchasing power realisable across NRIL's £21bn CP6 portfolio, and HS1's £20.7m CP3 stations renewal portfolio. This difference, DfT states, is the rationale for reducing the proposed efficiency overlay on HS1 from 2.5% p.a. to 2.0% p.a. but this appears to be judgement-based and not underpinned by evidence. Hence, we do not consider this scaling to reflect HS1's asset base is robust.

42. On asset mix, we note NRIL's portfolio is for operations, maintenance and renewal of route and stations assets (opex and capex). The more accurate comparison is with NRIL's stations renewals activity, but this has not been disaggregated in GHD and DfT's analysis.

43. We have determined through consulting NRIL's CP6 documentation[5] that the following efficiency levels were applied to the stations renewals:

    - Managed station operational property renewals: c.12.0% over CP6 (2.2% p.a.)
    - Station information and security system renewals: c. 35.4% over CP6 (5.9% p.a.)

44. The difficulty in applying these benchmarks is two-fold – one, as above the scale of interventions is markedly different (i.e. NRIL's stations renewal budget will be many multiples of HS1's £20.7m); and two, the basis on which the plans were built is different, so a larger efficiency target for NRIL may be more appropriate.

45. On this latter point, NRIL adopts a different approach to developing its stations renewal workbanks than HS1. As DfT is aware, HS1's approach is to build the workbank based on specific asset renewals at each station, generally informed by experience, manufacturers recommendations and warranty periods, and increasingly, asset condition information. By contrast, NRIL adopts a top-down methodology to build up a portfolio-level spending pot which is then applied to renewals requirements as needed within the control period. HS1 makes no judgement about which approach is better or worse; clearly, HS1 is a simpler, smaller operation than the national network, and we can understand that a top-down, broad-brush approach to setting budgets may be more appropriate across NRIL's portfolio of over 2,500 stations.

46. However, HS1 as noted in paragraphs 23 and 24, includes efficiency opportunities in our 'bottom-up' approach that is built into the unit rates and renewals intervention frequencies, which would not be the case in NRIL's top-down methodology. Hence,

[5] See: https://cdn.networkrail.co.uk/wp-content/uploads/2019/03/Final-Determination-consistent-price-lists-key-assumptions.pdf

a significantly greater discount needs to be applied when assessing an efficiency target appropriate to HS1 – and well above the 20% currently suggested by DfT.

47. This is issue is further compounded when considering catch-up efficiencies. The evidence provided by HS1 demonstrates there is no efficiency catch up required although clearly DfT has identified it would like to receive information in a different way. It will be for DfT to address that issue by setting out clearly the evidence it expects. However not withstanding this point it is clearly incorrect to apply a catch-up efficiency ongoingly for 40 years. This type of efficiency is short term in nature so any assessment by DfT needs to significantly discount a catch-up element over 40-years. Again this demonstrates the DfT needs to discount well beyond the 20% currently proposed when benchmarking against NRIL's 5 year efficiency.

Comparison with NR(HS) route renewal plans

48. GHD's technical analysis suggests HS1's route renewals plans could form a useful comparator with stations renewals, given the similarity in volumes and that the work would largely be delivered by the same organisation NR(HS). While we caution reliance on this comparison due to the different asset mixes in the route and stations portfolios, it is in our view the most relevant of the comparators available and certainly of greater relevance than a 5-year assessment of NRIL.

49. We note the ORR, in its draft determination of 30 September 2019, recommends an efficiency overlay on route capital expenditure of 0.5%. This is by far the most appropriate comparator and reflects the frontier shift type efficiency you would expect a regulator to apply. ORR set out the reasons for this in its PR19 Supplementary Document: financial framework over a longer time horizon (page 20). This approach is consistent with the initial efficiency set out in DfT's draft determination and that applied in CP2 which demonstrates its appropriateness. ORR has the competence to assess both NRIL and HS1 and has come to a view that 0.5% is appropriate and significantly lower than its assessment of NRIL – which DfT base the 2.0% on. Even if DfT takes into account the 1.8% efficiency ORR is considering for HS1 in CP3 that is no basis for extrapolating a 40-year view. HS1 notes that DfT officials have said ORR has supported DfT in coming to its view on a 2.0% efficiency overlay. Any advice from ORR in relation to an efficiency overlay requires transparency and should be part of the evidence presented in the consultation.

Conclusion

50. When considering the evidence DFT has received in relation to CP2 and the 40 year workbank, the serious shortcomings in the benchmarking including the use of a catch-up efficiency over 40 years it is clear that the evidence supports a much lower overlay in the order of 0.5% to 0.7% which brings the efficiency in line with typical frontier shift approaches such as that used by ORR in relation to the route, cross industry benchmarking and in line with DfT's own assessment in its Draft Determination. None of the evidence presented by DfT suggests 2.0% is reasonable and in fact confirms the appropriateness of DfT's initial assessment of 0.6%.

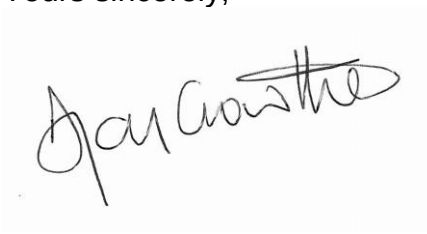
51. It is therefore unreasonable and irrational that a 2.5% p.a. efficiency overlay over 5 years, as applied to NRIL, is grounds to apply 2.0% p.a. efficiency overlay to HS1

over 40 years. As noted above, this level of sustained steep efficiency overlays would strip 55% of the costs out of HS1's indicative 40-year renewals plan – this is not a sustainable basis on which to fund the long-term renewal of HS1 station infrastructure. DfT as prudent landowner will seriously underfund its own asset and store up issues in the future. It is not credible that DfT simple note they will re-open the determination or reset it in 5 years – the precedent will be set.

52. For the reasons above, HS1 is therefore concerned that DfT has misunderstood our approach to the 40-year indicative plan and is proposing the efficiency overlay to 2% p.a. based on flawed evidence and reasoning. Our view is that, properly considered, the imposition of a 2% efficiency overlay would be neither rational nor proportionate. A much lower efficiency consistent with the approach adopted by the ORR and the DfT in its own Draft Determination in July is appropriate, particularly when discounts for catch ups is considered. DfT's current approach will seriously underfund the escrow account and store up a problem for the future.

53. Finally, we note that DfT has given itself 7 days to consider consultation responses before reaching its determination on 9 October. Can DfT urgently confirm with stakeholders its approach to considering evidence, its decision-making process and the timing of the final determination? We would be pleased to discuss the contents of this letter further with you. In the first instance, please contact James Mackay with any follow-up queries you may have.

Yours sincerely,



Dyan Crowther
Chief Executive Officer