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Dear Paul

### **2014 High Speed 1 Periodic Review: First consultation**

Thank you for the opportunity to respond to the ORR's first HS1 periodic review consultation. We have reviewed the consultation with interest.

Eurostar welcomes the transparent, open and inclusive manner in which HS1 and the ORR have engaged with stakeholders and looks forward to continued engagement and discussion throughout the periodic review process. We consider it key that the process builds on Control Period 1 experience to deliver rigorous scrutiny and outcomes that demonstrate efficiencies and a robust set of incentives for Control Period 2.

In this first consultation response we have picked up on certain themes of interest for us including performance regime incentives, the benchmarking exercises and escrow account contribution incentives together with the mechanisms for addressing these. We comment on these below.

#### **1. Do you agree that CP2 outputs should balance HS1 Ltd's vision, contractual requirements and customer views ? Are there any other relevant considerations ?**

We agree that the CP2 outputs should take these elements into consideration, and that customer views should include the vision and objectives for CP2 of HS1's customers, TOCs such as Eurostar. In respect of the elements in the consultation question, we think that the inputs of contractual requirements and HS1's customer views should be the key factors driving the CP2 outputs; we would expect HS1 Ltd's vision to be consistent with, and reflect, these factors.

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Eurostar's operations are built around and driven by the needs of its passengers. This means that, through Eurostar's input into the periodic review, the views of our passengers are also represented. As a commercial operator, Eurostar is on risk for correctly interpreting what its passengers want and, even where this is impacted by another entity or process, Eurostar remains on risk for this through the resulting effects on its business. We are keen to avoid a situation where HS1 is required to conduct an exercise to canvass the opinion of the passengers of HS1's customers. We believe that this would lead to duplication and potentially imports a risk where different, inconsistent interpretations of our passengers' requirements may arise. This in turn would raise questions about how any such inconsistencies are addressed in the periodic review.

We note the comment in paragraph 2.14 about 'commercial matters relating to the fixed OMRC' and we would be interested to learn more about this so that we may understand what this may include.

**2. Do you agree that a wholesale review of the contractual incentives mechanisms is not necessary ? In your experience, are the existing performance regime and possessions regimes working well ?**

We are mindful that the performance and possessions regimes have been in operation for only one control period. In our view it is not appropriate to conduct a wholesale review of the incentives mechanisms for the next control period. Within the existing regimes there is, of course, scope for vigorous review to ensure that incentives are working to encourage efficient operation of the railway.

A key area of performance regime focus for us is on incentives for recovery from major incidents on HS1. It is these types of incident that have the potential to significantly affect Eurostar's operational performance and can lead to significant costs for our business in terms of compensation payments that we are required to make to our customers in such circumstances, as well as the reputational damage our brand can experience following such incidents. HS1 has not been required to contribute to Eurostar's costs incurred as a result of major incidents originating on the HS1 network.

In terms of the cap on performance regime payments, we note that this can often be reached early in the operational period to which it applies. This raises a question about the level of operational performance incentive in place for the remainder of that period. We would be interested in exploring ways to maintain performance incentives throughout each period, while not changing the overall level of the annual cap on payments that applies.

We make preliminary comments on the possessions regime in advance of our review of the asset plan currently in preparation by HS1. Our experience is that the existing regime works, however we note that the possessions regime has yet to be tested in any significant capacity. As with the performance regime, given the short period of operation we would not wish to see a significant departure from the current possessions system. We consider it important that, in CP2, the aim of the possessions regime should be to avoid disruption to commercial passenger services while focusing on efficient delivery by HS1 of any work required.

We welcome HS1's intention to look at ways to improve processes for allocating delay, mentioned at paragraph 2.19 of the consultation. Currently delay attribution on HS1 is managed in line with the GB industry Delay Attribution Board's (DAB) 'Delay Attribution Guide'. We consider that this provides a reasonable approach on delay attribution matters on HS1 and that this tried and tested methodology will continue to do so in future when new traffic operates on the HS1 network. HS1 is not at present a DAB member which means that any improvements to the delay attribution process, whilst welcome, will be a departure from the GB industry established process. This is because HS1, not being a DAB member, is at present unable to propose changes to the Delay Attribution Guide. We suggest that, in order to ensure effective input into this process, that HS1 should become a DAB member.

We note that freight is incentivised to operate on HS1 at marginal cost and through mechanisms such as subsidies provided to assist freight operators. In return, freight operations are generally conducted outside core passenger hours. Eurostar supports the balance of this approach.

Were freight to operate during the day there would be a risk that these movements might impact on passenger operations, such as those provided by LSER and Eurostar, and that passenger operators would suffer financial loss. In these circumstances we would therefore expect to see freight paying a full commercial rate for access and to participate fully in the performance regime, including in respect of the level of delay payments.

