PR24

Initial consultation

30 September 2022

Contents

Executive summary

This document

This consultation seeks your views on our proposed process, timescales and approach to the next periodic review of HS1 Ltd: Periodic Review 2024 (PR24).

Process and timescales

We are seeking views in response to this document by 11 November 2022. We will take those into account when producing our Approach to PR24 document, to be submitted to the Secretary of State for Transport (SoS) on 31 January 2023 and published on our website.

We request that stakeholders provide clear evidence to support any recommendations on our approach for PR24. This evidence could include data, analyses, written commitments, or formal legal advice.

This initial consultation covers our approach to PR24. There will be further consultations during the PR24 process, giving stakeholders the opportunity to comment on specific documents. HS1 Ltd will be consulting us and stakeholders on its Five Year Asset Management Statement (covering HS1 route infrastructure) and Life Cycle Reports (covering the four HS1 stations). HS1 Ltd will be submitting draft documents to us by 29 February 2024, before submitting the final versions to us by 31 May 2024.

We will publish our Draft Determination on HS1 Ltd's plans and consult on it by 30 September 2024. We will then issue our Final Determination by 6 January 2025.

Our approach

The periodic review process for HS1 Ltd is set out in its concession agreement with the SoS (hereafter, the "concession agreement" for the stewardship of the HS1 route, and the leases for the stations (hereafter the "stations leases") on the network. In particular, we are required to approve or determine HS1 Ltd's plans, and charges for the use of the network and stations. In doing so, we must have regard to whether HS1 Ltd's plans are consistent with its asset stewardship purpose for the route, and life cycle purposes for each station, as defined in the concession agreement and stations leases respectively.

Introduction

The HS1 network and stations

1.1 The HS1 network is a 109km high-speed rail line that connects London St Pancras through Kent to the Channel Tunnel.

1.2 There are four stations on the line: London St Pancras, Stratford International, Ebbsfleet International and Ashford International.

1.3 International services on the network are currently only operated by Eurostar International Ltd, travelling directly to France, Belgium and the Netherlands. High-speed domestic services are operated by South East Trains Ltd, currently operated by the Government's Operator of Last Resort and stopping at all the stations on the line. East Midlands Trains and Thameslink also use London St Pancras Station.

1.4 The line is also key for international rail freight services supplying the UK.

1.5 The network was greatly affected by COVID-19 pandemic restrictions, and subsequent effects on passenger demand.

HS1 Ltd

1.6 HS1 Ltd holds a concession (until 2040) to operate, maintain and renew the whole line. The primary business of HS1 Ltd is to provide high-speed rail access to domestic and international passenger rail and international rail freight services. HS1 Ltd's revenue comes from access charges which are paid by train operators to use HS1 Ltd's track and stations. HS1 Ltd also receives income, which is not regulated, through its retail facilities and car parking at stations. Unlike Network Rail Infrastructure Ltd (NRIL), HS1 Ltd does not receive any government network grants.

1.7 The concession agreement sets out the terms of the agreement between HS1 Ltd and the SoS, who owns the HS1 railway infrastructure. This includes the charging framework, minimum operational standards including proper asset stewardship, protections against termination and protection from material adverse changes.

1.8 Many of the functions which HS1 Ltd must perform as infrastructure manager under the Railways (Access, Management and Licensing of Railway Undertakings)

Regulations 2016, such as operation and maintenance, signalling and timetabling, are contracted out to third parties: Network Rail (High Speed) Ltd and Mitie Plc.

1.9 HS1 Ltd also manages contracts for the provision of certain services, the costs of which are passed through to operators in charges, for example, UK Power Network Services.

1.10 Overall, HS1 Ltd's performance in terms of operations and asset performance has been historically good. In the period 1 April 2021 – 31 March 2022 only 0.32% of services were delayed by HS1 Ltd-attributable incidents. Information on HS1 Ltd's performance during the current control period is published in our annual reports on HS1 Ltd.

Our role in regulating HS1

1.11 In terms of compliance with health and safety legislation, HS1 is regulated in the same way as other railway networks in Great Britain. HS1 Ltd, Network Rail (High Speed) Ltd (NR(HS)) and Mitie Plc all have safety obligations. NR(HS) and Mitie Plc are the safety duty holders for the railway, the former also being the infrastructure manager under the Railways and Other Guided Systems (Safety) Regulations 2006. Mitie Plc is similarly the infrastructure manager for Ashford Station.

