Responses to Consultation on ORR’s approach to PR24

[Initial consultation on periodic review of HS1 Ltd 2024 (PR24) | Office of Rail and Road (orr.gov.uk)]

1. Campaign for Better Transport
2. Department for Transport
3. Eurostar International Ltd.
4. GB Railfreight Ltd.
5. HS1 Ltd
6. Network Rail (High Speed) Ltd.
7. South Eastern Trains Limited
8. Transport for London

Campaign for Better Transport Response to the Office of Rail and Road consultation asking stakeholders to provide their views on the processes and approach to the next periodic review (PR24) of HS1 Ltd.

We are pleased to contribute to this consultation in advance of the next periodic review (PR24) of HS1. While many consultation questions cover cost efficiency, investments, inflation, renewals and financial incentives, we would like to encourage you to prioritise the following related areas:

Integration of UK with European sleeper train routes
There has been a rapid revival of sleeper train routes in mainland Europe in recent years following a period of decline. This includes revived or new routes between Brussels and Vienna, 27 night train routes from Austria to cities in Germany, Italy, Switzerland and the Netherlands, overnight routes from Paris to Munich and Vienna, as well as Zurich to Amsterdam via Cologne. This offers a unique opportunity for us to tap into a growth market, bringing significantly more custom onto HS1 and contributing significantly towards vital modal shift from aviation to rail by connecting St Pancras with European destinations.

Through Ticketing
We would like to see the review consider introducing through ticketing from across the UK to Paris and beyond as part of a transition towards simpler, fairer ticketing. This could include, for example, opening up the potential for tickets for Birmingham to Paris, Manchester to Milan and similar (via St Pancras, where there is capacity for interchange). This would be genuinely transformational.

New destinations
Considering the number of connections within Europe and the revival of the sleeper network as reported we believe that some more destinations could be added to the network which would encourage people to travel across Europe for business and leisure by rail. For example, Hamburg, Prague (newly connected to Brussels and Amsterdam), Berlin, Warsaw and Vienna.

Border control delays
Border control delays, particularly at St Pancras International, need to be addressed as a matter of urgency. How will the review address this issue?

Campaign for Better Transport
10/10/2022

Department for Transport

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22 December 2022

Dear Debbie,

Thank you very much for providing us with an opportunity to comment on your consultation entitled "PR24: Initial consultation" (published 30 September 2022). We are grateful for the opportunity to set out the principles behind our approach to PR24 and for the extension in timings to enable us to do so.

Timing of PR24

The Department for Transport (the **"Department"**) agrees with the timescales set out in your consultation document and notes the intent to write to the Secretary of State on 31st January 2023 setting out your approach to PR24. We welcome HS1's industry workshops and ORR engagement at this stage. We consider that strong and effective collaborative working between all stakeholders in the HS1 system through the Periodic Review is vital to ensure an outcome which delivers the safe, reliable and efficient railway that customers expect – in that regard we consider that an approach which facilitates and supports strong stakeholder engagement through the PR24 process is vital.

Context PR24

PR24 takes place at a critical time for the UK railway. Public finances, and indeed rail finances, are under increasing pressure as a result of inflation and other economic factors. This has a direct impact on the affordability of track access charges paid by operators. The Department is currently exposed to Southeastern track access charges and is also financially exposed by the Domestic Underpin Agreement, whereby the Department picks up costs for a shortfall in domestic services on HS1. Eurostar also faces considerable financial challenges in light of Covid and the impacts that it has had on its business. **We consider that it is absolutely critical that this context is clearly and demonstrably reflected on as part of the Periodic Review process – with the affordability challenge placed at the centre of considerations.**

We also note that this is the first review conducted by the ORR for both route and stations, following the successful transfer of stations regulation from the Department to ORR earlier this year. As stated previously, we believe there are significant benefits to the system in a streamlined approach to regulation – and encourage the ORR to make maximum use of those benefits.

Our objectives for the PR are designed to address some of the context issues highlighted above, while maintaining a focus on the long-term health of the HS1 asset. We would like to make clear that we have not ruled out the possibility of amending the Concession Agreement in certain areas discussed below, albeit we would set a high bar for any such changes. Should it be clearly demonstrated that amendments would be beneficial to the system, then we would consider making them, considering the Concession Agreement and its overall risk profile as a whole.

The Department's Objectives

The Department has three overall high-level objectives for PR24:

1. **Secure an efficient outcome which delivers for passengers and freight customers** – we want the network to continue to deliver a safe, reliable railway, and to be as efficient as possible – with stretching, yet realistic efficiency targets. HS1 should assert maximum pressure on NRHS to deliver the operation and maintenance of the railway as efficiently as possible, while delivering a safe, reliable railway – which also facilitates broader Government objectives around environment and international connectivity. Considering new and innovative approaches could play an important role here, as does robust benchmarking with other infrastructure managers. Transparent and clear reporting of efficiency is also critical.

2. **A financially sustainable, affordable HS1 system** – Beyond efficiency, a key objective is to explore ways to make the system financially sustainable for operators and Government. This includes looking for ways to make the system affordable both in the short and longer term, whilst addressing some of the key challenges on HS1.

3. **Protect the value of the asset** - protect the long-term value of the asset to ensure it is returned to the Department at the best value possible in 2040. This is in the taxpayers' interest as our objective is to maintain the value of the Concession so it will be returned to Government in good operating order and optimum condition at the end of the Concession. This is done by ensuring the asset is properly funded and is expertly maintained and renewed throughout the Concession.

We fully accept that there is a balance to be struck in these objectives. We would propose striking them by ensuring a strong and robust challenge on efficiency, which has regard to the considerable affordability challenges in the system. Moreover, where there are broader changes which could promote affordability – whilst protecting the stewardship of the asset – we consider these must be carefully considered, including those which could impact on the Concession Agreement.

Particular issues

In that light, we would like to explore whether amendments may be justified in respect of some requirements around HS1 Ltd's investment strategy, the definition of specified upgrades (particularly in relation to digital signalling) and the approach to assessing asset condition over a 40-year period. In considering any changes, we would carefully assess the impacts on taxpayer value.

Escrow Investment Strategy

The Department has been in discussions with HS1 about the Escrow Investment Strategy, which is the strategy to manage the monies paid into the HS1 Escrow accounts. The wording in the HS1 Concession Agreement prevents new banks from signing up to investments and a lack of available banks means the interest rates on offer are particularly low. We are therefore open to amending the wording in Appendix 4 of the Concession

Agreement to enable more banks to sign up. We are also discussing the idea of diversifying the current investments which are currently restricted to fixed rate deposits. We have made it clear we are not open to taking on any additional risk. However, due to high inflation, the relatively poor interest rates also means the value of the money is eroding and taking no action is also not risk free.

European Rail Traffic Management System (ERTMS)
We understand operators' considerable concerns around the costs of ERTMS – and would like to explore solutions during this Periodic Review. We do not see Government funding as a solution but would be willing to consider options around the Concession Agreement definition of specified upgrade. We would like to work with all parties on this during the PR24.

40 Year Pay Ahead
The Department understands the concerns previously expressed by operators in this area and would be keen to explore solutions. We note, in particular, the reference in the consultation document to profiling of payments (at paragraph 3.32). We consider this could have considerable merit, particularly in addressing the affordability challenge. Of course, it will be necessary to be fully cognisant of long-term implications.

Moreover, we note that growing **freight** is an important priority for Government – reflecting its considerable economic and environmental benefits. We would therefore like to see more freight on the HS1 network. PR24 presents an opportunity to consider how the access charging and, critically, performance regime work best for all stakeholders, and whether a different balance can be struck which supports freight growth, whilst recognising the more limited contribution the sector makes to access charges and the need to manage performance risks.

Finally, and particularly in the light of recent events during Covid, we strongly agree with ORR on the importance of an effective approach to dealing with **risk and uncertainty.** We will continue to develop our thoughts in this area, but critically we do consider that a stress test should applied on the final settlement – which tests the robustness of the settlement to particular scenarios – inflation and impacts on demand in the light of Covid. A structured and predictable system approach to dealing with these issues is vital.

We look forward to continuing working with you during the Periodic Review.

Yours sincerely,

[redacted]

Dan Moore

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By email: [redacted]

11 November 2022

Non-confidential – version

Dear Debbie,

PR24 initial consultation

1. Thank you for this consultation. We welcome the opportunity to provide our response. This a very important process. It is key to the future robustness of the system, and to ensuring that the most passengers can benefit from services on HS1 at affordable prices.

Affordability is key

2. Affordability of charges is key to the approach in this periodic review. The system finds itself in an unprecedented economic position following the demand shock caused by the pandemic, soaring inflation levels that have already surpassed 12% and a cost of living crisis at levels last seen in the 1970s.
3. Over the last three years, at a time when Eurostar took on record levels of commercial debt absent of government-backed funding (funding which was available to its competitors), HS1 OMRC costs increased by 57%, of which 28% was caused by successive volume reopener processes for 2021 and 2022. And further increases are already in sight before the start of CP4. HS1 charges are currently three to ten times higher than track access charges EIL pays on the continent, as shown Table 1 below.

Table 1: Per track-km track access charge for EIL trains, 2022

Destination	HS1	SNCF Reseau (FR)	Infrabel (BE)
Paris	[✂]	[✂]	-
Brussels	[✂]	[✂]	[✂]

4. This will be exacerbated even further over coming years. Inflation indexation alone is expected to push up HS1's charges by another 10-15% next year whereas, in contrast, SNCF's charges have been confirmed to increase by 3.4% on average in 2023. These charging trajectories are unsustainable for

this UK asset, and it is key that the periodic review address this so that the asset remains efficiently utilised for the benefit of passengers[1].

5. It would be difficult to bear this level of increase in a stable operating environment. In the present, it is near impossible, and it is not without consequences. Increases of this magnitude import risk to the system, our operation and hold back growth. We are seeing this already. At the end of 2022, Eurostar continues to run over [✂] fewer trains than in 2019, pre-pandemic, [✂]. Our route network now resembles that of the 1990s, when we started operations, more than it does our network at the start of CP3. For example, it was recently reported that we will suspend the popular London – Disneyland Paris route from June next year and our two Kent stations, closed during the pandemic, will not reopen in the near future[2]. None of this could have been foreseen by the ORR when it conducted its last periodic review, but it must be taken into account in the forthcoming review.

6. We, and other system stakeholders, have already been discussing with the ORR the need to take an approach that thinks differently about this review in light of the challenges the system has, and still is, facing. It is key that in this review the ORR act to avoid the HS1 system becoming unaffordable, contracting in terms of trains, passengers and passenger choice. This is essential to enable a commercial recovery, rather than a public policy crisis. It must be noted that the ORR's own previous determinations designed to secure long-term funding stability all rely on volume growth projections which the current trajectory in charges is in danger of wholly suppressing. Over the past year, train operators have provided HS1 / the ORR with evidence illustrating the severe financial constraints affecting their businesses, including the ability to maintain even the current volume of train services. A summary of EIL's commercial performance in CP3 can be seen in **Annex 2**.

7. We welcome the ORR's confirmation that it will, as part of this review, take its section 4 of the Railways Act 1993 duties into account. In exercising these duties, we would expect that they are not inferior to the contractual obligations under HS1's Concession Agreement (CA). It is key that these statutory duties are given due regard and that the contractual obligations in the CA are not executed in such a way as to give preference to contractual responsibilities over the ORR's statutory obligations. If this is not the case, then we request clarification on the basis upon which the ORR has determined that its CA obligations have a greater weight than its statutory obligations as soon as possible.

8. In our view, the appropriate starting point to determine affordability is contained in the section 4 duties, in particular those which:
   - protect railway users interests,
   - promote efficiencies and economy; and
   - promote the use of the railway overall.

9. These support charges being set at a level which is efficient and effective in promoting the use of the railway and the right consumer outcomes in terms of volume, price and quality. This, at its simplest, encapsulates the underlying concept of 'affordability'. We provide in **Annex 3** a high-level overview of the link between access charges and consumer outcomes. We welcome further engagement with the ORR on how it may assess this question[3].