### **3. Do you have further thoughts and ideas on the ways in which parties can work with HS1 Ltd to improve efficiency, including comments related to the outperformance mechanism ?**

We consider the efficiency review to be a very important part of the periodic review. In view of the possibility that this may in future exert some influence on targets, establishing an efficient starting place from which outperformance may be measured is key.

This is particularly the case, given the background to the current operating and maintenance agreement which underpins a significant proportion of current charges. Until its restructuring in 2010, the Network Rail (NR) contract was on a cost-plus basis without any efficiency incentives. It had not been subject to any market testing when it was established some years previously, and had not been subject to any regulatory or external efficiency scrutiny since then. Eurostar understands that the restructuring of the contract in 2010 delivered some improvements – introducing the possibility of future market testing and putting NR more 'on risk' for the delivery of the work within budget. However, the fundamental level of that budget does not appear to have been revisited at that time (i.e. there were no *prima facie* efficiency gains from the contract renegotiation). The review conducted on behalf of the ORR by Arup in October 2009 appeared to support this contention suggesting that the costs on HS1 were between 7% and 60% higher than those of other Infrastructure Managers.

In 2012, HS1 again renegotiated this key contract. In doing so, it secured a 10% reduction in charges, in return for giving NR certainty of tenure for two control periods. HS1 retained 40% of these savings itself, the remaining 60% being split between Eurostar and LSER. Whilst Eurostar recognises HS1's arguments that it should benefit from having brought forward this "efficiency gain" ahead of the periodic review, we would now regard the 10% reduction as the "starting point" for the new review and for operators (collectively) to see the full benefit of this.

Indeed, we would expect the review itself to go considerably further. Whilst the reduction in charges is welcomed, NR did get security in return. Which means that the key contract underpinning current charges has still not been subject to any market test and will not be for 10 years. In addition, the Annual Accounts of Network Rail (High Speed) Ltd for 2010/11 show a stated net profit of £11.1m on revenue of £63.9m, entirely capable – if necessary - of absorbing the cost saving without any fundamental improvement in efficiency.

As a result, we consider it important that the ORR's starting point for this review is a first principles consideration of what is an efficient cost for this railway, putting the NR and HS1 contracts aside in order to consider this question.

That done, we strongly support HS1's proposals in relation to the sharing of future outperformance. All parties recognise that, for this to be effective it has to be based on a challenging baseline efficiency target (to avoid the perverse incentive of HS1 encouraging a softer efficiency target so as to benefit from resultant greater outperformance). But Eurostar also recognises that this approach goes beyond that which is contractually obligated and we very much welcome it.

#### **4. Do you consider that the existing structure of charges is consistent with the Regulations ? Do you consider that the existing structure of charges creates efficiency incentives ?**

We consider that the existing structure of charges is consistent with the Regulations and we generally agree with the principles applied to determine the charges. As a matter of principle, we encourage HS1 and the ORR to look for simplicity in respect of calculation of charges wherever possible.

It will be important for the periodic review to assess how these principles are applied to determine charges, in particular focusing on unit cost efficiency. We consider this regulatory review to be the key mechanism for setting efficiency incentives and driving efficiency improvements within the framework of the current structure of charges. Issues that we think should be addressed include how any volatility of services over the control period will be treated (for example, when new entrants start the operation of new services), how boundaries on reopeners are set and appropriate levels of pricing when boundaries are breached. We are also mindful that, during CP2, Eurostar will introduce new rolling stock onto HS1's infrastructure and the charging regime will, of course, need to accommodate this. It will also be important to look for opportunities for investment that might enable further efficiencies to be realised, for example in respect of energy distribution losses, EC4T and train metering.

We consider it important that cost/performance relationship information, such as that which identifies different levels of operational performance (for example measured in seconds of delay) in relation to the varying costs of delivering these levels of performance, is shared with operators by HS1 as part of the periodic review process. This is consistent with the approach being taken in other UK regulated industries, for example with the Civil Aviation Authority's (CAA's) regulation of NATS (En Route) plc (NERL). In its April 2013 document titled "The CAA process update for the economic regulation of NERL and contribution to the UK-Ireland FAB Performance Plan for Reference Period 2 (2015-2019) of the Single European Sky Performance Scheme: A mandate for Customer Consultation between NERL and airspace users" the CAA describes just this approach. The CAA is mandating NERL to consult with its customers and, among other topics, the CAA expects NERL to discuss "the priorities of airspace users in relation to certain trade-offs relating to strategic choices NERL could make regarding cost and service quality". We are strongly supportive of HS1 adopting a similar approach with its customers in relation to its own performance and cost trade-offs.