1.12 In addition, we hold duties to regulate HS1 Ltd under the terms of the concession agreement and stations leases. Our role includes:

(a) the monitoring of operational performance;

(b) the monitoring of asset stewardship obligations; to act as an appeal body; and

(c) the carrying out of a five yearly periodic review, which covers operations, maintenance and renewals charges for the route, and renewals charges for stations.

1.13 Schedules 10 of the concession agreement, and of the stations leases, set out the purpose and, in general terms, the process for conducting periodic reviews.

1.14 In addition to the concession agreement and terms of the stations leases, we have responsibilities concerning the regulation of HS1 Ltd under the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016. These functions include:

(a) a pre-approval role for new and amended framework agreements for track access;

(b) ensuring that charges for use of the infrastructure comply with the requirements of the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016; and

(c) ensuring, through our rights and responsibilities under the concession agreement, that HS1 Ltd is provided with incentives to reduce the costs of provision of infrastructure and access charges.

1.15 We have entered into a Memorandum of Understanding with the SoS in respect of the performance of our role. Our roles in relation to our regulatory functions in respect of the HS1 network and stations are outlined in two regulatory statements dated 2009[1] and 2022[2].

1.16 This suite of documents sets the broad framework and scope for conducting a periodic review.

Our statutory duties

1.17 We also have a number of wider statutory duties which we must consider when reaching our decisions on PR24. Our statutory duties are set out in Section 4 of the Railways Act 1993. These statutory duties are not in any order of priority and it is for us to decide how much weight should be attached to each duty.

Consultation responses

1.18 We invite responses to any aspect of this document to PR24@orr.gov.uk.

1.19 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.

1.20 We request that, wherever possible, stakeholders should provide clear evidence to support any recommendations on our approach for PR24. This evidence could include data, analyses, written commitments, or formal legal advice.

1.21 The deadline for responses is 5pm on 11 November 2022.

[1] Regulation of High Speed 1: Statement by the Office of Rail Regulation

[2] Second regulatory statement in respect of the HS1 network

Periodic reviews of HS1 Ltd

2.1 PR24 will cover Control Period 4 (CP4), that is, the period from 1 April 2025 to 31 March 2030. The outputs of the review as set out in the concession agreement and stations leases comprise:

(a) whether HS1 Ltd has had regard to, and fulfilled, the requirements and obligations set out in the concession agreement in relation to route asset stewardship and stations' life cycle purposes, as defined by those documents;

(b) the outputs that HS1 Ltd will deliver in CP4;

(c) HS1 Ltd's asset management plans for CP4 and beyond; and

(d) the structure and level of HS1 Ltd's regulated access charges.

2.2 A key element of the charges approved or determined at our periodic review are those which will recover the costs of future renewals of the route and stations. These funds are paid into five escrow accounts (one for the route, and one for each station) held between HS1 Ltd and the SoS.

2.3 Some elements which make up HS1 Ltd's charges are not included in the scope of our periodic reviews by virtue of the exclusions identified in the concession agreement and stations leases. These are:

(a) The investment recovery charge (IRC). This charge is levied on each passenger train service (freight services do not pay) on the route on a per-minute basis. This charge is levied to recover the initial construction costs of the HS1 network;

(b) the performance cap (as defined in Schedule 8 of the Passenger and Freight Access Terms), relating to a cap on performance payments made under Schedule 8; and

(c) other unregulated income. HS1 Ltd operates a dual-till model whereby the income from its property, retail, media and car parking at stations is not taken into account in determining the operation, maintenance and renewals charges (OMRC) for the HS1 route, or renewals charges for stations.

2.4 This will be our first periodic review of renewals funding for HS1 stations. Previous periodic reviews for stations were undertaken by DfT. The role was transferred to us through changes to the concession agreement and leases which came into effect in July 2022.

2.5 This review also follows a period of unprecedented challenges for the rail market due to the impact of the pandemic on travel, particularly internationally, as well as ongoing geo-political, economic and environmental challenges.

