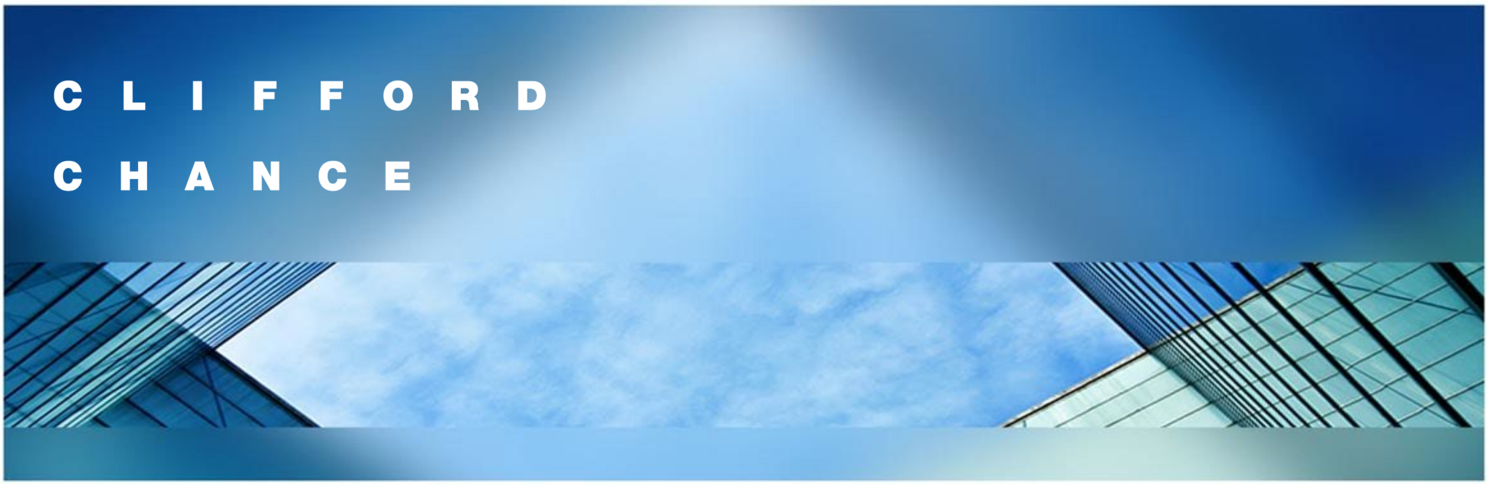

GREAT BRITISH RAILWAYS- THE WILLIAMS-SHAPPS PLAN FOR RAIL

INTRODUCTION

The Williams-Shapps Plan for Rail (the "**Plan**") is the long awaited shake-up of the UK rail industry billed in the foreword as "*the biggest change to the railways in 25 years*". The purpose of this briefing is to identify how substantial that change is, and what its implications may be for some key industry participants.

REAL CHANGE?

It is easy to be cynical about reports on the UK rail sector, with the Williams-Shapps white paper following the McNulty, Laidlaw, Brown, Bowe, Hendy and Shaw reports just in the past decade. While the enthusiastic tenor of the Plan is encouraging, whether the promised changes are real or illusory remains a reasonable first question.

The new "*guiding mind*" of the railway, Great British Railways ("**GBR**"), is effectively a merger of the DfT franchising function, the Rail Delivery Group and Network Rail, the national infrastructure operator.

The aim (amongst other things) is for the new GBR to manage both the network infrastructure and a new generation of Passenger Service Contracts ("**PSCs**") granted to train operators. The new GBR will thus have a very high degree of control over the railway's inputs and outputs.

The logic is ostensibly one of simplification (under the banner "*Simplification is better than Nationalisation*") and reduction of inefficiency. Certainly, the centralisation of power in GBR could catalyse more direct leadership of the sector, which could provide substantive change in itself.

Changes in the details of the industry, however, are less obvious. The current and future industry diagrams in the Plan show differences more aesthetic than substantial. And as part of the "*battalions of lawyers*" familiar with the existing "*maze of agreements*" deprecated by the Plan, it's not entirely clear to us which (if any) agreements are expected to disappear.

Unlike the previous franchise agreements under which franchisees took farebox risk, the new PSCs granted by GBR will basically be managed concessions under which operators will be paid a fixed premium over their costs in exchange for delivering a detailed service specification determined by GBR. It is conceivable that the PSCs may incorporate the (currently separate) track access agreements. Even so, many distinct elements will likely remain

