Responses to the Office of Rail and Road's periodic review of HS1 Ltd 2019 (PR19) – Matters to be determined – January 2020

- DB Cargo
- Department for Transport
- Eurostar International Ltd
- HS1 Limited
- London Sleeper Company
- Southeastern

DB

By Appointment to
Her Majesty The Queen
Royal Train Operator
DB Cargo (UK) Limited
Doncaster

DB Cargo (UK) Limited
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Nigel Oatway
Access Manager

PR19
Office of Rail and Road
One Kemble Street
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20 December 2019

2019 PERIODIC REVIEW OF HS1 LTD (PR19) – DRAFT DETERMINATION

Thank you for your consultation letter dated 11 December 2019. I can confirm that having considered the various aspects Office of Rail and Road ("**ORR**") has revisited as part of its final scrutiny of HS1 Ltd's Five Year Asset Maintenance Agreement (**"5-YAMS"**), DB Cargo (UK) Limited ("**DB Cargo**") has no further representations to make in respect of ORR's determinations in each case. However, DB Cargo does wish to understand whether or not the revisions to these various aspects will, when combined, impact upon the proposed level of the variable usage charge for freight operators (£8.35 per train km (ORR draft determination) or £8.80 per train km (HS1 final 5-YAMS)(both Feb 18 prices)) and, if so, what the final level of the charge will be.

Yours sincerely,

Nigel Oatway
Access Manager

Department for Transport PR19 matters to be determined response – 20 December 2019

FOR THE ATTENTION OF THE ORR HS1 PR19 TEAM

Thank you for the letter of 11th December (and subsequent emails) and for the opportunity to comment on the further matters to be determined.

We see the issues raised as particularly relevant for operators and HS1 Limited to comment on, but we do set out our views on the basis of the material presented on those issues where we have a position. These are:

- That the adjustments proposed by the ORR seem to us to be reasonable. We note and support, in particular, the approach to asset life modelling and the removal of the costs that have not been substantiated with sufficient supporting evidence.
- We also welcome the position on R&D – most particularly the importance of R&D being clearly linked to potential benefits for existing and future operators. We consider that this requirement, and the representation of operators on the R&D panel, is particularly important and should be explicitly required in the final determination. We also support the classification of R&D as renewals activity and would particularly support a focus on initiatives that drive efficiencies.

More generally, we note that there is limited information in the material about the further efficiency challenge that has been undertaken following the consultation on the draft determination, particularly given our view that efficiencies must be stretching, yet realistic. We consider that it is important that the ORR has fully tested this issue, including any challenges provided by operators, and look to the ORR to ensure that this is the case.

Thank you again for the opportunity to comment.

We should be very happy to discuss.

Dan

Dan Moore | Director, Rail Strategy, Analysis and Brexit, Department for Transport

19th December 2019

Graham Richards
Director of Planning and Performance
Office of Road and Rail
25 Cabot Square
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Dear Graham,

OFFICE OF RAIL AND ROAD PERIODIC REVIEW OF HS1 LTD 2019 (PR19)

Thank you for your letter of 11 December.

In your letter you set out the additional areas of consideration, on which the ORR is inviting comments ahead of its final determination on 7 January. In relation to the specific items itemised in the attachment, we support the approach being taken by the ORR and have no further comment to make.

However, I do wish to highlight three items, where additional evidence and further consultation is not required but for which we believe that the draft determination provided insufficient explanation or justification for the position to be simply re-confirmed ahead of any final determination.

1) **Efficiency of Operations and Maintenance.** HS1 are proposing unprecedented levels of price increase for rail infrastructure charges. They are offering efficiencies at the lowest end of the comparators presented by ORR and successive version of independent benchmarking commissions by HS1 itself. ORR has not demonstrated or explained how this is satisfactory. References to "bottom up" analysis have been inadequate, and the evidence of top-down analysis and benchmarking appears to have been discounted. The majority of costs are those incurred by a contractor, NR(HS) who has not been subject to market test. It is absolutely telling that the costs attributed to NR(HS) in the final 5YAMS have not varied in any way from those presented on the 28th February. **In other words, the whole Periodic Review process conducted by the ORR since February has failed to apply any further efficiency pressure whatsoever on the principal contractor.** This point must be addressed in any final determination.