[1] Further information on HS1's charges, which represent a significant share of EIL's costs and their unprecedented increases since 2019, to support the need for a strong focus on affordability is at **Annex 1**.

[2] https://www.bbc.co.uk/news/business-62728618

[3] A detailed technical econometric analysis that captures all factors impacting demand and supply levels *might* be able to establish a quantitative link between track access charges and demand and train volume levels. This has been done in other countries, for example the Italian regulatory authority recently carried out an ex post econometric analysis that established that higher charges for international operators had negatively impacted demand (Autorita di Regolazione dei Trasporti, Delibera n. 175/2021, 9 December 2021, available at: https://www.autorita-trasporti.it/delibere/delibera-n-175-2021/.) EIL however does not have the means or access to all the necessary data to establish such a model.

10. An approach that focuses on control of costs over CP4 and beyond is vital to ensure that the system can recover and grow to ensure that, ultimately, passengers will benefit from sustainable rail services at the best possible prices. Put simply, the market cannot bear the current trajectory of costs. Key to delivering this is for the ORR to ensure it is considering all possible avenues to address affordability. We welcome the ORR's suggestion of potentially considering a different annuity profile over time as one such option. However, outside of this the initial consultation is unduly narrow in the areas on which it proposes to focus the next periodic review. We believe that further elements must be open for review and consultation.

Review of the forty year pay ahead approach is permissible and essential for this review

11. There are other approaches, consistent with the CA and therefore within the scope of this periodic review, that must be examined as part of this periodic review. Importantly, this includes the forty year pay ahead approach.
12. The asset stewardship purpose in the CA does not prescribe any specific methodology by which long-term asset costs are to be funded. Adopting an alternative approach to the forty year pay ahead is not inconsistent with the asset stewardship purpose. There is no hierarchy between the need to consider best practice[4], to adopt a 'timely, efficient and economical manner' and a look ahead for forty years.
13. The HS1 General Duty is to achieve the Asset Stewardship Purpose at all times but subject to the additional qualification that it will be "to the greatest extent reasonably practicable" and "having regard to all relevant circumstances". Achieving the Asset Stewardship Purpose at all times is therefore not an absolute requirement but requires a consideration of, and is subject to a requirement to consider, all relevant circumstances and reasonable practicability.
14. In the initial consultation, the ORR indicates that it does not intend to deviate from this forty year pay ahead approach to calculating charges for PR24[5]. We have serious concerns about such an approach and are not clear on the legal basis for adopting this position, despite having previously asked for such clarification.
15. A process that excludes review of this previous approach would be fundamentally flawed. To adopt such an approach will mean that no meaningful analysis of the current economic and market conditions facing the system has been undertaken for this periodic review and, because of this, it is not possible to be sure that the choices made previously remain valid. This is important as:
    - The previous approach to pay ahead for a full forty years is not mandated by the CA.
    - It is the duty of the ORR to conduct its review against the requirements of the CA and the asset stewardship purpose with the benefit of the most current data and in the context of the current circumstances and those relevant to the Control Period under consideration.
    - Adopting an alternative approach is not inconsistent with the CA.
    - Valid alternative approaches consistent with the requirements of the CA exist and would address issues of affordability, such as the EIL 'ratchet' approach.
    - As acknowledged in the initial consultation, there has been a great impact on the market and the system as a result of the covid-19 pandemic in recent years. It is key the most current data inform the choice to be made this control period; and

[4] The exercise of that degree of skill, diligence, prudence, foresight and practice which would reasonably be expected from a skilled and experienced infrastructure manager engaged in the provision of high speed railway infrastructure.
[5] Paragraph 3.7, initial consultation

- The approach, and level of these significant charges, have a significant impact on passengers, operators and the system.

16. We have sought independent legal advice on this topic. [✄]
17. A range of suitable alternative approaches to the construct of a forty year pay ahead approach exist that are compatible with the current parameters of the concession agreement. We welcome the opportunity to discuss these further with the ORR.

Meaningful efficiency targets must be set

18. Also key to achieving affordability is a clear focus on efficiencies. We welcome the ORR's recognition that a strong focus on efficiency for both operations and maintenance as well as for renewals delivery is necessary and important to make system more resilient. We also welcome the upfront work of both HS1 and NRHS to begin the thinking on this topic. As we have discussed with the ORR, we are of the view that a realistic and entirely achievable target is 20% top down efficiency for track, mirroring the efficiency challenge for NRIL imposed by Government. This would contribute to rolling OMRC charges back to the level as determined by the ORR at the start of CP3.

First ORR stations review

19. We welcome the transfer of the HS1 stations periodic review to HS1 and note that the initial consultation does not contain detail on this aspect of the review. We considered the outcome of the last periodic review was not ambitious enough, in terms of efficiencies in particular, and welcome the ORR's expertise in this area to drive efficient and effective outcomes for station operators and passengers. We continue to have concerns about the lack of any contribution to St Pancras International costs from Thameslink, a key operator with significant passenger footfall and train volume in the station, as well as the lack of any contribution to station costs from the significant number of retail and food outlets in St Pancras International[6]. We look forward to the ORR setting out the approach and priorities for station long term charge review for stakeholder comment and input as soon as possible.
20. We are concerned that the HS1 Structure of Charges consultation dismissed long-standing EIL concerns about the allocation of 100% of long-term costs to the railways. Whilst the retail income sits outside the regulated till (and, unlike with NRIL, is not recycled to the benefit of RUs), nevertheless there is a regulatory interest to ensure what is allocated to RUs within the regulated till is fair. We therefore specifically ask the ORR to consider the current compliance of this element of charges.

ERTMS

21. We have significant affordability concerns in respect of ERTMS. We have previously set out our views on the funding of this project, which remain unchanged. As things stand, were this to progress, an open access operator on HS1 would be the only train operating company to fund ERTMS on track in the UK. This is unacceptable and is entirely unaffordable.

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[6] For clarity, this is not a challenge of the dual till concept, but one of determining the correct allocation of costs that are rightly due to be paid by the railways under the regulatory settlement in order that there is not a free ride from other outlets. It isn't the accepted approach in any other multiple retail operating space, and it should not be the case in St Pancras. Currently railways cross subsidise other unregulated businesses in the station.

22. We believe that ERTMS meets the definition of a Specified Upgrade. In fact, the Specified Upgrade provisions were included in the CA specifically to align the anticipated signalling investments with the national network. Importantly they are subject to an affordability test. Proper time must be afforded for such assessments. To assume works and funding as part of this control period would be pre-emptive for any party, including the Government.
23. The proposed approach and its timing also does not reflect developments on other networks and fleet replacement considerations which might cause system compatibility issues where different variants or releases of ERTMS are chosen at different points in time. It could catastrophically compound the existing affordability pressures.
24. We do not, however, at this stage object to the scoping work, provided this does not pre-empt the treatment and funding of the main works.

The forthcoming periodic review approach

25. In the current approach to PR24 and CP4 charges it is key that the review:
    - focuses on and sets charges which are affordable for HS1's users and that can be borne by the market. Increasing charges is not a risk-free choice. It will deliver lasting damage to the financial recovery and return to growth of the HS1 system, and therefore ultimately to its users by way of fewer and more expensive services and the sustainability of long-term costs.
    - recognises and adapts its approach in areas that are not mandated, and therefore not required, by the CA. The forty year pay ahead is not a CA requirement, and it is driving very high cost on the railway to the detriment of current operators and passengers, as well as making the system less robust for future passengers.
    - takes into account section 4 Railways Act 1993 duties, as well as CA obligations.
    - considers, independent of HS1 and NRHS' chosen contractual delivery framework, what an effective and efficient infrastructure manager should be expected to deliver in terms of an efficient cost envelope. We would be concerned, for example, if any aspects of the contract between HS1 and NRHS (two parties with considerable degrees of market power) were accepted without this scrutiny.
    - Reviews the charging system as well as the passenger access terms and conditions governing charges payments. These are critical elements of PR24 once the cost envelope has been determined. They determine reflect how costs are allocated to train operators and can affect train operators' decisions about their timetable, including:
        - A close review of claimed efficiencies and the relationship between costs and traffic. Variable costs (OMRC-A1) are deemed to vary with traffic. We did not see cost variations from record low levels of traffic, were told there were none, and that certain costs increased. At the same time, NRHS have signalled outperformance of the CP3 O&M cost efficiencies. If outperformance is due to a drop in volumes and therefore workload, this is not outperformance and should be returned in full to operators. If on the other hand there are no cost savings as a result of the pandemic, then it would stand to reason that a much lower share of costs is actually variable with traffic than previously assumed, which should then be reflected in the charging structure.
        - Review of the payment terms in the HS1 Passenger Access Terms (PAT) for consistency with the Railways Regulations 2016. For example, HS1 is on record on various occasions, that -A1 charges are only payable for trains that are actually operated, due to them only being incurred when a train uses its tracks. The PAT does not provide a refund mechanism for these charges where trains originally planned and pre-paid were not run.

Where payment terms are inconsistent with the Railways Regulations 2016, these should be addressed and amended retrospectively.
  - Other elements of the structure of charges and the PAT have also remained unresolved by HS1's Structure of Charges Review. These include the variability of train paths pledged and paid for in the First Working Timetable, the terms of the volume reopener process and the inclusion of reactionary delays in the Schedule 8 performance regime.
  - Additional points we would like to see included in the approach for this periodic review are at **Annex 5**.
- Utilises structure of charges levers to address affordability. An efficient charging scheme nevertheless needs to consider the impact of charges on different markets in which HS1 users operate[7]. This is already implicitly in place for freight operators that do not contribute to HS1's fixed costs, on the basis that their market cannot bear such charges. In **Annex 6** we provide evidence that it is reasonable to assume that the international market is more price sensitive than the domestic market, which could also be reflected in a differentiated allocation of fixed and common costs between these different markets.

26. Our response to the ORR's consultation questions is at **Annex 7**.

27. ORR requested that stakeholders submit evidence to support their arguments. We include in this response a range of evidence, but to provide clarity to stakeholders it is incumbent on ORR to set out it approach to how it will assess and balance these fundamental questions. This is the start of the periodic review work and it is not a complete dossier. We continue to be happy to feed in to the ORR's analysis. We request that the ORR informs us who it is commissioning to conduct this work and what the process for engagement will be. Under separate cover we will also provide the ORR with an overview of any submissions by EIL in the context of HS1 consultations and other industry engagements over the last two years that are relevant to the PR24 review.

28. We look forward to our upcoming meeting to discuss further information supporting our analysis of affordability, and to continuing to support the ORR in gathering the evidence it requires as it further develops and refines its analytical approach for PR24.

Yours sincerely

[redacted]

Gareth Williams
General Secretary

cc Samantha Spence, EIL
Isabell Kohten, EIL
Jason Lewis, EIL
Dan Moore, DfT
Andrea Pearson, DfT
Benn Hall, DfT

[7] This is the case irrespective of the section of the Railways Regulations that charges are levied under.

Annex 1

HS1 charges represent a significant share of EIL’s costs and have seen unprecedented increases since 2019

A1.1. Until 2019 HS1’s track access charges represented c. 8-10% of EIL’s travelled revenues[8]. Given the significant charge increases since then that have far outstripped inflation and yield growth, it’s likely that the share will increase once timetable planning has stabilised again following the pandemic.

A1.2. HS1’s charges have increased significantly since 2019. The regulated element, OMRC (excluding OMRCC, the pass through cost element) increased by no less than 57%, [✂] per train path, driven by three distinct elements:

- A step increase in charges at the beginning of CP3, in April 2020, of 16% in real terms.
- Two successive charge increases resulting from successive volume reopeners for 2021 and 2022 charges, increasing charges by 28% in real terms by 2022; and
- RPI indexation leading to a further cumulative charge increase of 12.4%.