2.6 The current regulatory frameworks are set by the concession agreement and stations leases between HS1 Ltd and the SoS. These require funds to be accrued for future renewals, and adequate planning and provision to be made for enhancing the capability (or capacity) of the network. Those documents also contain restrictions for the investment of funds held jointly by the two parties. Changes to the concession agreement and stations leases are outside the scope of the periodic review process and hence PR24 is not the appropriate mechanism to discuss fundamental changes to how the railway is funded, that being a matter for discussion between the SoS and HS1 Ltd.

2.7 The concession agreement and stations leases currently allow HS1 Ltd to apply to us for interim review of funding between periodic reviews, where a change occurs that results in the level of charges not being sufficient to allow HS1 Ltd to meet its general duty (as defined by the concession agreement, in relation to the route) or undertake forecast renewals (on stations). This control period (CP3), HS1 Ltd and DfT considered amendments to the concession agreement to allow HS1 Ltd to also apply to us for an interim review of route funding to instead reduce charges on operators, but the proposal was not pursued by the two parties.

2.8 If such a change to the interim review process was be pursued in future, HS1 Ltd and DfT would first consult publicly on a variation to Schedule 10 of the concession agreement, and ORR's consent would then be sought for amendment. We would expect to be able to consent to such a change. We would then expect (subject to the wording finalised for that mechanism) to assess an application from HS1 Ltd on whether its plan to reduce charges was consistent with its general duty as defined by the concession agreement.

Key issues and questions for PR24

Specific questions we would like consultees to answer are shown in boxes, like this.

Health and safety

3.1 We have undertaken proactive inspections and supervision activities with NR(HS) on its performance as dutyholder for the route and stations this control period. We have confirmed HS1 Ltd's achievement of the seven recommendations that we made at PR19. We have no immediate concerns in relation to the health and safety of the network, but we intend to continue to:

(a) carry out proactive, planned and targeted inspections;

(b) consider applications for exemptions from the Railway Safety and Interoperability Regulations;

(c) regularly liaise with NR(HS) for the purpose of monitoring health and safety performance; and

(d) investigate incidents in accordance with our processes.

3.2 In terms of our approach to PR24, we will be checking whether adequate funding is in place to comply with safety requirements. We will also be seeking assurance that there are plans with the appropriate level of capability and capacity to address specifically the challenges of maintaining an asset that is aging.

Asset stewardship and life cycle purposes

3.3 For the HS1 route, HS1 Ltd has a "general duty" under the concession agreement to carry out operation, maintenance, renewal and upgrade of the network in accordance with the asset stewardship purpose, as defined in that document. That is, to do so in a manner which is in line with best practice, timely, efficient and economical and as if it were responsible for the stewardship of the infrastructure for 40 years after those activities are planned or carried out, to the greatest extent reasonably practicable having regard to all relevant circumstances.

3.4 For its stations, HS1 Ltd is required by its leases to act in accordance with good industry practice and undertake such works of renewals and replacement which, in its reasonable opinion, are necessary in order for each station to satisfy the life cycle purpose ("*that the station shall be in good and substantial repair and condition during the whole of the Life Cycle Period*") at the end of the Life Cycle Period, that is, on 1 April 2061.

3.5 In terms of our approach to PR24, we will examine HS1 Ltd's detailed plans for renewals within CP4 to ensure they are efficient, deliverable and aligned to any outputs agreed as part of PR24.

3.6 Under the concession agreement, we are also required to examine the forward programme of renewals for a 40-year period (i.e. CP4 to CP11) as part of PR24, to ensure it is consistent with the asset stewardship purpose, as defined by that document. Under the terms of the stations leases, we are required to examine the programme of renewals for HS1 Ltd's planned renewals until the end of the Life Cycle Period (1 April 2061).

3.7 As such, HS1 Ltd needs to provide long-term renewals plans in its route five-year asset management statement (5YAMS) and stations Life Cycle Reports (LCRs). Our examination of these long-term renewals plans will be at a higher level (compared to renewals within CP4) and will focus on factors including: efficiency in terms of whole-life-cost; sustainability; management of risk and uncertainty; and assumptions around delivery strategies.

3.8 Under both the concession agreement and stations leases, HS1 Ltd is required to prepare and maintain asset maintenance strategies for its route and stations. We understand that the company is in the process of refining its objectives, policies, plans and strategies for CP4 with its suppliers.