Key issues

- A new "guiding mind" – Great British Railways – is effectively a merger of the DfT franchising function, the Rail Delivery Group and Network Rail
- GBR will manage the network infrastructure and a new generation of Passenger Service Contracts granted to train operators
- PSCs will be managed concessions where operators will receive a fixed premium over costs for delivering services in accordance with detailed specification
- Government funding settlement to be balanced against expectations for increasing farebox revenue and passenger numbers
- No direct change to current industry model for fleet procurement and maintenance by train leasing companies; core fleet and replacement requirements to be monitored
- Still a place for private infrastructure managers and private finance investment in infrastructure network

recognisable from the original agreements. Furthermore, standalone track access agreements should still be needed for freight operators and open access operators who don't have a new PSC. So we would expect evolution from existing contracts rather than revolution. We note that there will be a managed transition to the new PSCs involving, after expiry of the current Emergency Recovery Management Agreements, the introduction of new National Rail Contracts which will act as "*stepping stones*" to the PSCs and include "*incentives to drive revenue growth and the flexibility to 'switch on' further revenue growth measures when conditions allow.*"

More generally, the Plan highlights the "*blame culture*" that exists under the current system and the arcane system of adjudication of delay attribution disputes (including an example concerning a dispute related to the size of a pheasant) and states that the "*cottage industry*" of delay attribution disputes will end. How will this come about?

Service specifications in the new PSCs will presumably include some form of delay/performance incentive, and GBR will surely have its own performance metrics to defend. This seems an environment ripe for attribution of responsibility for delays, unless the operator and GBR win and lose together. It is possible that an enhanced version of Network Rail's "alliancing" or joint working arrangements with operators may be contemplated under the new GBR umbrella which might reduce the opportunity for delay disputes, but that point is not developed in the Plan.

The Plan, therefore, seems unlikely to change much of the legal detail underlying the sector. This puts more focus on changes in industry culture and leadership, which the new GBR would need to deliver.

GUIDING MIND AND OVERSIGHT

With a combination of functions currently existing within Network Rail, DfT, Rail Delivery Group and operators, GBR will certainly have wide-ranging power across the industry.

One question is how that power will be monitored. Can the government and the ORR effectively second-guess GBR's guiding mind?

GBR will be "*accountable to Ministers*", and its funding streams will be "*conditional on … delivering customer needs and making efficiency improvements*". Punishing GBR's failure to achieve efficiency by reducing funding has the potential to cause further harm to GBR, but if this threat is hollow, how is GBR to be motivated to change?

The other side of that coin is whether supervision can be achieved without hobbling GBR. Ministers will have "powers to issue guidance and mandatory directions to Great British Railways on any matter at any time". That seems to leave the railway's guiding mind open to political influence, which would allow GBR to shift blame to the government.

The ORR will also need an expanded set of skills, holding GBR to account, mediating between GBR and operators/suppliers and running the Rail Ombudsman function. We assume this includes more "value for money" analysis by ORR of the inputs and outputs of the new PSCs, with the same degree of scrutiny as is now applied to Network Rail's 5 year funding settlements.

CHANGES IN FUNDING

According to the Plan, "Great British Railways' regular five-year business plans will inform government decisions about rail's five-year infrastructure funding settlement and the level of operational subsidy. These business plans will develop 'in-life' to reflect multi-year operational budgets set through the government's Spending Reviews, whilst preserving the five-year infrastructure settlement. The clear planning horizon provided by these regular five-year business plans, and any changes to them, will give more certainty and stability than ever before".

It isn't clear whether the sum of the infrastructure funding settlement and the operational subsidy provided by HM Treasury to GBR will exceed, or be less than what HM Treasury have provided to Network Rail and DfT in previous periods. (both pre and post- pandemic).

These funding streams will clearly be subject to the government's Spending Reviews and the overall tone of the plan is that material savings will be expected.

Efficiency savings from structural simplification and other measures specified in the plan in the order of £1.5 billion a year or the equivalent of 15% of the network's pre pandemic fares income are expected after 5 years. It isn't totally clear that this order of savings are actually achievable in the context of the changes proposed (see earlier discussion above)

The other side of the funding equation will be the network's ability to increase farebox revenues back to or approaching pre-COVID levels following the collapse in passenger numbers during the pandemic.

The plan indicates confidence in GBRs ability to grow passenger numbers on the basis of responding nimbly to changed needs : "*Great British Railways will be better able to respond quickly to changing demand and lead the railways through the challenges of the post-pandemic world..."* . It remains to be seen whether this will be possible and if it isn't, whether a funding squeeze may result, with implications for services and investment.

Regardless, the position of GBR as a single body planning for the entire railway is a welcome development. A 30 year rail strategy, supporting 5 year business plans, could provide much-needed predictability for the sector. The plans for a devolved GBR with decision-making and budgets at a local level could also motivate stakeholders. GBR's ability to co-ordinate those local and regional decision-makers, and achieve consistency and economies of scale across the network, will be critical.

LIFE UNCHANGED FOR ROSCOS?

There has already been industry press suggesting that ROSCOs will be happy with the Plan, and that it leaves life essentially unchanged for them. This appears to be the case – the Plan is clear that the government intends to "*maintain and increase private involvement and private finance*" and that operators will continue to work with "*private partners, including train-leasing companies*".

There is also a clear statement that the paper does not assume "*any direct change to the current industry model for procurement of train fleets and maintenance by independent train-leasing companies*" – the ROSCOs will certainly not be first against the wall in this revolution.