A1.3. In addition to OMRC, HS1 also charges an Investment Recovery Charge (IRC) for each train movement. While not subject to the PR24 review process, its level is substantial since it represents c. 56% of the total track access charges and therefore must be included in any assessment of affordability of charges. IRC is adjusted for RPI twice a year, meaning that by September 2022 it had increased by 18% to [✂]. In total, therefore, IRC and OMRC together increased by 31% over only 3 years, [✂] (including the pass-through cost element of OMRC) – an increase of more than £1,500 per train. In 2022 EIL is expected to operate [✂] trains. That is an additional cost burden of [✂] per annum, with further charge increases expected resulting from further volume reopeners and RPI indexation.

A1.4. [✂] [EIL’s] portfolio [is] more akin to what EIL operated in the 1990s than at any time over the last two decades.

HS1 charges are 3-10 times higher than track access charges EIL pays on the continent

A1.5. In comparison with other high-speed networks in continental Europe, HS1’s costs stand out as extremely high and as rising at the fastest rate.

A1.6. In comparison to the Belgian and French track access charges, HS1’s charges are significantly higher. Table 1 shows the average per-track-km charge for EIL’s two core routes, London-Paris and London-Brussels, on HS1, SNCF Reseau (France) and Infrabel (Belgium). For a London-Paris route, the per-km charge for HS1 is three times higher than in France, and for a London-Brussels route, the per-km charge for HS1 is almost 6 times higher than in France and almost 10 times higher than in Belgium. This will be exacerbated even further over the coming years, when inflation indexation alone is expected to push up HS1’s charges by another 10-15% next year, whereas SNCF’s charges have been confirmed to increase by 3.4% on average in 2023.

[8] Source: EIL statutory accounts.

Table 1: Per track-km track access charge for EIL trains, 2022

Destination	HS1	SNCF Reseau (FR)	Infrabel (BE)
Paris	[✂]	[✂]	-
Brussels	[✂]	[✂]	[✂]

HS1's access terms provide less flexibility on charges than is the case in France and Belgium

A1.7. During the pandemic UK track access costs also proved to be the stickiest of all of EIL's infrastructure costs and least likely to vary with volume reductions, further incentivising a risk-averse approach to timetabling.

A1.8. In 2020, EIL had to pay HS1 track access charges for a full timetable that had been set on pre-pandemic parameters. In the event, EIL only operated a fraction, roughly 15% of its originally scheduled trains, from mid-March 2020, but paid for 100% of its originally scheduled trains. EIL paid full IRC and OMRC charges on [✂] trains that it did not operate, at a cost of more than [✂]. This included [✂] in IRC charges and over [✂] in OMRC-A1 direct cost charges. This was as a result of HS1's Passenger Access Terms (PAT) not providing a refund mechanism for any part of its charges relating to trains included in the committed First Working Timetable (FWT) that subsequently do not operate, irrespective of the time frame in which trains are cancelled.

A1.9. In 2021, only a negotiation with HS1 yielded an outcome that saw EIL's eventual per train access charges reduced by similar shares as for the track network usage in Belgium and France, and more in line with the reduction in train movements.

A1.10. In France, the mark-up elements of track access charges are reduced, or waived entirely, for trains that are not operated, depending on the time window within which the trains are cancelled. Direct cost-based charges are only charged for trains that actually operate. This helped reduce track access charges in France by 60-80%.

A1.11. In Belgium, the government made available a support scheme that reduced track access charges for all train operators in Belgium, so that in 2021 track access charges in Belgium also fell closely in line with EIL's train movement reduction, by around 80%.

A1.12. To compensate HS1's cost recovery shortfalls as a result of volume shortfalls, annual volume reopeners are expected to keep increasing the per train charges in the UK for the remainder of CP3. As we set out above, OMRC as of April 2022 has increased by 28% in real terms above the levels originally determined by the ORR for April 2020. Further increases are expected. There are no such provisions in France or Belgium.

Annex 2

EIL's commercial performance in CP3

A2.1. The pandemic caused a rupture to the international passenger market and previous trends that will take many years to reverse. Given the focus on cost saving and repayment of debt, EIL's timetabling decisions have become more, not less, sensitive to even small to moderate changes in its cost base.

A2.2. Eurostar suffered significant losses as a direct result of the pandemic: across 2020 and 2021 EIL made cumulative losses of £733m. Demand fell by around 85% across the time period March 2020-December 2021 and so did revenues. EIL [✂] had to take on around [✂] of debt that it will need to repay over the coming years, and certainly well into CP4. [✂]

A2.3. Against this background Eurostar deployed all levers at its disposal to reduce any cost exposures that it can control. By 2021, EIL had roughly halved its controllable operational costs [✂] compared to 2019 levels. [✂]

A2.4. At the end of 2022 Eurostar is at a critical turning point:

- Given the record levels of debt Eurostar has had to take on, there is now strong pressure to return the business to pre-pandemic levels of profitability as quickly as possible, despite the gathering macroeconomic headwinds.
- The inflationary risk alone exposes Eurostar to an estimated downside of over [✂] in 2023, [✂].
- Inflationary pressures on our consumers' travel budgets and the ongoing uncertainties caused by war and pandemic, which by all expectations will take several years to reverse, cast uncertainty over the future robustness of passenger demand.
- [✂]

A2.5. Against this background EIL must minimise its cost base where it can, [✂].

A2.6. EIL has successfully driven a strong push towards growing back volumes and even exceeded expectations, supported by pent-up passenger demand following two years of lockdowns and travel restrictions. For 2022 it expects to operate in total close to [✂] trains – a huge step forward following the pandemic but still c. [✂] trains p.a. less than before the pandemic. In September 2022, it operated around [✂] of its September 2019 train volumes.

A2.7. [✂]

A2.8. In response to the effects of the pandemic, Eurostar closed all regional routes and intermediate stations except Lille until further notice to focus on its core routes to Paris, Brussels and Amsterdam. The highly popular Disneyland Paris route will cease operating from June 2023. [✂] For example, [✂]. Overall, EIL expects to be able to operate at best at [✂] of the train volumes that were originally forecast in the CP3 determination.

A2.9. [✂] EIL continues some [✂] investments wherever it can, but some large projects, such as [✂], have had to be put on ice given the financial constraints. Absent such important investments, volume growth as anticipated by regulation cannot be realised, entrenching the status quo of increasing charges and stagnating volumes.

A2.10. In summary, previous trends of stable demand and revenue have been fundamentally reset. There has been a marked downward step change in volumes from which EIL now starts its path back to profitability and growth. It is certain that a recovery up to the previous trends will not take place for several more years.

Annex 3

The link between track access charges and consumer outcomes

A3.1. It is important to recognise the dynamic effect between volumes and track access charges embedded in the current charging structure where lower train volumes result in higher per-train track access charges, which in turn have a dampening effect on train volumes and so on.

A3.2. When ORR re-set the charges for CP2 and considered the appropriate level of renewals annuities, it recognised that unnecessarily high charges may adversely impact HS1's ability to attract new customers.[9] In CP3, which delivered a 16% increase in OMRC in real terms[10], ORR was more concerned about the risk of future underfunding of the asset and must implicitly have accepted that this outweighed any adverse impact on consumer outcomes that it had recognised previously. As explained above, however, the pandemic and ensuing high inflation environment have led to the regulated charges rising by 57% compared to 2019 levels, increasing the total charge per train by more than £1,500. That is a significant increase, which will increase the share of HS1 costs as a percentage of EIL's revenues from 10% to around 13% (based on pre-pandemic outturns). For comparison, EIL estimates [✂].

A3.3. As explained above, given the financial obligations on EIL, the sensitivity to cost increases is higher than it used to be, so that any cost increase, especially in avoidable costs such as track access charges, is more likely to trigger a volume reduction than it would have been prior to the pandemic.

A3.4. Furthermore, EIL needs to make trade-offs on where to spend its budget. A rising track access cost budget may limit EIL's ability to fund other aspects of the services it provides to passengers. [✂]

A3.5. Perhaps even more important is the impact of higher charges diverting cash away from EIL to HS1 that could have contributed to EIL's ability to re-invest those funds in [✂]. Any margin that is diverted from EIL to HS1 through high track access and station charges reduces EIL's capacity to carry out the investments themselves. [✂]

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[9] ORR, HS1 Periodic Review 2014 Approval, para 6.72.

[10] Compared to the last year of CP2, OMRC in the first year of CP3 increased by 19% in total (incl. RPI inflation). ORR, Periodic Review of HS1 Ltd. (PR19) Final determination, para 7.57.

Confidential Annex 4

[✂]

Annex 5

Elements of the PAT for this periodic review

A5.1. In its Structure of Charges Review Conclusion, HS1 highlighted that they would proceed to take forward potential contractual amendments other than metered billing in due course. EIL would like to see the following included in this work.

- FWT billing. EIL would like to explore the possibility with HS1 of FWT billing being assessed on quantum of train paths for a given day, rather than the current system whereby FWT train paths are billed on the basis of train headcodes and departure times. [✂]
- Volume reopeners. As noted in this response, the terms of the volume reopener provisions in the PAT led to OMRC increasing significantly, by 28% in real terms, between 2020 and 2022. We expect that further volume reopeners, to which HS1 and TOCs committed as a result of the pandemic, may lead to further charge increases for the remainder of CP3. The effect of the reopener provisions is to shift all risk for unforeseen volume changes wholly onto TOCs, providing scope for significant charge increases within the control period, due to their focus on full cost recovery. Although it is theoretically designed also to prevent over-recovery, in practice volumes more often fall below forecasts than exceed them. While there have been volume reopeners in the past (2016) to address volume shortfalls caused by external shocks such as strikes, terrorist attacks and loss of essential infrastructure (fire in Channel Tunnel, January 2016), there has never been a volume reopener triggered by volumes exceeding forecasts. Furthermore, in circumstances as extreme as the pandemic, the volume reopener provisions have proven to create adverse incentives for all stakeholders.
- Schedule 8 of the PAT needs to be updated for CP4 to explicitly incorporate reactionary delays, as agreed between HS1 and EIL in October 2022.

Annex 6

[✂]

Annex 7

Responses to the ORR’s consultation questions

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?

A7.1. As we set out in the letter, charges need to be assessed as to their affordability to HS1’s users – do they support the right outcomes in terms of train frequencies, prices and quality, or will they further contribute to an under-use of the asset, to the detriment of consumers and taxpayers, and create a railway system that cannot sustain operational levels or grow?

A7.2. The ORR should be mindful in their assessments of the extent to which proposed reductions in asset performance have the potential to deteriorate the service quality (e.g. if regular downtimes start to affect the service regularity, or increasing delay levels) and consequently affect passengers’ willingness to pay for a product that is entirely within a commercial competitive market and the relative attractiveness of the service vs competing modes of transport. In general, we believe that the most productive opportunities for the necessary cost reductions lie not in de-tuning asset performance but in unit-cost efficiencies and in the economic assumptions and contingencies associated with charges.

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

A7.3. In CP3 the efficiency challenge was only 0.5% and ORR acknowledged this was conservative.

A7.4. Given the pandemic NRHS and HS1 recognised the need to be more ambitious on efficiency. NRHS have currently put forward a [✂] target with a stretch target of [✂]. Efficiency savings should be deducted from the overall cost envelope at the start of the Control Period and taken out of the scope of Outperformance Savings. Any such should only be recovered if additional savings are then delivered within Period.

A7.5. We noted HS1’s and NRHS’s presentation of their top-down asset management scenarios at the October PR24 workshop. We welcome their approach to challenging the status quo in this way and to identify the scope and scale for efficiencies. However, as noted at that workshop, as a TOC EIL did not feel that they had available the information necessary to probe the scenario outcomes in a meaningful way. NRHS and HS1 committed to providing further information in follow up workshops in December and we are looking forward to engaging with NRHS, HS1 and ORR on this matter through those fora and beyond.

A7.6. We support ORR’s objective to carry out benchmarking with NRIL as well as relevant international infrastructure managers and other UK regulated utilities. We would invite the ORR to expand the benchmarking exercise also to other aspects of this periodic review, including particularly their approach to funding and planning renewals.

