Discussion document: HS1 Escrow arrangements

Financial risks, incentives and governance

12 July 2019

Contents

1. Introduction

1.1. High Speed 1 (HS1) is a 109km high-speed rail line connecting London St Pancras through Kent to the Channel Tunnel. It is currently the UK's only high-speed rail line and serves four stations (St. Pancras, Stratford, Ebbsfleet and Ashford) along the route.

1.2. HS1 Ltd holds a concession (until 2040) to operate, maintain and renew the whole line. The Concession Agreement[1] sets out the terms of the agreement between HS1 Ltd and the Secretary of State for Transport (SoS), who owns the HS1 railway infrastructure. The Concession Agreement includes the charging framework, asset stewardship obligations and minimum operational standards.

1.3. Many of the functions which HS1 Ltd must perform as infrastructure manager (such as track operation and maintenance, signalling and timetabling) are contracted out to Network Rail (High Speed) Ltd (NR(HS)). The relationship between HS1 Ltd and NR(HS) is governed by an Operator Agreement (OA), which is a commercial agreement between the parties and the terms are not subject to regulatory approval.

Renewals on HS1

1.4. ORR regulates HS1 Ltd under the terms of the Concession Agreement. Our role includes determining whether HS1 Ltd's plans for each control period (including proposed charges) are appropriate. We also monitor HS1's compliance with its asset stewardship obligations.

1.5. At each periodic review, HS1 Ltd sets out plans for the next control period and for a 40 year period, including a proposal for the level of the operating, maintenance and renewals charge (OMRC). HS1 Ltd also sets out plans for the renewals which it plans to carry out on the network during that period. ORR then determines whether these plans are consistent with HS1 Ltd's general asset stewardship duty and either approves them or directs that they should be changed.

1.6. HS1 has recently reviewed its governance procedures for renewals and is in the process of making changes to its processes.

[1] The concession agreement can be found on the HS1 website at: https://highspeed1.co.uk/regulatory/key-regulatory-documents/concession-agreement

Escrow arrangements

1.7. The Concession Agreement requires the renewals elements of the OMRC, recovered through track access charges, to be paid into and held in an Escrow account[2] operated jointly by the SoS and HS1 Ltd throughout the concession. The Escrow account arrangements are intended to:

(a) fairly spread the cost of renewals over time; and

(b) avoid the build-up of a backlog of renewals that are potentially difficult to fund.

1.8. HS1 Ltd can only drawdown money from the Escrow account for specified purposes following sign off by the SoS. Currently, quarterly meetings are held to process withdrawals from the Escrow account.

1.9. Money can be drawn down to fund renewals projects which have been approved by ORR through a periodic review. If HS1 Ltd wishes to fund a renewals project which was not approved by ORR in a periodic review, it may notify ORR of its plan for the project and request a separate approval. ORR will currently approve the plan where it determines the plan to be consistent with HS1 Lt's general asset stewardship duty (as above).

1.10. Money can also be drawn down to be used for certain authorised investments, but the class of investments authorised under the Concession Agreement is limited. Given the Escrow account governance determines how the money paid by operators is used, it is important that the process is as transparent as possible.

PR19 process

1.11. On 31 January 2018, we published our approach to PR19[3] following our consideration of the responses received to our PR19 initial consultation document[4].

1.12. We identified that the two most important issues for PR19 with regard to renewals are:

(a) being clear about the allocation of financial risk between the operators and HS1 Ltd; and

[2] There are separate Escrow arrangements for station renewals, which are not the subject of this paper.

[3] Available on our website at: https://orr.gov.uk/__data/assets/pdf_file/0011/26597/orr-approach-to-pr19.pdf

[4] Non-confidential responses are available on our website at: https://orr.gov.uk/__data/assets/pdf_file/0011/26597/orr-approach-to-pr19.pdf

(b) to determine an appropriate level of funding of the Escrow account, the long-term renewals forecast in the 5YAMS should be as robust as possible.

1.13. The Concession Agreement sets out the provisions of the agreement between HS1 Ltd and the SoS. ORR's role is also set out in the Concession Agreement. It is not within ORR's power to change the terms of the agreement. An amendment of the Concession Agreement would require agreement between HS1 Ltd and the SoS.