Passenger Service Contracts may vary in length to a greater degree than current franchises, although the suggestion appears to be that longer contracts are more likely than shorter, a relief for investors assessing re-leasing risk. Competitions for the new Passenger Service Contracts are expected to be launched "*by the time the emergency recovery agreements end in 2022*" (with the stepping stone National Rail Contracts operating in the interim), so this will soon become evident .

There are some items that might raise eyebrows. The Plan hints at a reduction in the variety of passenger rolling stock fleets going forward, which might narrow procurement competition in the rolling stock market. We assume that that is being proposed with a view to bringing down the whole of life maintenance cost of relevant stock by achieving economies of scale on the maintenance side in particular.

There is also a strong statement that "*Great British Railways will bring forward the normal replacement cycles on existing trains equipped with "ironing-board"-like seats, beginning with long-distance trains, in order to make the seats significantly more comfortable, or to replace and eventually remove them altogether*", which seems to presage expensive upgrading of existing rolling stock, or the potential for relatively new trains to be replaced entirely by those which are "more comfortable". Recent rail press articles suggest that this is quite a complex issue constrained by the latest fire safety requirements in relation to seat padding, so query what will ultimately materialise.

The Plan contemplates increased operator competition, including potentially within the same parts of the network. While that may increase demand for new fleets, it could come with risks of those fleets not being "core fleets" if new entrants choose to exit a competitive market. Certainly increased competition should reward private investors willing to be innovative and flexible. It is not completely clear how operator competition will arise in an environment where GBR specifies all of the services. The role of open access operators as a source of competition in the new environment is in particular not elaborated upon, and merits further detail.

A key question is how much influence GBR will have on fleet requirements. If GBR is acting as procurement authority, and specifying timetables and service levels in PSCs, it will presumably have a high degree of control over how many trains are needed, and of what type. Query whether this will involve an appreciably different approach to that of the DfT. The paper certainly assumes so: "*Great British Railways will not design services that the infrastructure cannot support, or that are based on unworkable timetables, as happened repeatedly under franchising*" but it does not say how. The risk for ROSCOs is that GBR becomes a de facto monopoly customer for UK rolling stock with a very tight grip on all possible leasing opportunities, including all the cascading opportunities which are necessary for the re-leasing of older stock. That may give rise to stronger pressure on ROSCO margins with significantly tougher rental negotiations. This is particularly a risk in the context of significantly reduced post-COVID (commuter) ridership, which may lead to a shrinkage of the overall demand for certain types of passenger rolling stock and displacement of under-performing or technically obsolescent fleets.

The picture is brighter in the field of technical innovation in the context of de-carbonisation. As well as GBR continuing electrification, the paper notes that "*battery and hydrogen-powered trains will be trialled for passenger routes where conventional electrification is an uneconomic solution*" . We understand that this is an area where ROSCOs have already been doing extensive work and will thus be in a position to take advantage of the new opportunities.

RAIL INFRASTRUCTURE

The picture for rail infrastructure also appears largely unchanged, but with perhaps some small positive steps.

Private infrastructure managers and arms-length bodies (HS2, East-West Rail) will remain responsible for their areas of the network.

While GBR will remain responsible for most infrastructure, opportunities may exist for private finance in rail infrastructure, whether with local authorities or via the "*integration of fleet planning with infrastructure improvements*" (page 80). Project Reach is used as an example of how private funding can be attracted for new technologies (page 84). Electrification projects may also provide additional opportunities.

PLUS ÇA CHANGE… ?

Substantial changes lie ahead for the UK rail industry. Some of these are an inevitable result of the disruption caused by the pandemic, and the Plan looks to utilise that disruption to resolve enduring issues affecting the sector. Changes to industry forms and structures seem relatively limited, so the Plan's success will depend on stakeholders (particularly GBR) seizing the opportunities to drive substantive change.

In the near term, life for ROSCOs and other private investors appears to be relatively unchanged. There are however several trends to look for in future, particularly as GBR's approach to the industry develops. Perhaps the revolution will arrive after all.

CONTACTS

Paul Carrington
Partner

T +44 20 7006 8124
E paul.carrington@cliffordchance.com

Ranbir Hunjan
Partner

T +44 20 7006 2612
E ranbir.hunjan@cliffordchance.com

Michael Pearson
Partner

T +44 20 7006 4753
E michael.pearson@cliffordchance.com

Dominic Watts
Senior Associate

T +44 20 7006 2053
E dominic.watts@cliffordchance.com

Su Lin Khor
Senior Associate

T +44 20 7006 4883
E sulin.khor@cliffordchance.com

Michelle Lovick
Senior Associate

T +44 20 7006 3024
E michelle.lovick@cliffordchance.com

Alain Dodds
Lawyer

T +44 20 7006 6183
E alain.dodds@cliffordchance.com

Anna Mammedova
Lawyer

T +44 20 7006 2241
E anna.mammedova@cliffordchance.com

Marisa Chan
Knowledge Director

T +44 20 7006 4135
E marisa.chan@cliffordchance.com