A7.7. It is important that the ORR establishes its own view of what it regards as a notionally efficient infrastructure manager. HS1’s chosen operating model, including its contracts with Mitie and NRHS, should not prejudice any of the ORR’s assessment of what constitutes an efficient cost envelope.

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

A7.8. [✂]

A7.9. [✂] A commercially oriented business facing effective competition would make such investments on their own risk in order to remain competitive. Where NRHS and HS1 show reluctance to bring forward specific investments then regulation may need to bring about these outcomes. For the avoidance of doubt, we do not consider an extension of the regulatory period to be either necessary or appropriate. We believe that it is both reasonable and appropriate to assume that HS1/NRHS can and should take a risk-based view over future control periods.

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

A7.10. Since this is most relevant to the determination of the renewals related charges, please see response to the next question.

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?

A7.11. As set out in this letter , the ORR has more flexibility in the design of renewals cost recovery under the Concession Agreement than described in the consultation document. In light of the fundamental shift in the market caused by the pandemic, a re-think is not only possible but necessary to ensure that the regulatory approach remains appropriate.

A7.12. For example, the ORR appears to start this periodic review from the assumption that the escrow account is "underfunded"[11]. This presumes that the escrow levels as modelled in 2019 were the minimum necessary across the entire 40-year period. It precludes a number of alternative reasonable interpretations of what would constitute a minimum necessary level of escrow balance at any given point in time. Indeed, all the evidence provided from HS1 and NRHS over the past 3 years (nearly a quarter of the total experience to date) points in this direction and should not be discounted. The ORR should not foreclose this and instead embark on a detailed consideration of the appropriate approach to funding the escrow account and modelling exercise. In this context we believe that alternative approaches such as EIL's "ratchet approach" or a risk/certainty-based option remain valid alternative methods that should be taken into consideration.

A7.13. Other aspects of ORR's renewals modelling methodology should also be subject for review and consideration of alternative approaches, to avoid precluding a more appropriate approach to renewals funding in CP4. These include:

- What would be the time horizon over which an effective and efficient infrastructure manager would fund upfront its future renewals spend and would it do so for the same period or on a consistently "fully-funded" basis for all types of renewal? The ORR's current interpretation of the 40-year time frame referenced in the CA is not the only possible answer, and unlikely to be the most efficient answer, particularly during a period of time when the asset is underused and its customers struggle to afford its use.

[11] Paragraph 3.30, initial consultation

- The profile of the annuity. We welcome the ORR's willingness to consider such alternative approaches. As HS1 has already indicated, the current method does not lead to trains operating in different time periods all paying the same level of renewals annuity. Assuming volume growth over time, today's users pay a higher per-train annuity than future users. Further profiling, for example in line with economic depreciation principles that reflect the relative economic value of the asset over time, may be useful concepts to help further design a more equitable annuity profile over time.

- How to handle the considerable uncertainties involved in choosing a very long forecasting horizon such as 40 years to fund the asset. The ORR must decide whether it is more harmful to market outcomes to risk an overcharging of today's users (by overstating the renewals annuity) or to risk a funding gap several decades from today (by understating the renewals annuity). Since overcharging today's users also has dynamic effects for future generations (by depressing and slowing down volume growth, which in turn increases charges and diverts funds away from other necessary investments for the system, such as in stations). EIL is of the view that it is more efficient to attach weight to the risk of overcharging today's users, particularly in the current financial circumstances.

- The ORR's previous interpretation of intergenerational equity should also be reviewed since in our view it omitted some important aspects that constrained the ORR's methodology unnecessarily. First, the volume growth over time discussed above is one such aspect that the current methodology does not account for and implies higher per-train renewals charges for today's users than for future users. Second, depending on timing and scale of volume growth and potential entry of another operator, allocating renewals costs evenly across time may over-allocate renewals spend caused by future users to today's users. Third, today's users also pay IRC, defined as a charge to cover the initial costs of construction. In other words, IRC has the character of a historical depreciation charge. Paying ahead an annuity for the asset's renewal is the equivalent of a forward depreciation charge. So, today's users pay for the asset's use twice, through the IRC and the renewals charge. Once the initial costs of construction are fully covered, users (potentially after the end of the current concession period) may no longer have to pay IRC and would then (rightly) only pay for the asset's use once. Even though the IRC are not part of the regulated charges, they must be recognised in considerations of "user pays" and intergenerational equity concepts and how they apply to renewals charges. In light of these considerations taken together, it may well be that the principle of intergenerational equity requires a backloading of renewals cost recovery rather than an equal distribution across time.
- The way renewals costs were estimated in CP3 included a number of compounding contingency, risk and management uplifts that in some instances appeared to cover the same original risk. Given the speculative nature of these costs they should not drive up costs for renewals today.
- Since any perceived or actual "underfunding" is incorporated into the renewals annuity in subsequent periodic reviews, there is a reduced incentive for HS1 and NRHS to manage renewals costs in the most efficient way possible. Sharper incentives need to be set for HS1 and NRHS to drive efficiency in renewals delivery.
- The ORR should, as part of a new approach to funding the future railway, consider allowing other sources of funding to complement the escrow-based funding of renewals, debt-based or upfront funding by HS1 in a similar manner to AIRC. TOC-funded escrow payments have as opportunity cost the TOCs' WACC. This may be costlier than the financing costs of alternative funding routes on occasion. A mix of escrow and pay as you go funding may be another alternative, reducing losses caused by inflation over time.

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

A7.14. As for previous questions regarding efficiency, the ORR should establish what costs a notionally efficient organisation such as HS1 would incur, bearing in mind that it almost exclusively subcontracts the operation and management of the asset. This chosen construct should not lead to inefficient levels of double marginalisation for TOCs.

A7.15. We would also invite the ORR to assess the allocation of HS1's total costs between the regulated till and its unregulated business and whether this represents a fair allocation (see Stations, above).

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

A7.16. We note that in the UK the use of RPI has been replaced almost in all regulated utility sectors by CPI or CPIH indexation. There is consensus among the economic and statistical community that RPI is a flawed index that no longer provides a useful presentation of inflation.

- In 2015, a report commissioned by the UK Statistics Authority recommended that Government and regulators should move towards ending the use of RPI as soon as practicable[12].
- In 2018, the National Statistician discouraged the use of RPI as an inflation measure based on the ONS' own analysis[13].
- Later in the same year, the UK Regulator's Network, of which the ORR is also a member, published a common position paper on inflation measures in which it states that "RPI is a flawed statistical measure of inflation and, since 2010, systematically overstates inflation in the UK economy. The extent of overstatement is in many cases material to the decisions that regulators make and to the understanding of information that they from time to time present."[14]

A7.17. In light of this consensus, we believe there is no justification to retain RPI indexation for the setting of HS1's charges, either in the annual RPI indexation of OMRC or in the estimation of the renewals cost envelope and annuity.

A7.18. If RPI is no longer regarded as effective and efficient (and indeed RPI is likely to overstate inflation compared to CPI or CPIH) then the fact that HS1 has chosen to retain an inefficient inflation measure in its agreements with its main subcontractor(s) is irrelevant to the decision at which level to set efficient regulated charges.

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

A7.19. We have no further comments at this point.

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?

A7.20. While we do agree that sharper incentives are necessary to incentivise HS1 and NRHS to improve efficiency, at this stage we would not expect that a higher percentage allocation of outperformance

[12] UK Statistics Authority, UK Consumer Price Statistics: A Review, January 2016, available at https://uksa.statisticsauthority.gov.uk/reports-and-correspondence/reviews/uk-consumer-price-statistics-a-review/.

[13] ONS, Shortcomings of the RPI as a measure of inflation, March 2018, available at https://www.ons.gov.uk/economy/inflationandpriceindices/articles/shortcomingsoftheretailpricesindexasameasureofinflation/2018-03-08.

[14] UKRN, Position paper on the use of inflation indices, 2018, available at https://ukrn.org.uk/app/uploads/2018/06/UKRN-2018-Inflation-paper.pdf.

than is currently in place is necessary or appropriate. Rather, building a more ambitious top-down efficiency target into the renewals cost envelope may be a more effective approach to avoid the risk that achievable efficiencies are simply retained as “outperformance”.

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

A7.21. The ORR should consider whether the differences between the international passenger market and other markets served by HS1 are sufficiently significant that it merits a differentiated allocation of fixed and common costs. This principle is effectively already being applied to the freight market that does not contribute to fixed and common costs. In Annex 6 we set out high level evidence indicating that the international passenger market has a higher price elasticity than the domestic market such that it would merit a lower allocation of fixed and common costs to the international market. In other countries such as France track access charges are differentiated for international and domestic routes so as to capture the different level of costs each market is able to bear.

A7.22. Separately we have identified a number of areas where the requirements for the PAT create inefficiencies by locking operators into forward commitments (and costs) that are subject to high levels of uncertainty and may lead to unnecessarily conservative outcomes.

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7th November 2022

Dear Debbie,

Initial Consultation on the Periodic Review of HS1 Ltd. 2024 (PR24)

Thank you for the opportunity to respond to this initial consultation on the Periodic Review of HS1 Limited for 2024 onwards.

GB Railfreight Limited (GBRf) is a freight operating company that currently runs railfreight services through the Channel Tunnel, with occasional services using the HS1 network to/from Ripple Lane Exchange Sidings.

Much of our European traffic tends to use the "conventional" NRIL network to/from Continental Junction (via Westernhanger) due to it having greater and more consistent availability during the late evening/early morning, week on week.

GB Railfreight does not have comments on all the questions in this consultation but does have some pertinent comments of how lost and future railfreight opportunities might feature in some of the points being raised here.

General Comments:

- Paragraph 1.2: It is worth noting at the end *"....but Eurostar is currently only serving London St. Pancras"*. The stations that South Eastern serve are listed in paragraph 1.3 so those actually being served by Eurostar should also be stated. The industry really needs to understand what the future is for Stratford International, Ebbsfleet International and Ashford International (and their on-going maintenance). If there is no intention of serving one or more of these stations in the future, that will need to clearly understood.

- Paragraph 3.51: GBRf notes that HS1 Ltd. has stated *"a strategic aim for its recent review was to encourage greater network usage to both lower costs overall as well as promoting the sustainability of rail in the longer term".* GB Railfreight is very interested to know of HS1's detailed plans for encouraging modal shift of freight from road to rail and believes ORR should be as well.

- Paragraph 3.57: Again, GB Railfreight is interested to understand HS1's plans to encourage new freight to rail that is not priced off the HS1 network (other than late evening/early morning slots) due to what can be seen as unreasonable performance regimes.

<u>Specific Questions</u>:

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

GB Railfreight believes that HS1 should take into account how much freight traffic might be affected by future plans in dealing with asset performance or, indeed, any infrastructure maintenance & renewals activities. This is both for currently running freight services and those future railfreight opportunities that have not come to pass due to line closures.

It is GBRf's view that a key part of not already having attracted more freight to the HS1 network is the fact that there are just too many all-line blocks late evening/early morning, throughout the year, to permit new freight business opportunities from ever coming to fruition. If a new railfreight service is unable to reach the Channel Tunnel (via HS1) in over 2/3 of the nights in a calendar year, it will not be attractive enough to come to rail in the first place.

Over the last two years, there have been two HS1 new freight opportunities (specific gauge traffic from Duisburg and Antwerp) that GBRf has not been able to bring to fruition due to the above regular "all-line block" closures between the Channel Tunnel and Ripple Lane.

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

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?

The real danger is that, with overall decreasing passenger usage and probable reduced demand from 2024, the costs per train would increase and could easily lead to existing freight services coming off rail (having attracted too high a charge going forward from 2024) just at the time our urgent environmental agenda is demanding modal shift from road to rail.

This applies to the "main" HS1 network from the Channel Tunnel up to Ripple Lane (for through freight) and also for other domestic traffic needing to use Ripple Lane Exchange Sidings to access the Ford terminal at Dagenham, which are attracting commercially disproportionate charges for the distances covered by domestic services.

There needs to be a more stable and certain outlook that permits freight services to be planned and costed with some certainty, then consistently be able to run them without overnight possessions affecting the continuity of freight services.