2) **Efficiency of Capital.** Separate to the question of the period over which the Escrow operates in the approach to risk which it applies in the calculation of the required escrow

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balances. In order to avoid the risk of an (itself uncertain) projected deficit, the Escrow account ends up with carrying balances of more than £100m for 31 consecutive years, more than £200m for 13 consecutive years and more than £300m for 8 consecutive years. The ORR assumes an interest rate return of 1.22% on these balances. This is at least 6% less than EIL would require from the use of this capital in any investment proposal under our own business investment framework. In other words, this represents a grossly inefficient way of tying up huge amounts of capital that could more productively be employed improving services, the resilience of the railway and/or its ability to afford future charges. Again, Eurostar believes that ORR must address this issue of efficient use of railways capital in its final determination.

3) **Escrow Closing Balance**. A significant topic of debate during PR19 has been the appropriate pay-ahead period for the escrow under the terms of the Concession Agreement (CA). Eurostar has argued that the CA does not require a 40 year pay-ahead and a more nuanced approach to asset life and forecasting risk should be adopted. By contrast, ORR has maintained a 40-year period based on its interpretation of the CA; you intend to confirm this within the final determination. A £60m closing balance is inconsistent with the ORR's own approach. It implies (and the draft determination explicitly acknowledges) an element of provision even beyond the 40-year time horizon. If the ORR wishes to revisit the time horizon of different elements of the Escrow pay-forward, Eurostar is open to that debate. But if not, it should be consistent with its own approach and reduce the closing balance to nil.

Thank you to you and the team for your continued engagement in this process. I look forward to seeing these important points (which, as I say, do not require additional evidence beyond that already presented) addressed within the Final Determination.

Yours Sincerely

Gareth Williams
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Graham Richards
Director Planning and Performance
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20 December 2019

Dear Graham,

December Consultation – 2019 Periodic Review of HS1 Ltd (PR19)

1. Thank you for your letter of 11 December 2019 setting out an additional consultation which the ORR proposes to determine as part of making its final determination on the revised final Five-Year Asset Management Statement (5YAMS).

2. The letter states that the ORR is required to consult parties to access contracts and other interest parties on any proposed determination in accordance with paragraph 8.10.3 of Schedule 10 of the Concession Agreement. HS1 does not accept that the ORR is required to consult on any proposed determination, rather the requirement to consult is, as necessary, indicating a degree of materiality, proportionality and reasonableness can be applied. It is not clear how the ORR has sought to apply this principle in the current circumstances, but we note that the ORR has narrowed the consultation to a specific set of seven issues.

3. Notwithstanding the point above HS1 welcomes the ORR's decision to accept the majority of our 5YAMS. HS1 provides comment on the seven points raised by the ORR in its consultation letter.

   a. **Asset Lives:** HS1 disagrees with the ORR's proposed approach to asset life modelling. In support of our approach to asset life modelling we have provided detailed evidence that demonstrates we have applied best practice to the development of the track renewal work bank and volumes. The ORR has only provided limited evidence that supports the proposed 10% reduction in volumes as being more representative of best practice. As we stated in our consultation response of 11 November, we consider that the ORR's approach is likely to under fund the long-term renewals program based on the best evidence available today.

b. **Programme Management Costs:** HS1 disagrees with the ORR's proposed determination of an allowance of 10% for project management (PMO) costs in control period (CP3). In our 5YAMS we provided a detailed bottom up forecast of PMO costs in CP3. We did this to provide a strong evidence base and because PMO costs were not explicitly set out in CP2. Despite this evidence ORR is simply providing a high level top down benchmark. The ORR has not provided any evidence that supports its view that by repackaging and rephasing some of the works that PMO costs could fall within the 10% allowance. HS1 will monitor this closely in CP3 as we expect under resourcing in this way will impact deliverability of the programme.

c. **Research & Development (R&D) Funding:** HS1 welcomes the ORR's proposed determination to include funding for R&D costs in CP3 however we do not agree it should be funded through the escrow account. ORR has noted it believes R&D is more 'renewal' like in nature and will be subjected to greater scrutiny. While we understand the ORR's points we think the way HS1's charging model works must be considered.

   Treating R&D as a renewal in the charging model will apportion some R&D to operators based on both direct and non-direct costs. By including an element of direct costs when treating R&D as a renewal the ORR approach will impose a greater cost on operators who run faster heavier trains. While there may be some cost causation – for example, if research and development relates track and train interfaces - HS1 can't clearly split our R&D funds for these activities nor model for them in the remaining timeframe. HS1 believes it is better to treat R&D as a non-direct cost because R&D is more fixed in nature. It is for this reason R&D was included within HS1 Internal Costs and we encourage the ORR to maintain the HS1 position.