3.9 All of these aspects of the plan are important to the evaluation of costs and consequently confirming the required levels of funding of the escrow accounts, particularly important as assets reach life-expiry in the coming control periods. This will inform our determination on the level of charges for operators.

Specified upgrades

3.10 The concession agreement allows for expenditure on "specified upgrades" or other upgrades to the capability or capacity of the network, that may be proposed by either HS1 Ltd itself or the SoS.

3.11 The concession agreement states that “specified upgrades” means major upgrades of the signalling system, control systems or trackform. Detailed discussions at PR19 concluded that, as agreed at PR14, HS1 Ltd’s proposed upgrade to the European Rail Traffic Management System (ERTMS) signalling system should be treated as a Specified Upgrade.

3.12 HS1 Ltd will need to provide adequate information on the Specified Upgrades or other upgrades to be carried out in CP4 and demonstrate that the costs will be efficiently incurred. In addition, HS1 Ltd will have to provide details of the resultant additional investment recovery charge along with evidence that those amounts are of a level that can be borne by operators on the network. This is likely to include an earlier submission to cover preparatory works for the upgrade to its signalling system, which HS1 Ltd has indicated it intends to request in advance of funding of the full project in CP5.

3.13 HS1 Ltd is also expected to present justified traffic demand forecasts compared against asset capability to demonstrate when the capacity or capability of the route may need to be enhanced through a future programme of Specified Upgrades.

Cost reduction and efficiency

Cost reduction

3.14 While HS1 Ltd must produce plans that deliver its asset stewardship and life cycle purposes and comply with safety requirements, there may be opportunities to balance long-term asset management savings and asset performance against maintenance or renewal interventions that could reduce costs in the short-term, while still in compliance with the concession agreement.

What factors do you think we should take into account when assessing HS1 Ltd plans that comply with the concession agreement, stations leases and safety obligations but deliver lower levels of asset performance (e.g. more unplanned delays, or more maintenance down-time) to reduce charges?

Cost efficiency and benchmarking

3.15 In scrutinising HS1 Ltd’s plans, our starting point will be the cost efficiency plan included in its 5YAMS and LCRs. Our approach to assessing efficiency in PR24 will include use of top-down cost benchmarking statistical analysis. We will use this analysis to complement our understanding of the relationship between HS1 Ltd’s key cost drivers and its efficiency.

3.16 We understand that HS1 Ltd is undertaking revised benchmarking analysis to allow comparisons with other infrastructure managers to try and quantify the efficiency position. We expect that this work will be supplemented by:

(a) analysis of life-cycle costing;

(b) out-turn information on the efficiency initiatives in CP3; and

(c) other efficiency initiatives that will be developed for the purpose of the review.

3.17 HS1 Ltd should provide both top-down and bottom-up benchmarking data to support the costs put forward in the 5YAMS and LCRs. Benchmarking should include a sufficient number of comparator organisations to allow meaningful conclusions to be drawn. Depending on the extent to which we are satisfied with the robustness of HS1 Ltd's approach and the way in which it uses its benchmarking analysis to inform the 5YAMS, we may wish to undertake our own analysis.

Do you have any comments or suggestions on how cost efficiency is assessed, including on our proposed approach to benchmarking?

Financial framework

3.18 The financial framework sets the rules and guidelines for a range of financial issues that determine how HS1 Ltd is funded to operate, maintain and renew its rail network, and renew its station assets.

3.19 In PR24, we will determine the regulatory treatment of a number of key issues affecting HS1 Ltd's financial framework. These include:

(a) the allocation and management of financial risk;

(b) the framework for the escrow accounts, including issues relating to the profiling of payments by operators;

(c) our approach to assessing and monitoring HS1 Ltd's efficiency; and

(d) the treatment of tax, inflation indexation and financing costs on authorised investments on the escrow accounts.

Financial risk

3.20 HS1 Ltd is exposed to a range of risks. These include macro-economic risks, like inflation and interest rates as well as specific risks, such as uncertainty in the supply chain and demand. In simple terms, we would expect that risks should be borne by those best placed to efficiently manage them. There are a number of recognised strategies to mitigate risk, e.g. using insurance to transfer the risk to another party. Also, we must have regard to the terms of the concession agreement and stations leases.