1.14. However, as part of our role in monitoring asset stewardship obligations, stakeholders have made representations to us about the matters consulted on in this paper and we deem it appropriate that we explore any issues arising and discuss options with interested parties. Therefore, this document sets out our further thinking on the financial risks, incentives and governance of the Escrow arrangements for PR19. We are seeking views from stakeholders on the options discussed.

Next Steps

1.15. We welcome responses to the issues raised in this consultation. Responses will help inform our thinking and future decisions on these issues.

1.16. Please send your responses in electronic (or if not possible, in hard copy) format by 11 November 2019 to:

PR19@orr.gov.uk

PR19 Programme team

Office of Rail and Road

1 Kemble Street

London

WC2B 4AN

1.17. If you send a written response, please indicate if you wish all or part of your response to remain confidential. Otherwise, we expect to make it available in full on our website. Where your response is made in confidence, please provide a statement summarising it that can be treated as a non-confidential response. Please note that we prefer Microsoft Word format rather than PDF. If you do email us a PDF document, where possible please:

- create it from the electronic Microsoft Word file (preferably using Adobe Acrobat), as opposed to an image scan; and
- ensure that the PDF's security method is set to 'no security' in the document properties.

2. Independent review of Escrow arrangements

2.1. In 2018, ORR commissioned Steer to undertake an independent review of the Escrow arrangements. We asked Steer to focus on the following questions:

(a) the degree to which the Escrow arrangements enable efficient financial risk allocation between HS1, NR(HS), the Department for Transport (DfT) and other parties;

(b) whether the governance arrangements for the Escrow account support effective decision making; and

(c) whether the arrangements are sufficiently clear and transparent to provide stakeholders with confidence that they operate effectively.

2.2. As part of this work, Steer held discussions with stakeholders to understand different perspectives on the financial risks surrounding the planning, delivery and funding of maintenance and renewals activity. The Steer team also carried out an investigation into some comparators (including the Channel Tunnel, the M25 and Thames Tideway) to identify any learning points that may be relevant for the Escrow arrangements.

2.3. Steer's review concluded that some aspects of financial risk are not allocated to those who are best placed to manage it and that there is not enough clarity over who does take financial risk.

2.4. Steer identified a number of issues, which it considered would be difficult to fully address without modifying the allocation of risk which flows from the current Concession Agreement. These issues included restrictions on where Escrow investments can be held, and the relative bureaucracy of the process. They also concluded it would be helpful for the Concession Agreement to have further detail on the hand-back condition of assets.

2.5. Steer's report included a number of recommendations, which are summarised here. A full copy of the Steer Report is being published as an appendix to this document.

(a) **Planning and delivering an efficient profile of renewals**: That discussions on hand-back condition requirements and intermediate asset condition benchmarks should be initiated, and potentially further details on this included in the Concession Agreement. The benchmarks could also inform discussions about the approval of expenditure on individual renewals projects and programmes. The development of appropriate requirements and benchmarks should draw on relevant asset engineering capability within both HS1 and NR(HS) and be subject to critical review by independent experts.

(b) **Efficiency and transparency of decision making:** Train operator representatives should be present at key meetings preceding the sign off of withdrawals from the Escrow account. Lead parties (i.e. DfT and HS1) should exercise judgement as to whether operator attendance would be beneficial in a particular case. This decision should include guidance from ORR and build on HS1 Ltd's sharing of its Asset Management Annual Statement with users. Consideration could be given to establishing a framework of delegated authority for approving renewals activity and the associated withdrawal of Escrow funds, based on clearly defined thresholds. This would enable the approvals process to operate more efficiently. We are pleased that HS1 Ltd has implemented this recommendation.

(c) **Management of delivery financial risk:** There is a concern about whether the current arrangements allocate risk effectively. Particularly, in setting the right incentives to keep costs down or reduce the risk of significant increases in the future to cover asset renewal uncertainties. To ensure greater confidence in the management of cost risk following sign off of withdrawals, Steer recommended that ORR undertakes targeted reviews of particular renewals projects and programmes at short notice on a sample basis.

(d) **Ensuring adequate accumulation of funds:** Steer considered that the provisions in the Concession Agreement limiting the range of assets in which HS1 is permitted to make Authorised Investments are too restrictive. Steer proposed that HS1 should have greater flexibility to seek higher returns within an envelope of acceptable risk. The report includes a suggestion that the existing provisions are replaced with general obligations, analogous to the legal requirements governing the activities of the trustees and managers of defined benefit pension funds. These could be supplemented with guidance based on a suitable adaptation of that published by the Pensions Regulator.