Yours sincerely,

[redacted]

Ian Kapur.
Head of Strategic Access Planning.

HS1 Limited

4 November 2022

Debbie Daniels
Delivery Manager
Office of Rail and Road (ORR)

By email

Dear Debbie

HS1 response to ORR's PR24 Approach Consultation

1. The Periodic Review is an important regulatory process for the highspeed system and we welcome the opportunity to respond to the ORR's consultation on the proposed approach to Periodic Review 24 (PR24).

2. We have been discussing with ORR and other stakeholders the need to think differently about the PR24 process given the unprecedented macroeconomic challenges the HS1 system is facing. This is why HS1 acted early to launch the PR24 process, with HS1 and NRHS driving a PR24 sprint and holding regular stakeholder workshops since July. At the launch, we set out our intention to accelerate certain aspects of the PR24 process to set out a top down funding envelope for CP4 to give a clear indication of likely costs that NRHS will strive to achieve.

3. We have now delivered on this – we presented this funding envelope to stakeholders at our latest workshop in October – offering choices and setting out a target cost per train of between 5 to 15% reduction in nominal terms from CP3 exit prices. We will now work with NRHS to validate this funding envelope through the usual assurance process and challenge NRHS to go further where it can. HS1 and NRHS have been improving our asset maturity and deepening our knowledge of the HS1 asset and we will use this to drive cost efficiencies while ensuring long term planning in line with asset stewardship best practice.

4. We have set objectives for the asset based on the feedback of operators – including maintaining a 7 day railway and high levels of performance. We have presented options for deeper cost reductions as set out in our Strategic Asset Management Plan (SAMP). However deeper cuts would require a fundamental rethink on the HS1 asset and require changes to the requirements set by the HS1 Concession Agreement.

5. While we are pursuing cost efficiencies within the parameters of performance standards our customers expect, HS1 and NRHS have also identified several structural initiatives that, if implemented, could deliver significant cost savings for operators, such as a different approach to the renewals annuities calculation and ERTMS. The high speed rail system faces a real risk of a managed decline in train paths and asset utilisation and addressing these structural challenges are needed to make a real impact on affordability and support train volume recovery.

6. HS1 has been working hard to ensure we deliver on our CP3 commitments and are in the best place possible to begin CP4. To support this, HS1 goes beyond the regulatory reporting requirements to provide more detailed and frequent reports to the ORR on our progress. We've also worked hard in CP3 to implement Regenerative Braking on HS1 – we took a different approach to efficiently deliver this using Escrow funds, in agreement with DfT and SET, to the benefit of the wider HS1 system and in the strive towards Net Zero. If we hadn't taken a different approach, Regenerative Braking and its benefits would not likely have been realised for some time.

7. We have also taken a different approach to this Periodic Review, learning from PR19 and adapting to the unprecedented macroeconomic conditions. We've worked to accelerate certain elements of the process to give stakeholders an early indication of the likely outcomes for CP4. We're ensuring regularly and frequent engagement with stakeholders throughout PR24 so they are aware of the direction of travel and can input and help steer this in a timely way. At our October PR24 workshop, the ORR noted it will be proactively engaging with us and other stakeholders early on in PR24. We welcome this – we also welcome regular and timely feedback from the ORR and updates on your expectations as this is important to ensuring the direction of travel and success of PR24.

8. We have reviewed the ORR's proposed approach and broadly agree with the areas of focus. The approach consultation however does not provide detail on the specific approach to PR24 for Stations. We ask that the ORR provide more detail and clarity on this as soon as possible as this will inform our PR24 work on stations. We welcome the ORR's consultation recognising HS1 Ltd's Dual-till model and that unregulated income is outside the scope of the Periodic Review process. We also expect the ORR will have regard to the different characteristics, economics and business model of HS1 relative to NRIL in regulating stations, as stated in the ORR' second regulatory statement on stations.

9. The ORR also makes reference to the financial risks that HS1 faces and the importance of considering this risk landscape in setting the financial risk assumptions and charges to ensure HS1 is adequately funded and financially stable. We agree that the financial risk assumptions need to be set appropriately to ensure HS1 adequately recovers its costs. We note, however, that HS1's financial stability is outside the scope of the ORR's regulatory framework and the risk profile set at the point of the asset sale drives HS1's approach. It is not for the ORR to change that risk profile which will remain a matter for DfT and HS1.

10. We have provided responses to the ORR's specific consultation questions along with some additional comments in the Annex below.

11. We look forward to ongoing constructive engagement with the ORR and other stakeholders through the PR24 process.

Yours sincerely

[redacted]

Andrew Ellis
Interim Head of Regulation

ANNEX - Responses to specific questions

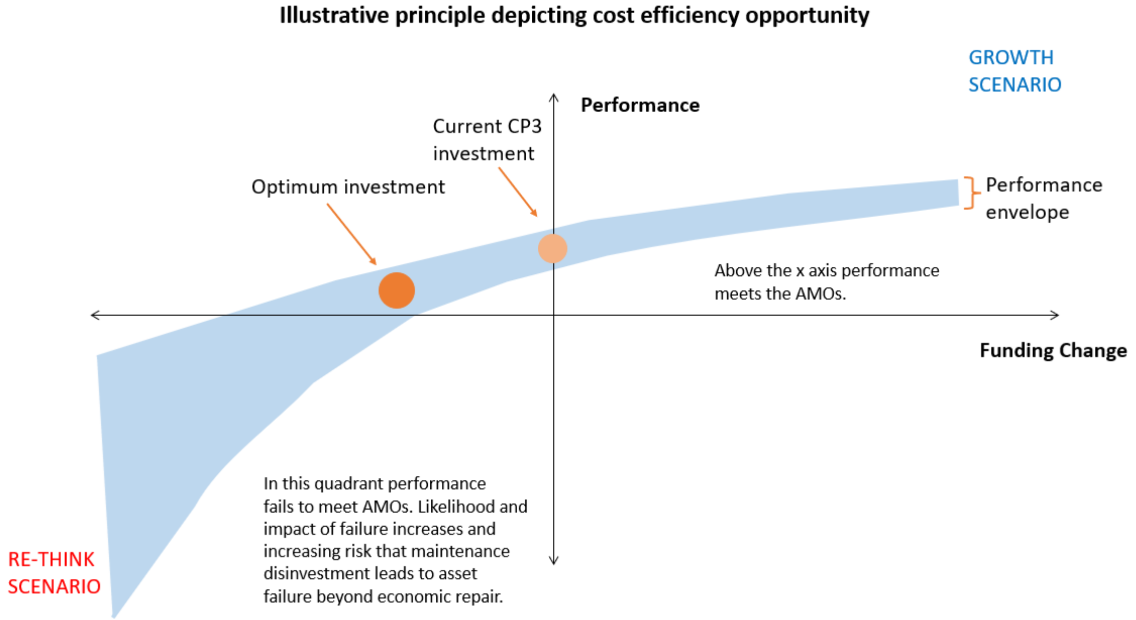
1. Cost reduction and efficiency: What factors do you think we should take into account when assessing HS1 Ltd plans that comply with the concession agreement, stations leases and safety obligations but deliver lower levels of asset performance (e.g. more unplanned delays, or more maintenance down-time)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

HS1 has been working with NRHS to look at these trade-offs early on in the PR24 process for both route and stations. We first presented our SAMP in July 2022 to stakeholders and sought their feedback on what outputs they want for the HS1 system – the operators told us they wanted a 7-day railway and performance standards maintained.

In developing our SAMP we set out four volume scenarios and challenged NRHS to consider these scenarios and what these would mean for the route and station asset performance and costs and where cost efficiencies can be achieved within this context. At the 13 October workshop, NRHS presented the top down view on what these outcomes would be under the four scenarios and an emerging view on the likely cost envelope based on what operators have told us they want from the system. We presented this as a cost envelope, and not as Asset Management Objective weightings, because this is more meaningful to the operators.

NRHS is now working on the bottom up validation of these scenarios. NRHS will develop Specific Asset Strategy documents that will present the outcomes of each scenario against our Asset Management Objectives - safety, performance, cost effectiveness, environment & social, growth and legal compliance. Safety and legal compliance outcomes will be protected and will not vary across scenarios. The lower demand scenarios give less priority to achieving performance, this includes punctuality, asset availability and customer satisfaction in stations.

The graph below illustrates the trade off in costs and performance that inform this assessment of scenarios and outcomes. Given the current high performance of the asset, there are diminishing returns to increasing opex to drive higher performance. Alternatively, reducing opex costs too low will result in a rapid decline in performance that can have long term impact on asset condition and costs (to recover the condition).



NRHS's top down assessment of this trade-off has identified O&M cost efficiencies of up to 10% that could be achieved while maintaining the asset performance and condition – i.e. the 'sweet spot'. This includes the NRHS-led sprint initiatives that could drive further efficiencies if the system is willing to take strategic decisions on certain structural challenges.

Driving further efficiencies risks driving us past that sweet spot where HS1 would not be delivering on our asset stewardship obligations. In assessing these trade offs, the ORR must take account of both the minimum operating standards of the Concession Agreement and performance floor. These will need to be protected unless there is a change in approach agreed with the DfT. Therefore, if operators want further efficiencies, such decisions will need to be made in partnership with the operators, the DfT and ORR as this would not be compliant with HS1's asset stewardship purpose as it currently stands.

2. Cost reduction and efficiency: Do you have any comments or suggestions on how cost efficiency is assessed, including on our proposed approach to benchmarking?

The PR19 process set a clear framework for assessing route cost efficiencies for O&M where NRHS uses the fishbone analysis to demonstrate efficiency to the ORR.

HS1 is not able to assess this analysis in any detail due to the commercial sensitivity of the information – the ORR must undertake this assurance. We have not had any negative feedback or concerns raised by the ORR on this approach, so we plan to continue in this way. If the ORR wants to change this approach, it will need to ensure HS1 has sufficient time to implement any such changes.

HS1 spent three months at the start of CP3 working with the ORR on how we would track efficiency in route renewals. Through the work undertaken by both NRHS and the ORR cost consultants who referenced the HS1 costs against a wide range of project cost information, it was agreed that the PR19 determination reflected efficient project costs. In CP3 we are now comparing the project final costs to the determination costs and identifying why there has been a variation. This is being done to help inform how reliable the process used in PR19 was and also to understand any issues that might be contributing to both efficient or inefficient renewals delivery. It will also help inform how much contingency should be applied to the project portfolio. We would welcome the ORR setting out their views on a framework for assessing efficiencies for route renewals and the behaviours ORR wishes to incentivise (see Section 9 below).

With regards to providing our estimated renewals costs in PR24 the ORR more recently explained that we should provide best estimates of renewals profile and how these have been benchmarked against previous control periods, with more detailed examples of assets with more uncertainty and cost ranges. In PR19 where HS1 had data from earlier renewals this information was used, and we would propose to use both CP2 and CP3 renewals costs along with other cost benchmarks to inform the project estimated costs. The ORR has explained it does not want detailed modelling of renewals. We ask that the ORR confirm this in its final approach document.

For station renewals, we are currently suggesting that we adopt a similar monitoring and reporting process that we are using for the route projects. We have agreed with the ORR on reporting renewals costs and variance based on our reporting for route. We are also proposing to develop efficient project costs based on benchmarking project costs against CP2 and CP3 costs and the use of published renewal cost information from similar industries. We would welcome the ORR setting out their views on a framework for assessing efficiencies for stations renewals.

HS1 has arranged for independent benchmarking of route and stations costs with similar domestic and international infrastructure managers. The route benchmarking exercise is underway. The stations benchmarking is being launched but we have been waiting for the ORR to set out its approach to stations regulation to help shape this. Rebel (the consultancy undertaking the benchmarking) recently met with the ORR to explain its approach. For route, Rebel will do a bottom up type analysis of operations, maintenance and renewals costs and will also produce an equivalent unit cost measure that will take into account cost drivers which will allow for top-down benchmarking. For stations, Rebel will take a proportionate approach to analyse and compare unit costs and cost drivers for a few major assets across domestic and international stations and some airports. If the ORR would expect something different, we ask that the ORR provide further clarification of this in its final approach.

