UK RAIL: THE WILLIAMS REVIEW

The Williams Rail Review of the structure of the UK rail industry is currently ongoing and expected to report in autumn 2019, with its recommendations to be implemented from 2020. This briefing discusses potential outcomes of the Review and considerations for rolling stock lessors and financiers in the event of changes to the franchising regime.

OVERVIEW

The Williams Rail Review (the Review) was established in September 2018 to look at the structure of the whole rail industry in the UK and the way passenger rail services are delivered. The Review is being led by independent chair, Keith Williams.

The Review was set up by the UK government in response to numerous problems that have affected the rail industry, including the issues with introduction of a new timetable, the collapse of the East Coast franchise and the impact of industrial action on services on the Southern franchise.

In recent speeches, Keith Williams has given a reasonable insight into the direction of travel of the Review.

- *Root and branch change* – Both the Department for Transport (DfT) and the Review have been described as committed to "root and branch change". We can thus expect the impact of the Review to be significant.
- *Loss of public trust and need for customer focus* – The need to recover public trust in the railway by increasing customer focus has been emphasised.
- *Structure versus ownership* – The focus of the Review has been stated to be finding the right industry structure rather than focussing on ownership.
- *The end of the current franchising model and new alternative models* – It is apparent that the Review aims to replace the current franchising structure with a different model or models.

ALTERNATIVES TO THE CURRENT FRANCHISING SYSTEM

Possible solutions under consideration

In terms of alternative models, Keith Williams has suggested that "there is unlikely to be a 'one size fits all' solution", and that a mix of solutions may be where the Review lands.

Some of the areas that have been mentioned as under consideration include "new models of franchising", "greater public control of contracts", "much more localised decision-making" and "integrated concessions, where those operating trains and managing infrastructure work together in genuine partnership, acting like a single business absolutely focused on customers".

Alternative models

Whilst awaiting the outcome of the Review it is possible to speculate that elements of the following models which have been tabled or developed previously may be considered to form part of the chosen outcomes:

Integrated franchises combining track and train operation

This would follow the model originally proposed for East West Rail and the route from Oxford to Cambridge and would involve the transfer of relevant Network Rail infrastructure into the franchise. The franchisee would then assume an O&M role in relation to the infrastructure as well as managing passenger operations. Where used, this would address the "fragmentation" and "localised decision making" issues that the Review has identified.

A wider abandonment of the separation of infrastructure and passenger operation would need to await clarity as to the UK's future relations with the European Union and the continuing applicability of the European Union's 'railway packages' to the UK.

This model also infringes on Network Rail's current remit and opens issues as to the rights of freight operators under such a structure.

Expanding the role of Local Transport Authorities

Local Transport Authorities, such as Transport for London (TfL), and regional Passenger Transport Executives already integrate track and passenger train operation.

Expanding TfL's remit to include London's suburban transportation network has been under discussion for many years and is a realistic option following the successful adoption and branding by TfL of the London Overground network. We assume similar options could be considered in other major cities.

Where used, this option would address both the "fragmentation" and "integration of transport modes" points identified by the Review as well as engaging "localised decision making" and "digitisation of ticketing" in the context of TfL's Oyster Card arrangements.

Rail would however need to compete for funding with other modes of local transport, such as buses.

Deeper alliancing between operating companies and Network Rail routes

As an alternative to full integration of infrastructure and passenger operation, it may be possible to pursue deeper 'alliance' arrangements between individual Network Rail routes and passenger franchises which operate within the region. The aim would be to strengthen co-operation between the two, following on from previous successful Network Rail–TOC alliancing arrangements (such as have been operated on the South Western franchise).

Public sector award of management contracts rather than franchises

Setting aside fragmentation issues, one of the major problems of the current franchise system is the inability of bidders to correctly assess future revenues, leading to unrealistic bids based on unrealistic expectations of future revenue growth, with the consequent risk of franchise failure. One of the options to avoid such a scenario in the future is to transition to a management contract (as currently exists with Govia Thameslink) where the TOC entity is paid to run the service but does not take farebox or revenue risk.

The downside with this model is that under a management contract, the TOC may no longer be properly incentivised to maximise ridership and revenue, leaving it to the procuring authority to do that.

To the extent any new rolling stock procurement was required into a franchise where a management contract was in place, we assume the procuring authority/DfT would need to specify and direct that process.

One of the recurring issues being brought up in the context of the Review is that DfT may not be best placed to 'micro-manage' franchise specification, giving rise to a debate about who would be the appropriate party to take on this responsibility.

Where considered appropriate, the management contract option could be combined with other options discussed above.