   HS1 understands the importance of transparency around how operators money is managed. HS1, through its Research, Development and Innovation Panel will consider business cases for R&D funding. The panel will include HS1, NR(HS), Innovate UK (through the Connected Places Catapult) and operators are also able to participate if they wish. Like renewals, projects would work through the Project Gateway Process and we would expect them to be captured by the governance process that is used for the Renewals Board. At the time the Panel determines R&D should go ahead the Renewals Board would take that recommendation, and if approved, money would be drawn down from HS1's accounts. We would expect additional scrutiny to be included in the ORR monitoring guidance and at the end of CP3 there will be a reconciliation of funds collected through HS1 charges and money spent over the control period. This would be considered in setting the R&D budget for CP4. HS1 believes this provides sufficient scrutiny over the management of R&D funds.

d. **HS1 Internal Costs:** HS1 is disappointed that the ORR has not engaged HS1 on this issue since the Draft Determination. HS1 has provided evidence to the ORR and followed up with requests to discuss it further and take challenge. ORR has not so. As such HS1 does not accept there has been insufficient justification to make these changes as the ORR has had the opportunity to engage with HS1 on these issues. HS1 sets out below the detail of these costs, why they are required and the likely impact of disallowing them:

i. **ORR Costs (£0.5 million):** The ORR has made an error in its analysis. The £0.5 million increase does not relate to new staff as stated in the consultation letter. This increase is to reflect the actual costs invoiced by the ORR (including the safety levy) to HS1 and the approach adopted in control period 2 (CP2). The ORR provided guidance to HS1 in setting costs for CP3 based on extrapolating Q1 and Q2 of the 2018/2019 financial year. It is reasonable to re-forecast those costs on the basis you will impose similar costs in CP3 to those in CP2, including updated information from the last year of CP2. For example - in this year alone (first 2 Quarters of this year) ORR has invoiced HS1 for £330,000 (without considering the safety levy) which is already significantly over the allowance set by the ORR for Year 5 of CP3. It is for this reason we have increased the forecast in CP3, this is particularly important given HS1 has no way of making efficiencies on these costs, as they are controlled by the ORR.

ii. **Cybersecurity (£290,000):** As the ORR would be aware the UK government put forward the Network and Information Systems (NIS) Regulations in 2018 based on the EU NIS directive. This regulation came into force on the 10th May 2018. Since then the Department for Transport has deemed that HS1 is an operator of essential services (OES) and as such all HS1 systems are required to meet the NIS regulations. In order to understand compliance HS1 has had to undertake an extensive review of its IT assets, interfaces with the supply chain and our ability to protect against cyber-attack. The self-assessment was completed in and submitted to the DfT in April 2019. The DfT released the baseline requirement in July 2019 and this has led to costs to upgrade infrastructure and software over CP3. There is clear evidence-based justification for this increase in costs.

    Further, HS1 has already set and priced IT efficiency challenges of £200,000 over CP3. ORR is arbitrarily applying a significant efficiency burden without providing any meaningful analysis or comment, and despite the increased NIS requirements since the May 2019 regulatory submission and the draft determination.

iii. **Regulatory Staff / Structure of Charges (£750,000):** As the ORR and DfT would be aware, the burden of regulation is increasing significantly for both route and stations. HS1 has typically relied on external resource for specific expertise. As we have set out in the 5YAMS, by 'in housing' this capability HS1 reduces its overall regulatory costs. We think this is consistent with the ORR's drive for greater assurance and ownership from within HS1. For example, developing expertise 'in house' on track-train interfaces to continually challenge our supply chain, reviewing our structure of charges and significantly increasing regulatory reporting and monitoring – activities the ORR has noted it expects HS1 to take forward. HS1 will review its approach based on the ORR's Final Determination and clearly set out activities in the 5YAMs we no longer expect to take forward in CP3, without the funding.

iv. **Consultancy Costs (£340,000):** HS1 has already applied significant efficiency challenges to its consultancy spend in CP3 with a £2.5 million reduction over CP2 outturn. HS1 is disappointed ORR is not considering these costs and believe the evidence, particularly around the need to rebuild our charging model is clear. The additional staff above drive much of the proposed reduction (saving over £260,000). There is general recognition between ORR, operators and HS1 that it would benefit the industry to rebuild the charging model. In not allowing these costs ORR is setting an unhelpful incentive. HS1 will consider how it can work with operators to evolve our approach, for example by maintaining the current model if these activities remain unfunded.