HS1 is assessing efficiencies in HS1's own costs to discuss with the ORR. In assessing these efficiencies, it's important to consider the trade off in the value-add that HS1 provides relative to these own costs. For example, some of HS1's own costs relate to the significant work we do to drive cost savings in pass through and other non-own costs (costs which HS1 has little control over) for the benefit of operators. Such as:

- For traction electricity costs, HS1 uses a hedging approach, involving significant market research and negotiation, to purchase volumes two seasons ahead to lock in prices. This has protected operators against significant prices increase – purchasing electricity at Wholesale WAP of £220MWh against current market price of >£650MWh and highs of £800MWh – while also provided them with stability in energy prices in a turbulent market.

- Business rates is another area where HS1 goes to great lengths to protect the interests of TOCs. During the previous Business rates review, the initial valuation from the Valuation Office Agency was £100m. During extensive negotiations involving senior HS1 staff and external rating consultants this was reduced to £20m. The next Business Rates review is under way and HS1 is once again negotiating to obtain the best possible position for TOCs.

- HS1 has consistently challenged costs on stations Qx. We have outperformed against Stations Qx best estimates over the past two financial years – we achieved £2.5m (8.6%) in cost savings in FY21-22 which has been passed on to TOCs.

Stakeholders will need to be mindful that if HS1 is not sufficiently funded for its own costs, HS1 could not continue to pursue this work as rigorously which would be to the detriment of operators.

We were disappointed that HS1 has had to cover the ORR's costs related to the work done to transfer stations regulation from DfT to ORR and that the DfT would not reimburse HS1 for these costs. We had agreed with DfT that we would undertake the project on the principle that HS1 would not incur any additional costs with the transfer and we had expected that DfT and ORR would agree their own cost arrangement. So we were surprised that DfT expects the HS1 system to cover these costs, particularly as the ORR's costs were incurred undertaking work that the DfT specifically requested for the transfer and which HS1 had no control over.

As HS1 was left with no other options, we've had to pay for these costs from the route CP3 budget for ORR regulatory fees – that is, from fees gathered from operators that use the route which are not the same as those that use the station. For example, EMR will not have contributed to these costs. This supports our position that ORR regulatory fees should be treated as pass through costs for greater transparency and decision making for the TOCs, and we'll be taking that forward as part of PR24 charging structure (as explained in more detail in Section 3 below).

3. **Risk and uncertainty: How could the financial framework facilitate improved decision-making, to better align incentives in relation to risk allocation?**

The risk profile and associated costs for the HS1 system is well established and codified in a range of contracts, including the Concession Agreement and supply chain contracts with NRHS and Mitie. HS1 has confirmed with NRHS and Mitie and we will share these contracts with the ORR. We note that given the role of DfT in setting some of these contracts it is likely they will need to be involved in any detailed review.

As part of our CP3 commitments HS1 is undertaking a review of risk. This will inform all parties on how risk is currently managed and who holds what risk with a view to identifying any opportunities to improve risk management and possibly reduce cost.

We agree that the risks and associated costs should be borne by those who can best manage them within the overall risk profile laid out in the concession agreement. For instance, through our Structure of Charges Review, a CP3 commitment which was completed in August 2022, we identified some costs such as ORR regulatory costs that would be better allocated from HS1 own costs to pass through costs. This is because it would better align incentives around risk and costs and also to provide operators with greater transparency on the outturn of ORR costs. This will improve decision making on how these costs should be set.

While pass through costs – such as OMRCC and Stations QX – are outside HS1's control, HS1 undertakes significant work to drive efficiencies by reviewing and driving down costs where possible for the benefit of TOCs. HS1 adds significant value in this process as demonstrated by our work on managing electricity prices through the recent turbulence, negotiating lower business rates and producing real term Stations QX savings in recent years for the sole benefit of TOCs (as outlined in more detail in Section 2 above).

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

The overall approach to risk and uncertainty for the HS1 system is set by the Concession Agreement and on the basis of which HS1 Ltd purchased the Concession.

With regards to the inflation risk, the Concession was sold as an indexed-link asset where the inflation risk was passed on to the operators. This is fundamental to how the Concession was sold and how it is financed by HS1 Ltd. If the ORR is of the view that approach to these risks should change, this would be a fundamental change to the Concession and would need to be referred to the DfT.

For forecast demand, HS1 does bear some volume risk under the regulatory framework. The fixed priced contract with NRHS has meant that HS1 has had to absorb £2.9m in OMRCA1 costs as result of the impact of Covid on train volumes. The Volume Re-opener offsets volume risk for fixed OMRC charges. HS1 also takes the volume risk on IRC recovery.

5. **Escrow annuity: 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?**

HS1 has led early discussions on the approach to calculating the renewals annuity, given the concerns TOCs have raised about the PR19 approach to fully fund renewals for a 40-year period. As set out in PR19 this methodology is the most expensive approach – the impact this has on operators in current macroeconomic climate and the risk of a managed decline in train volumes needs to be balanced with the longer term funding risks as HS1 has set out in our PR24 workshops with stakeholders in July and September this year.

We welcome ORR's recognition that renewals annuity is a key issue for PR24 and the work to try deliver annuity relief that was considered this year. HS1 is keenly aware of impact of renewals charging on TOCs – this is why HS1 has pursued potential annuities relief with stakeholders

Following our request, the ORR has stated its position on the renewals annuity for PR24 in the Consultation – that renewals must be fully funded over 40 years, but there is a degree of flexibility in how the annuity is recovered – such as phasing the annuity charge over time. The ORR has also since clarified that HS1 would not bear any underfunding risk for any phasing – as the funding of renewals can be reset at the next Periodic Review. HS1 would be responsible for making sure renewals are financed noting the ORR has taken a policy decision that the escrow may not go into negative balance. We ask that the ORR confirm this in its final approach document.

We understand that the ORR needs evidence from TOCs on the relationship between HS1 charges and train volumes. HS1 is open to reducing the annuity burden on TOCs but we would also need clear evidence it would drive increased train volumes to the benefit of the HS1 asset and system in the longer term. To date, HS1 has not been provided with any data or evidence from the TOC and we welcome the ORR working with TOCs to demonstrate this demand relationship.

Once the trade off between price and demand is established by the ORR, HS1 can explore with stakeholders what flexibility in approaches could be employed. As this could result in a wide range of approaches, we will require a clear framework and expectations set out up front by the ORR to guide this to ensure effective use of of stakeholders' resources.

HS1 is willing to explore this phasing approach to the annuity. We will also be challenging NRHS to deliver an efficient renewals profile (through the work with PA Consulting) and driving efficiencies in the renewals cost to support a better outcome on the renewals annuity for operators. If however operators need us to make significant changes in OMRC charges to avoid a managed decline, we need to address the structural challenge of the fully funded 40-year annuity approach to make a substantial impact.

On a related matter, in discussions on the CP3 annuity relief proposal and PR24 annuities approach, the route asset condition at handback was referenced with different interpretations by several stakeholders. We want to ensure a common understanding on this, particularly as it forms the basis of our approach in PR24. In relation to the HS1 route there is no explicit reference or provision for asset condition at handback. Instead, the Concession Agreement focuses on HS1's requirement as asset steward to manage the asset in accordance with best practice, in a timely, efficient, and economic manner with a 40 year look ahead at renewals activities, along with other requirements in relation to an asset management strategy and asset information. HS1 sets out its asset management plans, forecast asset conditions and escrow balances through the 5YAMS, the Strategic Asset Management Plan and supporting Specific Asset Strategies that the ORR approves as compliant with the Concession Agreement through the Periodic Review process. This is the approach we will take for PR24.

We have written to DfT (copying in the ORR) setting out this position in detail and asked that DfT confirm if it has a different view. We also ask that the ORR confirm if it has a different view.

The ORR should be aware that in relation to HS1 stations the consideration of asset condition at handback is contractually different. Under the lease HS1 has a 'good and substantial repair condition' over the asset life cycle (40 years). Working with DfT we have defined what this condition means and developed a Target Asset Condition Survey. This sets the expectation for condition of the asset on a rolling 40 year basis and is reset every 5 years. Working with the ORR and DfT we will need to repeat this process as part of PR24.

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

This question is similar to Section 2 above and our response above sets out our views on assessing efficiencies in detail.

It is important to note that HS1 Ltd was set up to oversee a supply chain and drive cost efficiency within that, while also driving efficiencies in its own costs.

The ORR notes at paragraph 3.34 the HS1 R&D programme to drive long-term efficiencies. To deliver the £2m fund within CP3, HS1 has implemented a governance process that includes representation from train operators, NRHS, UKPNS and HS1 to approve R&D initiatives, monitor spend and track benefits. 16 initiatives have been selected so far, that address the defined challenges of: Automated Inspection; Cross-Domain Integration; and Efficient Possessions.

Early findings of the six initiatives that have concluded indicate that these would deliver long term efficiencies.

For example, the Tunnel Vision initiative demonstrated the use of Artificial Intelligence and Machine Learning analysis of video footage and laser scans to assess tunnel asset condition, significantly reducing the need for manual inspection. Based on early findings, the inspection process could be reduced from 65 days in a year to 6 days a year, representing improvements in safety, availability of asset, sustainability, and cost performance, whilst delivering against the challenge statements of Automated Inspection and Efficient Possessions. When adopted into business-as-usual, which is being progressed by NRHS and has been taken through Safety Case, this will support NRHS to deliver its committed O&M efficiencies in CP3.

As all the initiatives progress and draw to a close, NRHS will assess their suitability and findings to decide on how initiatives are taken forward, either through Business-as-Usual adoption or to take the findings and adjust current approaches to Operations, Maintenance and Renewals. Depending on the maturity of the solutions explored, the implementation is either within CP3, will be built into the PR24 submission, or forms part of longer-term research into degradation.

As part of the close out to CP3 and our PR24 process, HS1 and NRHS are documenting our CP3 Research and Development findings and setting our approach and intent for CP4 based on our CP3 learnings and experience. This will include a focus on the implementation of Digital Asset Management and Digital Twins alongside technology embedment – taking the outputs from several CP3 initiatives and centralising the data to deliver further efficiency and allow for wider analysis of data around the HS1 asset. HS1 would welcome the opportunity to detail more of our R&D output in CP3 via an R&D showcase and outline our CP4 approach.

We are considering how to structure the funding of R&D for CP4 in the HS1 charging model. Based on ORR feedback that R&D should be treated as a renewal cost, in our rebuilt charging model we have proposed to treat R&D costs as separate to the annuity charge for the 40-year renewals annuity calculation. This is based on the principle that the R&D costs are costs that should incurred within the Control Period and not be spread over a 40-year look ahead. We will be consulting stakeholders on this as part of PR24, but we would welcome early views from the ORR on this approach.