## **5. Are there other issues that we should take into account as we consider the operation of the escrow arrangements ?**

We provide general observations on the escrow arrangements at this stage as it is difficult for us to comment on the escrow arrangements in any level of detail before we have reviewed the 5YAMS. The HS1 asset condition register and maintenance/renewal strategy are key elements that we will need to have full visibility of, together with any restriction of use (possessions) proposals and any associated costs that may be proposed to be generated as a result.

We think that there is a need for a detailed conversation during this periodic review in respect of the escrow arrangements in respect of account funding, how this is built up and the future spend as driven by the asset management strategy. We recognise the principle that amounts in the escrow account may be expected to earn some interest while held and agree that this is a reasonable expectation which may need to be looked at as part of this periodic review.

An element that we consider needs to be included in this periodic review relates to the level of contributions to the escrow account and the possibility for a potential perverse incentive for HS1 in respect of setting this level. This may arise as HS1 is on risk for any shortfall in the escrow account and, in order to mitigate this, it may be incentivised to seek a level of contribution that provides a substantial cushion against escrow account shortfall risk. We recognise that this presents a genuinely difficult issue that needs to be carefully considered by all concerned and that the ORR will wish to guard against such incentives arising. We welcome such discussions. In considering how this issue may be addressed it will be important to preserve the fundamental principle that the purpose of the escrow account is to smooth costs.

We would be interested in exploring other mechanisms that continue to seek to smooth costs while mitigating the potential incentive for HS1 to seek higher escrow contributions to protect itself against a potential shortfall. We assume the cost for future renewals will be determined based on levels of both activity and unit costs consistent with an efficient whole-life asset management strategy and incorporating movements in the best practice efficiency frontier over time. We suggest exploration of areas such as inclusion of a separate renewal plan consultation at the start of each Control Period and a possible mid-control period review of the escrow contributions, if required, which would be subject to ORR review and approval. We consider that this part of the review could be an area for a robust CP2 efficiency determination.

**6. Do you consider that there are gaps in the benchmarking programme put forward by HS1 Ltd ?**

We support the benchmarking workstream as this offers us all an opportunity to understand HS1's costs and the drivers of these costs underpinning the charges.

We recognise that there are difficulties associated with successful completion of top-down railway infrastructure benchmarking activities, for example in the identification of comparator networks that are both sufficiently similar in terms of their infrastructure to be genuinely comparable and cost efficient in their operations. However, HS1 is the closest the UK has to a comparable European railway and we think that this periodic review in particular offers an opportunity to get close to establishing a comparable benchmark. Of course, we do not believe that the top-down review should be at the expense of detailed bottom-up benchmarking analysis and we would welcome a detailed presentation on HS1 spending and further efficiency plans to bring this alive for us on a line-item by line-item basis.

We look forward to exploring the benchmarking process further when more information is available on this topic, including understanding the methodology that is being applied to accomplish both the bottom-up and top-down benchmarking activities.

**7. Do you agree that this document comprehensively covers those areas which should be considered by PR14 ? Are there any other areas which you consider we should be exploring ?**

We believe the document covers the key themes for exploration during the periodic review. We have indicated in our response, as well as in discussions with the ORR, HS1 and its stakeholders, certain areas that at this stage are of particular interest to us. As the review progresses and further information becomes available, there may of course be additional areas or points of importance to the review.

**8. Do you have any comments on the timescales set out in this chapter ?**

We welcome publication of the PR14 timetable to 2015. This approach enables us to plan and resource our PR14 team effectively.

We have one observation in respect of the timetable. The consultation document notes that HS1 Ltd launches its consultation on the draft 5YAMS in October 2013. In order to provide adequate time for review and consideration of the contents of the consultation, we consider it important that this be issued in early October. This will provide for adequate time for stakeholders to digest the information presented and consider their responses, as well as providing adequate time to address these responses while avoiding what is a traditionally busy time for operators running up to/during the Christmas holiday period. During this time even with careful planning specific resource may not be available, in particular certain expert/technical areas. Starting the consultation process later and attempting to conclude during this time may import additional risk into the process.

**9. Do you have any further comments on any aspect of PR14, including any subjects not explicitly discussed in this document ?**

We are keen to fully support and engage with the periodic review process. As the review progresses we understand that we will be asked to review and comment on various workstreams and information. We urge the early, prior provision of information and requests as this will ensure that we are able to review with our experts in the areas concerned in good time and then provide a timely, substantive and informed response to the questions that will be asked of us.

We are happy to discuss any areas of our response further if this will be helpful.

Yours sincerely

Samantha Spence

**Head of Regulatory Affairs**