e. **CP4-CP10 Risk:** HS1 accepts ORR's proposed determination of a 13% allowance for risk and contingency for CP4 10 renewal costs.

f. **Interest Rate Return (CP4-CP10):** HS1 is disappointed the ORR has maintained a 2.5% average interest rate for authorised investments. HS1 is surprised by the ORR's comments on our approach to deriving an average interest rate of 1.92%. HS1 simply replicated the ORR's approach to deriving 2.5% but with more up to date information so does not accept we didn't explain our approach sufficiently. Further, we have discussed with ORR on several documented occasions that HS1 does and should not hedge and forecast interest rates and it is for these reasons we take a forward look. This principle has been agreed with the Department for Transport (DfT), as accepted best practice is to use current rates as the best estimate for future rates. By forecasting higher interest rates, there is greater risk of further underfunding the escrow accounts if the rates are not realised, but HS1 notes that the magnitude of the impact is small relative to other assumptions and can be updated in CP4, if rates do change.

g. **Interest Rate Return (CP3):** While HS1 welcomes the application of 1.22% we do not accept the requirement to apply an 80 % / 20% allocation. On the one hand the ORR appear to be wanting to maximise returns whilst also limiting HS1's ability to do it. As ORR would be aware the Concession Agreement already significantly limits the investment strategy, with at least 10% of funds required to be available in readily accessible current accounts and not in long term "Authorised Investments", so having a further 10% less funds not maximising returns means operators are missing out on potential returns and this risks underfunding the escrow account again. HS1 does not accept ORR has not seen enough evidence to stay with the 90% / 10% allocation agreed with the DfT. ORR has been fully appraised of HS1's Escrow Investment Strategy over the last 12 months, as agreed with the DfT, and has provided no response or requests for further information in relation to evidence around the allocations.

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

London Sleeper Company PR19 matters to be determined response – 20 December 2019

Dear PR19,

Thank you for the update.

LSC support the ORR determination on the outstanding issues attached to the latest missive.

[REDACTED]

In conclusion, we can add nothing to the recent specifics.

Kind regards,

Mike

southeastern

Graham Richards
Office of Rail and Road
25 Cabot Square
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E14 4QZ

17 December 2019

Dear Graham,

ORR Periodic Review of HS1 Ltd 2019 (PR19): Matters to be determined

Thank you for your letter regarding matters which have yet to be determined following the publication of the ORR's Draft Determination for the 2019 Periodic Review of HS1. Southeastern's views regarding the outstanding items are represented below;

Asset life modelling
We agree with the ORR's findings that HS1's assumptions around asset life are overly conservative and we agree with the proposal to retain the 10% reduction in renewals presented in the Draft Determination. HS1 must be incentivised to realise the full value of its assets and this target should drive the right behaviours, however this must be delivered without cost to performance.

Project management costs
We agree with the ORR's proposal that project management costs should be capped at 10% as this is consistent with industry benchmarking.

Research and development funding in CP3
If this £2m funding is agreed, we would like to see some defined outputs and reporting requirements attached. We would also like to have input and transparency around how this is spent.

HS1 proposed internal cost increases
We support the ORR's continued challenge on HS1's plans and budgets to ensure value for money and we are therefore pleased that any unsubstantiated cost increases have been opposed. We do however have concerns that HS1 may try to pass these costs on to operators in any case through a different funding stream.

Risk funding for CP4 – CP10
We agree it is sensible to retain the proposed 13% allowance for risk and contingency for CP4 – CP10 renewals costs.

Interest rate for authorised investments for CP4 – CP10
We have no objection to the ORR's proposed approach to interest rate assumptions and allocations.

Interest rate for authorised investments for CP3
We have no objection to the ORR's proposal to reduce the interest rate assumption on authorised investments to 1.22% for CP3 in line with HS1's request. It is correct that HS1 has agreed this approach

with operators to not invest in Government or corporate bonds due to constraints imposed by the Department for Transport.

If you have any questions regarding our response, please don't hesitate to contact me.

Yours sincerely

C. Moftah

Chantal Moftah
Senior Commercial Manager

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