3. Issues and options

3.1. Taking into account the responses to our initial consultation and the work undertaken by Steer, we have identified four key issues that underpin the issues identified. We set out below:

(a) for each issue, some thoughts on the scale of and reason for the issue;

(b) where possible, potential short-term options to address the issues – generally through improved guidance; and

(c) for each issue, potential longer-term options to address the issues – generally by way of changes to the Concession Agreement.

3.2. We are seeking views from stakeholders on these options.

> ***Questions***
>
> 1. Do you consider that we have identified the relevant underlying issues? Are there other issues you think we should consider at this stage?
>
> 2. What are your views on the potential options for addressing these issues?

Issue 1: The incentives on HS1 to spend efficiently on renewals

3.3. The incentives on HS1 to spend money on renewals efficiently, and to propose appropriate amounts in its plans for the control period may be limited due to:

(a) variations in the cost of approved renewals projects are not borne by HS1 but by current and future operators (through the Escrow arrangements). This lack of exposure to the full cost of renewals decisions reduces the incentive on HS1 to ensure the most efficient timing and phasing of works;

(b) a lack of clarity on the treatment of certain issues within the renewals process, such as whether contingency/risk should be included in the Escrow arrangements;

(c) limited detail in the Concession Agreement about the necessary hand-back condition of assets and future longer-term performance. This could unintentionally incentivise HS1 (and others) to prioritise the near-term (at the expense of long–term asset condition) when making decisions about necessary renewals; and

(d) Network Rail's position as a monopoly supplier, regarding renewals works on the high speed network (through NR(HS)), means that it plays a significant role in determining the scope of works.

3.4. However, HS1 does have general asset stewardship responsibilities in the Concession Agreement around efficiency. It also has a reputational incentive (and an albeit limited financial incentive) to make efficient decisions, as those decisions will impact the service provided, affecting future revenue and business opportunities.

3.5. We have identified two options that we consider could help address this issue:

(a) <u>Short-term option:</u> Additional guidance on HS1's duties regarding efficient renewals; and

(b) <u>Longer-term possibility:</u> Amending the Concession Agreement to improve incentives and provide further detail on the hand-back condition requirements.

3.6. Additional guidance for HS1 on its renewal duties could be reasonably expected to:

(a) set out ORR's expectation regarding the market-testing of renewals costs – providing greater transparency around efficient costs;

(b) explain how financial risk is allocated in the current arrangements; and

(c) include our expectations for a stronger challenge process – with a key role played by operators in developing proposals.

3.7. A clear explanation of the allocation of financial risk (point 3.6 (b) above) would help identify who is exposed to the different risks including:

(a) renewals planning/forecasting risk (borne by operators who bear the costs if the original forecasts are too low);

(b) Escrow investment risk (also borne by operators – although the downside risk is limited by the nature of the investments); and

(c) delivery risk (borne by HS1 and NR(HS) – see paragraph 3.15(c) for more details).

3.8. We welcome views on the different risks that should be considered as part of this work.

3.9. Such guidance, could then in the longer-term, help stakeholders propose and give views on any potential changes to the Concession Agreement.

Issue 2: Ability of operators to influence the renewals profile

3.10. Train operators are important consultees as part of the periodic review and their views are taken into account when ORR makes its periodic review determination. After this, under the existing arrangements, operators have no formal role around renewals to the network. This means that they have limited opportunity to influence the scope, timing or profile of expenditure, which could give rise to a number of issues or concerns including:

(a) missing opportunities to use operators' operational knowledge to inform asset management choices;

(b) a disconnect with what operators need including the potential 'gold-plating' of the network; and

(c) operators are not adequately informed about the basis of costs they are required to pay.

3.11. However, it also needs to be recognised that operators may not always be best placed to advise and/or influence renewals decisions:

(a) there may be a tendency for operators to take a short-term view; either because of the length of their franchise agreement (i.e. they may not be operating on the network in the longer-term) or the need to focus on shorter-term shareholder interests; and/or

(b) operators may also not always be experts on the renewals under consideration.