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

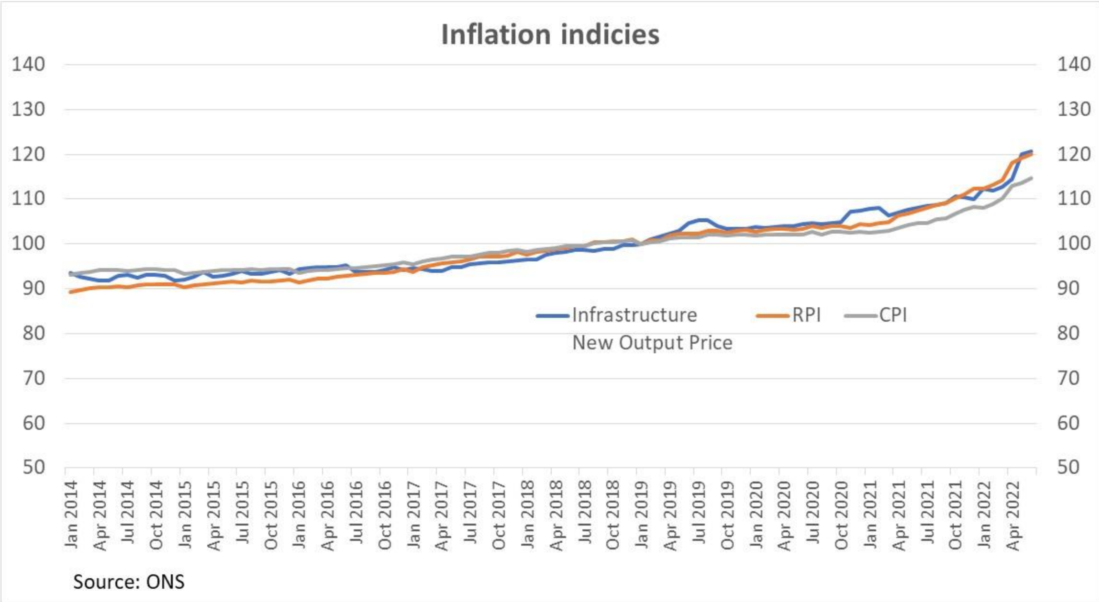
HS1 welcomes the ORR's recognition that RPI is the appropriate index for O&M inflation index because the contracts are RPI-linked.

At paragraph 3.38, the ORR states that HS1 needs to produce a forecast of the efficient level of input price inflation. It is important to note that HS1 is not an inflation forecasting company and so we must rely on external benchmark forecasts. Although no individual index accurately reflects the mix of input prices for the works involved in HS1 renewal activities, the Construction Output Price index from ONR for "New Works: Infrastructure" would most appropriate reflect this.

As shown on the graph below, there is not a large difference between New Works Infrastructure, RPI and CPI indices over a 7 year period (the extent to which the

Construction Output Index is available), although RPI has been a much better proxy for the New Works Infrastructure index since early 2019.

We consider the use of RPI remains the most appropriate inflation index for HS1 renewals as it is a good proxy for input prices and has the advantage over a Construction Output index in that there is a wider availability of sources from which to forecast future movements. We do not think the CPI is appropriate as it is less reflective of renewal input prices and there is no clear reason why CPI should be used over RPI, particularly as all other prices in the HS1 system are linked to RPI.



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

The key factors ORR should take into account are Security, Liquidity and Yield. However, the existing framework set out in the Concession Agreement is restrictive and therefore limits our ability to maximise each of these factors:

- Currently security is limited to the number of banks that are willing to sign up to Sch10, Appendix 4 and therefore this increases concentration risk to only 4 banks. If one bank fails, potentially 25% of the investments will be lost.

- As part of HS1's review, we look at the expected income and expenses from the escrow accounts to ensure liquidity is maintained throughout the period, however due to the limited investment options (bank deposits) available, we have to be slightly more cautious as bank deposits are fixed term in nature, whereas other common corporate treasury investments products would provide greater liquidity and flexibility.

- We also look at yield, which includes reviewing the prevailing yield curves available at the time the investment is made, however the other points raised that limit our ability to maximise security and liquidity also restrict our ability to maximise yield since we are nearing capacity within the limits set out in the Concession Agreement and we are therefore at the mercy of the rates offered by the 4 banks that have been willing to up to the agreement.

We have approached all banks within our banking group and banks outside to expand the number of counterparties, however they are not prepared to sign up to the terms.

We have raised these issues with the DfT and we're in discussions to amend the Concession Agreement in order to allow the escrow banks to be spread across other investment types and institutions to maximise security, liquidity and yield. However, it is important that the ORR acknowledge these issues in assessing HS1's approach to authorised investments.

9. Outperformance: 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

Outperformance sharing for route O&M works well in the HS1 framework. NRHS has outlined plans to deliver outperformance of c.£2.1m in years 3-5 of CP3, and the relevant proportion of this will be passed on to TOCs.

For the outperformance sharing on route renewals, the clauses in the Concession Agreement have never been used; HS1 have never claimed any out-performance payments to date.

One of the major issues that has stopped the incentive being used is that we have not been able to agree with the ORR what outperformance and underperformance actually is and what the correct approach is.

The cost of the renewals portfolio that is determined in the 5-year settlement is based on renewal prices that are typically at gate 1 and include a high contingency cost. Using a project by project base line to measure outperformance does not seem appropriate as the costs vary at project level almost as soon as work commences. That may be the heart of the issue that the performance mechanism was intended to be with regards to portfolio performance and yet we are trying to measure it at project level.

Following the ORR recommendation on trialling new ways of contracting we have explored NEC Option C target cost contracting. This approach was used for the Galley Hill Earth Works project where the outperformance of £62 k was shared with the contractor and the escrow account. NRHS did not receive any payment. HS1 did not bother to claim our £9k and the £9k out-performance share was simply left in the escrow account to the benefit of the TOCs. Given that the majority of renewals projects are very simple in scope it is hard to see how target cost contracts on a project-by-project level will create significant savings, but we do recognise that they are one mechanism that could be used to deliver an overall portfolio saving.

The current outperformance mechanism is ineffective in that the organisation letting the contract for the works is usually NRHS (or HS1 in the case of the Station Communication System Renewals) and they receive none of the gain yet is the organisation most likely to influence whether the contract is successful or not.

Under the current incentive arrangement in the CA, if the contract is delivered well, the benefit goes to the train operators and HS1. NRHS are not rewarded. If NRHS exceed the fixed cost agreed at gate 4 due to poor project management, they carry the risk and indeed have lost money in CP2 where the DfT have refused to make payment when additional costs have been claimed. The current arrangements do not incentivise those most able to make savings to do so and if anything, are likely to build in hidden costs to counter the risk of non-payment due to poor performance.

The train operators actually hold very little risk, while NRHS are the most exposed.

The current approach does not incentivise those most able to create savings.

The ORR should also consider the emerging thinking on the delivery integrator model that is currently being developed by HS1 and NRHS and how incentivisation would be managed in the contractual arrangements between HS1, NRHS and the Delivery Integrator.

The concept of the "fixed price" in the Concession Agreement does not reflect the fact that change will happen so we welcome the fact that the ORR has agreed with HS1 a change process that we have used successfully in CP2 and CP3. This does help protect NRHS and HS1 when change occurs for reasons outside of our control.

We would welcome the opportunity to discuss with the ORR how incentives might be better aligned. If any proposals required changes to the Concession Agreement, then DfT would need to be involved.

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

A key CP3 commitment for HS1 was to undertake a review of the current Structure of Charges. We concluded the review in August 2022 after several iterations of stakeholder engagement. The review concluded that the current structure of charges was largely appropriate, and no material opportunities to incentivise efficiency or growth within the regulated framework were identified. HS1 did raise the structural challenge of the current renewals annuity calculation within this review as noted in Section 5 above.

The SoC review did identify some changes to inputs and the charges modelling (as outline by the ORR) – we are taking forward these proposed changes as part of the PR24 process and will be subject to further stakeholder consultation. One of these is to consider if there is a better way to model wear and tear from different rolling stock from the current EMPTGA calculation. Research is currently being undertaken and as findings emerge we will take this into consideration for consultation with stakeholders.

In paragraph 3.50, ORR notes the allocation of renewals annuity between charges for direct and indirect costs is an especially important issue. Under HS1's current approach for allocation between direct and non-direct costs, there are ten renewals cost categories: Track – wear related; Track – non wear related; Civils – track related; Civils – bridgeworks; Civil – other; E&P – OLE – wear related; E&P OLE – non wear related; E&P – other M&E assets; E&P – rail plant; SC&C. For PR19 we reviewed the costs and data to determine how they should be allocated. This resulted in Track – wear related and E&P OLE – wear related being allocated to direct costs. For PR24 we will review these cost allocations again and present these to stakeholders, noting that any changes to this allocation must be driven by data and evidence.

HS1 has also worked with NRHS to challenge how renewals and ongoing maintenance costs have been impacted by reduced volumes during the height of the pandemic. As we set out in our Structure of Charges Review, the fall in traffic volumes over that period did not fundamentally alter the track renewal profile for CP3 as the majority of renewals are not traffic dependent. Maintenance was also not materially altered as HS1 is required to maintain the HS1 asset to high standards to operate the asset safely and in lien with our Concession obligations. We note that operators are not charged for OMRCA1 direct costs on any trains that are not run unless they had firm rights (ie in the FWT).

In paragraph 3.52, ORR notes in our Structure of Charges Review we did not propose any changes to the split between different types of operators at this time. We will of course review these are part of setting PR24 charges as we noted in SoC conclusions.

We note that freight charges are structured to provide as much support as possible in line with regulations. Any changes to this is likely to have a negative impact on freight.

11. Other comments on consultation

<u>Treatment of ERTMS</u>

The treatment of ERTMS was another structural challenge HS1 has raised through CP3 and early in this PR24 process. HS1 considers ERTMS meets the definition of a renewal as it is a modern day equivalent replacement. Treating ERTMS as a Specified Upgrade is the most expensive funding approach for TOCs as they must also cover financing cost, which are significant for such a large project – based on project cost estimates it could add a 5% increase in charges for TOCs relative to the CP3 exit OMRC charge. HS1 has explored other funding options such as Government Funding or using escrow balances (which is a more efficient use of funds) but to date we have been told these are not available. We would welcome the opportunity to explore with ORR and DfT a potential alternative approach to the treatment of ERTMS where the ERTMS costs might be allocated across a Renewal component and Specified Upgrade component – similar to the treatment of GSMR.

Performance Regime

HS1 and NRHS are reviewing the incentive framework under the Performance Regime. We do not think the current regime drives the right incentives to minimise disruption and improve performance. This is because the current tolerances under the regime are largely skewed towards compensation for underperformance, providing little incentive for delay recovery. One of NRHS's PR24 sprint initiatives is looking at how it could incentivise swifter operational recovery linked to contingency plans, placing risk where it is best managed or incentivised to manage for the HS1 system. We are exploring this further with NRHS and will engage with operators and the ORR on how this could be taken forward.

Thameslink and Ripple Lane

Paragraph 1.3 the ORR mentions that Thameslink uses London St Pancras station. While Govia Thames Railway (GTR) passengers access the station via the Thameslink box, GTR is not included in the allocation HS1 station access charges. HS1 committed in CP3 to look at the treatment of GTR in our station access charges, which we did as part of the Structure of Charges Review. Through this process the DfT concluded that these costs should not be allocated to GTR.

The ORR's Approach Consultation does not reference how it will approach the treatment of Ripple Lane sidings. HS1 also committed in CP3 to work with NRIL and DfT to consider the transfer of Ripple Lane to NRIL, which HS1 supported. HS1 explored this with DfT, however the DfT decided that it would not transfer Ripple Lane to NRIL.

HS1 is of view we fully delivered on requirements set in CP3 to take these two issues forward. We ask that the ORR clarify both these issues its final Approach document.

Network Rail High Speed Ltd.

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4th November 2022

Sent by email: [redacted]

Dear Debbie,

Network Rail (High Speed) Ltd Response to the ORR PR24 Initial Consultation

1. Network Rail (High Speed) Ltd (NR (HS)) welcomes the opportunity to comment on the ORR's PR24 Initial Consultation document issued on 30th September 2022. The regulatory review process is important for NR (HS) and its client, HS1 Ltd, so this consultation is a key milestone in the Periodic Review process.

2. NR (HS) together with HS1 Ltd are taking a different approach to PR24 when compared to PR19. This is in recognition of the wider industry and macroeconomic challenges brought on by the pandemic. The programme for PR24 commenced earlier this year with a HS1 System meeting taking place in May 2022, followed by a number of stakeholder bi-lateral sessions and a stakeholder workshop in July 2022. This facilitated the launch of a Sprint with the aim to provide stakeholders an indication of likely CP4 costs through the creation of a top-down cost range much earlier in the process. At the stakeholder workshop in July, HS1 Ltd also presented its Strategic Asset Management Plan (SAMP) which contained four scenarios for train volumes in a post-pandemic future: Growth; Rebuild; Restructure; Rethink.