3.21 As the future is inherently uncertain, some risks will materialise while others will not. To ensure the company is adequately funded, and remains financially sustainable, it is important to consider the risk landscape, and ensure the company recovers a fair and proportionate level of income from operators to cover risk.

3.22 When calculating the charges on operators in PR24, we would expect to review HS1 Ltd's contractual arrangements with NR(HS) and Mitie Plc to consider whether the company's approach to risk follows best practice.

3.23 In addition to the costs of contracted services, HS1 Ltd has two other broad categories of cost:

(a) HS1 Ltd's internal costs, such as staff costs and office running costs; and

(b) Pass-through costs where HS1 Ltd procures a commodity or a service on behalf of its customers.

3.24 Once the level of income has been established in the calculation of the charges, HS1 Ltd bears the risk of any cost increases for its own costs (and also receives the benefit of any cost reduction). In contrast, movements in industry costs are subsequently passed through to customers. This means that customers receive the benefit or bear the cost of any changes to the original assumptions.

How could the financial framework facilitate improved decision-making, to better align incentives in relation to risk allocation?

Do you have any comments or suggestions on approaches to risk and uncertainty, in particular relating to inflation or forecast demand?

Escrow accounts

3.25 The concession agreement and stations leases require funding for renewals to be held in escrow accounts operated jointly by the SoS and HS1 Ltd throughout the concession and lease terms. The escrow account arrangements are the mechanisms through which HS1 Ltd secures the required outcomes of the route asset stewardship purpose and stations life cycle purposes. The process is intended to avoid the build-up of a potentially unfundable backlog of renewals, including after the end of the concession and leases; smooth charges over time to avoid cost shocks to operators; and avoid intergenerational inequity for new entrants to the market.

3.26 We have a role in determining the value of deposits into the escrow accounts. HS1 Ltd would need to fund any shortfall in the escrow accounts over the concession and lease periods for actual renewals works. Given the purpose of these funds in the concession agreement and leases, HS1 Ltd must make adequate provision in its forecast for the renewals annuity for its forecast renewals activities, with due consideration for current challenges around inflation and emerging lessons learned, as the volume of renewals increases during CP3.

3.27 We set out our approach to the 40-year calculation period (i.e. the ‘pay-ahead’ time period) in paragraphs 5.17 – 5.24 of our PR19 Final Determination of route funding. In summary, our approach smooths the financial impact on operators, is consistent with the principle that users should pay for their use of the assets, and supports intergenerational equity. It is also consistent with the asset stewardship purpose set out under Schedule 10 of the concession agreement, which requires HS1 Ltd to secure the operation, maintenance, renewal and replacement of the HS1 Railway Infrastructure in accordance with best practice as if HS1 Ltd were responsible for the stewardship of that infrastructure for the period of 40 years following the date of those activities. We do not intend to deviate from this approach for PR24.

3.28 There is a degree of flexibility within the general duty set out in the concession agreement, which requires HS1 Ltd to achieve the asset stewardship purpose to the greatest extent reasonably practicable, having regard to all relevant circumstances. Therefore, the impact of charging on operators should be taken into account by HS1 Ltd when determining the amount for renewals charges, and in turn for ORR when considering whether to approve the 5YAMS as being consistent with HS1 Ltd’s general duty.

3.29 Our Section 4 duties under the Railways Act 1993 require that we promote the use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent that we consider economically practicable. Our approach to PR24 will take both of these factors into account, but our determination must still meet our obligations under the concession agreement, to ensure HS1 Ltd's plans are consistent with its duties in terms of funding for renewals. For example, at PR19 our determination achieved a balance between increasing charges from the previous control period, to address historical underfunding and to prepare for long-term peaks in renewals, while also reducing charges from what was initially proposed through efficiencies and treatment of risk, to ensure costs could be borne by operators.

3.30 In PR19, we made a number of changes to our calculation of the renewals annuity. These changes made the calculation more robust and recognised that the escrow account had been underfunded in CP1 and CP2 and that long-term renewals forecasts were rising. Given reduced services in CP3 following the pandemic, it is likely that the escrow account has also been underfunded in CP3.

3.31 Since PR19, the industry has been dealing with the effects of the pandemic and the resulting lower levels of revenue. This lower level of revenue is likely to continue into CP4.