3.12. The additional guidance for HS1 on its renewal duties (as described above) could also help improve transparency of costs and performance through for example:

(a) setting expectations for sharing information tailored to operators needs on upcoming renewals and providing a clear line of sight for any changes to renewals profiles and expenditure proposals; and

(b) setting ORR's expectations around a better explanation of changes in plans and of variances within the control period.

3.13. This improved governance and transparency around information sharing could be expected to improve the effectiveness of engagement with operators and allow them to have a greater (and still appropriate) influence on renewals.

3.14. In the longer-term, it may be possible to amend the Concession Agreement such that operators have a more clearly defined role in the process. The effectiveness of the additional guidance in the short-term could help shape changes to behaviours. Such an amendment might formalise governance around stakeholder engagement such that:

(a) HS1 must follow the principles of good stakeholder engagement as per ORR's approach for Network Rail under its network licence (or similar); and

(b) stakeholders have an increased formal role in the decision making process around projects, beyond their involvement in a periodic review.

Issue 3: The process for determining renewals expenditure

3.15. It is generally agreed that the current process, which is used for determining and approving HS1's renewals expenditure through quarterly meetings (where SoS sign off is given) is cumbersome. It also does not reflect wider principles of regulatory proportionality. Specifically:

(a) the current quarterly process (for obtaining SoS sign off) is very detailed and time consuming and is probably not workable when more projects are being considered;

(b) under the Concession Agreement, individual project approval must be obtained from ORR for any project not approved through the periodic review; and

(c) who bears the financial risk associated with cost increases varies depending on the timing of the increase. This makes the process less transparent than it could be. This also makes comparisons (across the renewals portfolio) more difficult. The allocation of this risk may affect the assessment of efficiency. For example, NR(HS) currently bears the risk of cost increases post agreement of the price of the renewal, but these risks are likely to have been built into its bid.

3.16. The additional guidance for HS1 on its renewal duties (as described above) could help to improve the process for determining renewals expenditure. Specifically, the guidance could:

(a) ensure good use of the periodic review process, potentially by limiting the scope through which new projects within a control period could be considered outside this process (e.g. only if the project is unexpected or costs were considered too uncertain at the time of the periodic review);

(b) enable the trialling of changes to the approvals process;

(c) set out ORR's expectation for qualitative reporting to help identify future improvements to the process; and

(d) support improvements in the procurement process (e.g. setting out ORR's expectations around market testing or enabling fixed price contracts).

3.17. In the longer-term, it may be possible to amend the Concession Agreement to formally embed improvements in the process.

Issue 4: Risks of inadequate return on funds

3.18. The current Escrow arrangements provide little flexibility for HS1 to manage the investments in a way that ensures appropriate returns within an acceptable risk profile[5]. This is because any permitted investment (funds can be held on deposit or used to purchase treasury bills or short-dated gilts) is intended to be low-risk and highly liquid. Such investments are likely to have a relatively low rate of return, which affects the incentives on HS1 to increase its return.

3.19. Given these matters are fixed in the Concession Agreement, it is difficult to make short-term changes. However, there are a number of improvements that could be considered in the longer term through an amendment to the Concession Agreement. These include:

(a) replacing the specific constraints in the agreement with more generalised obligations that would allow greater flexibility in investment opportunities whilst ensuring good practice is followed;

(b) enabling HS1 Ltd in certain circumstances to invest outside the Escrow account where it provides a guarantee that as a minimum it would cover the original capital and a reasonable return regardless of the actual return and allowing them to keep any additional returns; or

(c) potentially, allowing operators to invest the required funding outside the Escrow account (assuming appropriate guarantees can be given) in a similar way.

[5] See paragraph 5.20 of the Steer report for further detail

High level summary of the benefits of the short and long term options

Short-term options: Improved guidance	
✓ Could be put in place fairly quickly for CP3 and kept under review to enable further improvements ✓ Setting clear expectations on both parties, which could result in material improvements in processes and increased transparency	× May not fully address the lack of incentives × Different effect to binding contractual changes
Longer-term options: Changes to concession agreement	
✓ Puts in place further incentives ✓ Could more fully address issues flagged including nature of investments	× Likely to have little or no impact early in CP3

This publication is available at orr.gov.uk

Any enquiries regarding this publication should be sent to us at orr.gov.uk