ISSUES FOR LESSORS AND FUNDERS

Legislative changes to franchising regime

It is expected that the overhaul of the franchising system resulting from the Review will result in new legislation in 2020. Lessors leasing rolling stock into current franchises (and their lenders) will need to consider the potential implications for them of legislative changes to the franchising structure.

The implications may differ depending on whether:

- the new arrangements are for a similar or different term to the franchise arrangements which they replace
- the new arrangements are for a similar set of geographical routes to the franchise arrangements which they replace, maintaining the need for the same or a substantially similar rolling stock fleet
- the new arrangements involve a better or worse credit as lessee counterparty. (If, for example, TfL's remit was expanded, its credit rating (which would be significantly better than that of a typical TOC) would be beneficial to lessors leasing into the replacement arrangements.)
- the existing franchise is allowed to expire before being restructured/ replaced to reflect the new arrangements, or whether the changes are introduced 'mid-franchise'
- relevant rolling stock leased into an existing franchise currently benefits from Section 54 or analogous arrangements guaranteeing re-leasing of rolling stock in future franchise periods.

Re-leasing risk and compensation

Existing franchise unchanged

If existing leasing arrangements were allowed to run their course for the residue of current franchises, and setting aside any leases where Section 54 arrangements apply, lessors and their lenders would be subject to 're-leasing risk' in the context of the new framework. The benefits and disadvantages of that framework could only be assessed once the framework is published.

Technical factors which make relevant fleets essential to a particular route and/or difficult to displace would however continue to apply.

Termination of existing franchise

If leasing arrangements aligned with franchise terms were disrupted by mid-franchise termination by operation of law, with relevant rolling stock not immediately rolled-over into the successor framework, the issue of Lessor compensation for the loss of contracted lease revenues would arise.

Section 54 Agreements

If Section 54 Agreements were involved, the removal or material variation of the statutory underpinning to the Section 54 Agreement giving rise to an inability to obtain 'guaranteed' re-leasing for future franchise periods up to the scheduled Section 54 Agreement backstop would be a significant issue. The question then would be whether and how government would put in place arrangements to put Lessors in the same position they would have been in had the legislative change not occurred. In the absence of such replacement arrangements, the issue of Lessor compensation for the loss of contracted lease revenues would again arise.

We would expect industry consultation on this type of issue (if applicable) once the Williams Review recommendations are published.

Rolling stock-related infrastructure

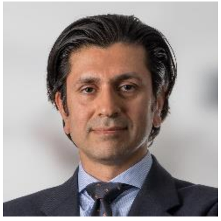
In relation to the leasing and financing of rolling stock related infrastructure assets such as depots, which typically would be on Network Rail owned land and subject to a headlease from Network Rail to the lessor and then an underlease from the lessor to the franchise operator, changes to the franchising structure could present opportunities. To the extent the new arrangements involved integrated franchises combining track and train operation by the operator, lease structures could be simplified through the potential removal of the additional Network Rail interface.

If new franchise arrangements with an integrated infrastructure component were granted for a longer term than typical current franchises (see for example the 20 year term granted in respect of the Chiltern Railways franchise to enable the Evergreen 1/2 projects), that could assist in amortising investment in such assets over the franchise term, rather than requiring lessors and their financiers to take re-leasing risk on the asset.

NEXT STEPS

The Clifford Chance rail team will publish a further update to this briefing when the Review's findings are published in autumn 2019**.**

CONTACTS



Ranbir Hunjan
Partner

T +44 20 7006 2612
E Ranbir.Hunjan
@cliffordchance.com

Paul Carrington
Partner

T +44 20 7006 8124
E Paul.Carrington
@cliffordchance.com

Michael Pearson
Partner

T +44 20 7006 4753
E Michael.Pearson
@cliffordchance.com

Dominic Watts
Senior Associate

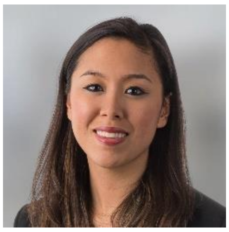
T +44 20 7006 2053
E Dominic.Watts
@cliffordchance.com

Edward Norman
Senior Associate

T +44 20 7006 4520
E Edward.Norman
@cliffordchance.com

Michelle Lovick
Senior Associate

T +44 20 7006 3024
E Michelle.Lovick
@cliffordchance.com



Su Lin Khor
Senior Associate

T +44 20 7006 4883
E Sulin.Khor@
@cliffordchance.com

Alain Dodds
Associate

T +44 20 7006 6183
E Alain.Dodds@
@cliffordchance.com