3.32 For PR24, one of the key issues will be how we balance the impact of our decisions on the renewals annuity that operators pay against HS1 Ltd's ability to recover the efficient costs of renewing the HS1 network. How the financial framework deals with risk and uncertainty is a key issue to be considered together with how the revenue required to cover the costs of the renewals annuity are profiled over time and incorporated into charges as discussed below.

Are there any issues that we should take into account as we consider the level of charging for renewals of the HS1 network, in particular how we incorporate the effect of the renewals annuity on operators?

Reporting efficiency

3.33 It is important that HS1 Ltd demonstrates that it is delivering efficiently for its customers by transparently reporting on it.

3.34 As part of PR19, we determined an efficient level of cost for the operations, maintenance and renewal of the route infrastructure. The largest element of HS1

Ltd's cost is its contract with NR(HS). At PR19, NR(HS) committed to an efficiency increase of 6.7% across the five years of CP3, which it has outperformed annually thus far. At PR19, we also determined that HS1 Ltd should establish a research & development programme to drive long-term efficiency.

3.35 DfT applied an efficiency overlay of 2.0% to HS1 Ltd's plans for stations at PR19 for CP3 and CP4, and a 0.6% frontier shift overlay beyond that, to determine charges for stations renewals.

3.36 In terms of our approach to PR24, we will review the potential for efficiencies within HS1 Ltd and through its management of its supply chain. We will also review HS1 Ltd's planned CP4 renewals in detail and discuss scope efficiencies (identifying work which does not need to be done) and cost efficiencies (delivering the same outputs at a lower cost).

3.37 At PR19 (and earlier periodic reviews) HS1 Ltd had limited data on renewals, or maintenance of assets approaching life-expiry, because the assets were still relatively new. Since PR19, HS1 Ltd has gathered significantly more asset data and our approach to reviewing efficiencies in PR24 will focus on this data.

Do you have any comments on our approach to assessing HS1 Ltd's cost efficiency?

Other financial issues

Inflation

3.38 Broadly, inflation risk can be split into two categories: general price inflation, which covers overall inflation within the economy, and input price inflation, which covers the increase in costs of individual items, such as steel relative to the level of general inflation. As part of its plans, HS1 Ltd needs to produce a forecast of the efficient level of input price inflation. In relation to operations and maintenance, we understand that HS1 Ltd is tied to indexing by the retail price index (RPI) by its contractual arrangements with suppliers. So, our approach to PR24 will only consider the appropriate index for renewals cost inflation.

3.39 The ONS methodology on consumer price inflation statistics[3], last updated in October 2016, recommends the use of the cost price index (CPI) as a more robust general inflation index than RPI. From 2019-20, we have used CPI for Network Rail for all of its income and expenditure. This change did not affect Network Rail's

[3] Link to ONS website

overall revenues as we also adjusted the input price assumption. But, it did change the profile of charges, so that the Year 1 charge was higher and the expected increases each year were lower.

3.40 Given the contractual arrangements on operations and maintenance it is not possible for us to use CPI instead of RPI for all of HS1 Ltd's income and expenditure. We also note that the IRC paid by operators to HS1 Ltd, which is unregulated, is indexed by RPI in line with the terms of the concession agreement So, in PR19, for these reasons we retained the use of RPI.

What factors do you think that we should take into account when deciding on the appropriate inflation index for regulated renewals charges at PR24?

Authorised investments

3.41 HS1 Ltd is allowed by the concession agreement and stations leases to invest up to 90% of escrow funds. We expect proposals from HS1 Ltd on the proportion of funds that it plans to invest, and forecast rates of return for those funds in CP4 and beyond.

What factors do you think that we should take into account when accepting or determining HS1 Ltd's approach to authorised investments?

Outperformance sharing

3.42 The Operator Agreement between HS1 Ltd and NR(HS) includes a mechanism by which NR(HS) shares outperformance against operations and maintenance costs for the last three years of each control period. The benefits are to be split 50% NR(HS), 30% to be shared between operators and 20% to HS1 Ltd.

3.43 The concession agreement and stations leases do not contain any outperformance sharing requirements in respect of operations and maintenance costs. However, there are outperformance sharing mechanisms for the treatment of renewals efficiencies.

3.44 Outperformance on renewals can be allocated 70% towards future renewals (that is, retained in the escrow account) and 30% to HS1 Ltd for both the route and stations. Whether any payments arise in accordance with this mechanism, is dependent on us determining that HS1 Ltd has complied with its general duty, asset management strategy, life cycle reports/5YAMS, and outperformed against plans set out in its previous 5YAMS/ life cycle report, and the escrow account balances being at the level necessary for HS1 Ltd to comply with its general duty in so far as it relates to renewals.

3.45 As part of a periodic review, we must review these allocations for the route escrow account. In PR24 we will scrutinise any new proposals from HS1 Ltd for this mechanism as part of our overall review of incentives, alongside the views of stakeholders.

What factors should we take into account when assessing the allocation of outperformance against forecast renewals costs on the route in order to incentivise HS1 Ltd to improve efficiency?

Charges and incentives

Charging structure

3.46 As part of PR24, we expect HS1 Ltd to provide evidence that the charging structure for its route and stations are consistent with the charging requirements in Part 4 and Schedule 3 of the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016.

3.47 For the route, the components of HS1 Ltd's track access charges include the IRC, OMRC, performance and possession regime costs and a capacity reservation charge. HS1 Ltd's charges recover avoidable costs (costs for specific services), variable costs, fixed allocated costs and other common costs. Different elements are allocated in different ways, as set out below.

3.48 Avoidable costs are allocated to the relevant operator (for example, the costs relating to track between Ashford and the Channel Tunnel are allocated to international operators). Where there is more than one operator, allocation is based on a share of the timetabled minutes:

(a) variable costs of shared infrastructure are allocated using an engineering model on an 'equivalent gross tonne miles' basis (i.e. heavier trains running faster tend to get a higher share);

(b) costs that vary with length of track but not with the level of traffic (e.g. plant, signalling, electrification) are allocated using the share of timetabled minutes;

(c) other common costs are split by the share of timetabled minutes; and

(d) freight operators pay only incremental costs.

3.49 The structure of charges determines how these costs should be recovered from different operators and also how to incentivise efficient use of the network over time. For example, once a renewals annuity is calculated that amount of revenue needs to be incorporated into HS1 Ltd's charges.

3.50 The allocation of the renewals annuity between charges for direct and indirect costs is an especially important issue for PR24 given the effect of the pandemic on train service levels and revenue.

3.51 HS1 Ltd carried out a review of if its charges structure (not including the IRC) which concluded in August 2022. HS1 Ltd stated that its strategic aim for the review was to encourage greater network usage to both lower costs overall as well as promoting the sustainability of rail in the longer term.

3.52 As a result of its review, we understand that HS1 Ltd intends to implement the split between direct and indirect costs based on a review of NR(HS)'s costs in consultation with operators during PR24. However, HS1 Ltd proposed no changes to split between international and national operators; and the split between passenger and freight operators.

3.53 We understand that HS1 Ltd also intends to take forward a revised approach to pass-throughs to include those that HS1 Ltd does not control.

How should charges be structured in CP4, particularly to incentivise efficiency and consider the effect on operators of the renewals annuity?

Determining charges

3.54 HS1 Ltd will provide its initial views in the draft 5YAMS and LCRs. Together with any conclusions we draw from our independent scrutiny, this will form the basis of our calculation. In the event that we consider HS1 Ltd's proposals in the 5YAMS and LCRs to be deficient we will explain our reasons why and HS1 Ltd must then re-submit an amended 5YAMS and LCRs within the prescribed timescales of the periodic review.

Performance and possession regimes

3.55 The performance regime is part of the charging system designed to encourage all parties to minimise disruption and improve the performance of HS1. Through the regime, operators and HS1 Ltd bear the financial impact of unplanned service delays and cancellations. The regime is designed to incentivise all parties to minimise performance-disrupting incidents and to contain their impact when they occur. The regime includes:

(a) payment thresholds (the point at which performance is sufficiently good or bad to trigger payments from operators to HS1 Ltd, or from HS1 Ltd to operators); and

(b) payment rates (the amount, per minute delay, that one organisation pays another because of its below-threshold performance).

3.56 Under the possessions regime, HS1 Ltd compensates its operators for any planned disruption it causes.

3.57 At PR24, we would expect HS1 Ltd to undertake a review of the incentives framework, to ensure that it is coping well with the levels of performance on the HS1 network and to benefit from past experience.