3. During the Summer of 2022, NR (HS) assessed its business against the four HS1 Ltd SAMP scenarios to understand how it would operate and maintain the HS1 infrastructure differently, considering the opportunities and risks associated with each. In parallel, NR (HS) also developed business cases for a number of initiatives that could generate efficiencies. Following both exercises, NR (HS) was able to present at the most recent stakeholder workshop in October the results of the assessment, which identified Rebuild as the optimum scenario that would meet all objectives such as asset stewardship obligations and stakeholder requirements of a 7-day railway and maintaining performance. This scenario would be underpinned by a target top-down 7.5 % O&M cost efficiency on the CP3 exit position, with a further 2.5 % efficiency potential, subject to some structural changes which could be implemented in collaboration with stakeholders. NR (HS) is really pleased to have met the challenge set by HS1 Ltd and be able to provide this target top-down cost reduction to stakeholders. This top-down range will now go through a period of bottom-up validation and assurance during 2023 as NR (HS) prepares and submits its 5 Year Asset Management Statement (5YAMS) to HS1 Ltd. NR (HS) together with HS1 Ltd will also look at ensuring the renewals portfolio for CP4 and the 40-year renewal volumes is efficient; this will be delivered through the CP4+ Delivery Integrator workstream, which takes forward the renewals deliverability study carried out by Bechtel during PR19.

4. It is important to set out the risks and consequences associated with the other HS1 Ltd SAMP scenarios, to explain how Rebuild was put forward as the optimum scenario. Whilst Restructure and Rethink provide a lower O&M cost, not all savings can be considered as efficiencies without altering the risk horizon in the future. The cost savings identified for Restructure and Rethink were typically related to cost avoidance. Whilst these may lead to a CP4 cost reduction, it would introduce a significant risk to the longer-term performance of the system and achievement of HS1 Ltd Asset Management Objectives. Reducing O&M to the levels stated in Restructure and Rethink would create long-term negative consequences in asset stewardship, contractual obligations, performance, capacity, and capability which would require significant future investment to regain. The Restructure and Rethink scenarios would require a fundamental shift in the HS1 asset management approach and would require changes to the requirements set by the HS1 Concession Agreement and subsequent requirements contained in the NR (HS) Operator Agreement for asset stewardship.

5. At the stakeholder workshop in October NR (HS) presented a number of other structural initiatives, that if implemented could deliver further cost savings for operators. (1) the '5+5 YAMS' initiative proposes to remove the boundary of funding in 5-year periods and extending this further, to generate savings through greater supplier investment and unit cost savings by committing to buying services over a longer horizon in addition to internal planning and delivery efficiencies. (2) the 'Renewals to Maintenance' initiative is seeking to re-categorise elements of the renewals work bank as maintenance activities based on a more appropriate criteria and definition. This would reduce additional costs associated with the treatment of renewals (e.g. risk and PMO costs) and create greater planning and delivery certainty through the existing maintenance regime. (3) the 'Rapid Response' initiative would optimise the response resource (subject to Trade Union consultation) through investment in Remote Condition Monitoring. This would provide live asset condition knowledge at key sites and predictive maintenance capability. (4) the 'Performance Regime' initiative reviews the incentivisation associated with operational recovery from incidents linked to contingency plans, placing risk where it is best managed or incentivised to manage for the HS1 system. This particular initiative is explained further in our response to question 11 contained in the Annex below.

6. In facing the real risk of a managed decline in train paths and asset utilisation, addressing these and HS1's proposed structural challenges are necessary to make a real impact on affordability and support train volume recovery for the HS1 system; NR (HS) will work with the ORR and wider stakeholders to progress these structural changes through the PR24 process.

7. As the next stage of the process commences, NR (HS) together with HS1 Ltd has been developing an assurance plan for PR24 that spans the 5YAMS and underpinning strategies. It will consider areas it can improve from PR19 and seek guidance and best practice from Network Rail Infrastructure Limited (NRIL) as CP7 plans are developed for PR23. NR (HS) would like to agree this assurance plan with the ORR, to ensure it meets the requirements and it can demonstrate progressive assurance in readiness for receiving the 5YAMS submission from NR (HS) and HS1 Ltd.

Overall Comments

8. In reviewing the ORR PR24 Initial Consultation document, NR (HS) has a number of comments which are outlined in the following points.

9. The ORR has noted in section 2.4 that it has taken over responsibility from the DfT for the stations periodic review process in July 2022. This is really positive and will create alignment across the periodic review process for the benefit of stakeholder across the HS1 system. In the lead up to the transfer from DfT to ORR, NR (HS) has been working with HS1 Ltd in parallel to transfer responsibility for stations asset management from HS1 Ltd to NR (HS). This will provide a common approach for both route and stations, ensuring that best practice from both areas is shared between the two teams, in order to generate the PR24 submission for stations. To inform the work NR (HS) is doing for stations, the ORR are requested to provide more detail and clarity on its approach for stations as soon as possible as this isn't clear from the consultation document.

10. It is important that the ORR has recognised the wider industry challenges brought on by the Covid-19 pandemic, which started at the beginning of CP3. This was also a topic of discussion at the recent stakeholder workshop in October 2022, whereby the ORR requested operators to advise of the cost pressures being facing and to the extent the HS1 system should consider altering its AMO's to support these pressures. NR (HS) would appreciate the ORR progressing this matter, so it can be considered as plans are developed over the coming months.

11. NR (HS) welcome the positive statement from the ORR in section 3.1 that through its engagement with NR (HS) to carry out inspections and supervision activities, it has no immediate concerns in relation to health and safety of the HS1 network. NR (HS) look forward to continued engagement with the ORR in this area.

12. With reference to section 3.3 - 3.9 (Asset Stewardship and life cycle purposes), NR (HS) would like to remind the ORR that NR (HS) is required to produce a 5YAMS, asset management strategies and a 40-year renewals volume plan and submit these to HS1 Ltd for route and stations. In turn, HS1 Ltd will produce an overarching 5YAMS and submit this to the ORR and stakeholders. This is an important element of our contractual arrangement with HS1 Ltd, as any approval or determination made by the ORR through the periodic review process is applied to NR (HS).

13. NR (HS) has provided responses to the specific questions set out in the ORR consultation document as an Annex below. NR (HS) look forward to working collaboratively with the ORR and wider stakeholders in the months to come. Should you have any immediate questions, please do not hesitate to contact me.

Yours sincerely,

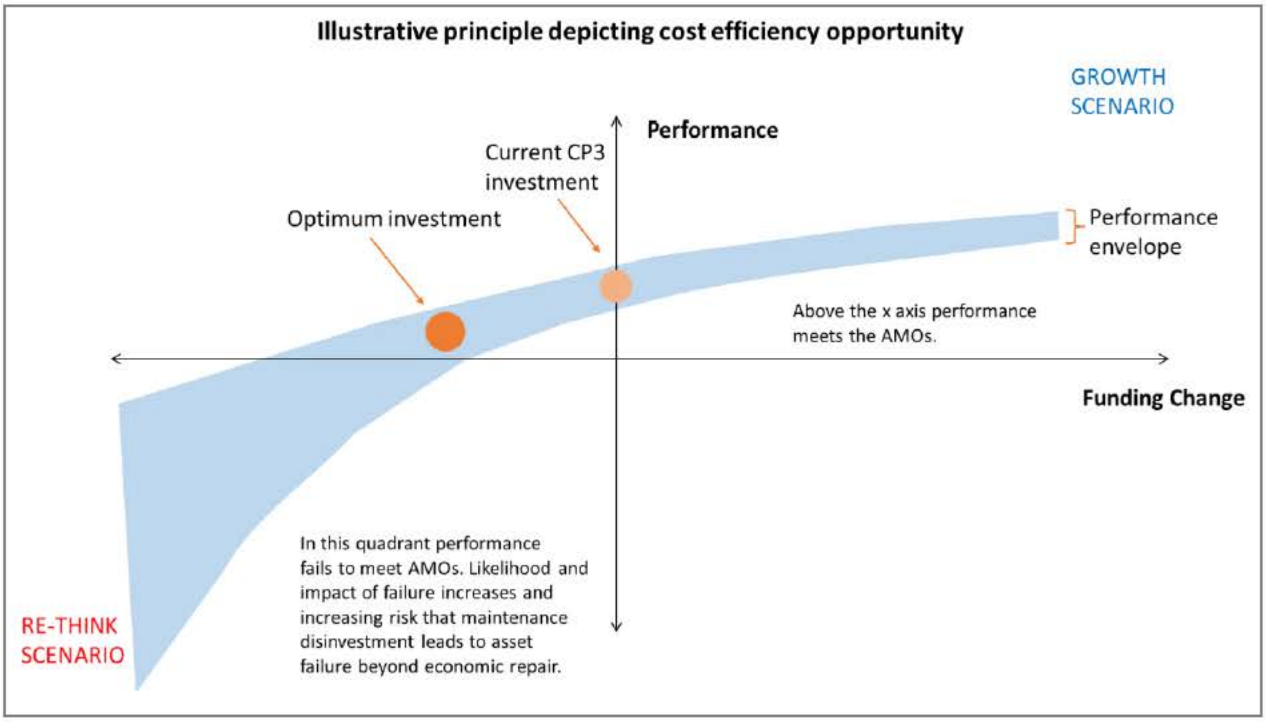
[redacted]

Chantelle Casula
Programme Lead – PR24
Network Rail (High Speed) Ltd

ANNEX – Responses to specific questions contained in the ORR PR24 Initial Consultation document

1. **Cost reduction: 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?**

As explained in point 3 of our main response above, NR (HS) has assessed the four scenarios contained within the HS1 Ltd SAMP to understand the opportunities and risks to operating and maintaining the HS1 infrastructure. The assessment considered stakeholder requirements gathered during the bi-laterals and workshops that have taken place so far. The graph below illustrates the trade off in costs and performance that informed this assessment. Given the current high performance of the asset, there are diminishing returns to increasing O&M costs to drive higher performance. Alternatively, reducing O&M costs too low will result in a rapid decline in performance that can have long term impact on asset condition and the associated costs to recover the condition. This extreme cost reduction also increases the risk profile, as represented by the light blue range in the bottom-left quadrant.



The output of the assessment identified that the Rebuild scenario would meet stakeholder requirements of a 7-day railway, addresses cost pressures by delivering efficiency savings, whilst still achieving the HS1 Ltd Asset Management Objectives (AMOs), enabling asset investment, innovation and continuous improvement to support future growth. This is represented by the optimum investment point in the above graph. The Restructure and Rethink scenarios could drive further cost reductions typically in the form of cost avoidance and not cost efficiency, but it does not deliver on a 7-day railway that stakeholders want, and NR (HS) and HS1 Ltd would not be able to meet the HS1 AMOs. These scenarios will also create long-term consequences for the HS1 system whereby asset stewardship and train performance declines, and a fundamental change will be required to the HS1 Concession

Agreement and the NR (HS) Operator Agreement. These scenarios would not drive future growth on the HS1 network as the HS1 system recover from the pandemic.

Working with HS1 Ltd, NR (HS) would welcome feedback from operators if there is an appetite to deviate from current or improved performance levels, or the Asset Management Objectives (AMOs) as set out by HS1 Ltd. However, the ORR must also take account of contractual obligations such as the minimum operating standards and the performance floor, as set out in both the NR (HS) Operator Agreement and HS1 Concession Agreement, and also the condition of the asset, in particular asset hand back condition at the end of the HS1 concession. Any decisions to deliver performance or conditions below these contractual obligations would require ORR and DfT agreement. This should also include a clearer understanding of the cost pressures faced by the operators, as discussed during the recent stakeholder workshop in October. This would need to be evidenced by the operators before further assessment could be made to amending the AMOs. If elements of this information are commercially sensitive, NR (HS) would welcome the ORR working with the operators to confirm and determine requirements.

In the context of balancing cost, risk and performance of assets on the HS1 infrastructure, it is important to set out the approach NR (HS) is taking in PR24 for whole lifecycle cost modelling. The ORR will recall that in PR19, whole lifecycle cost modelling and asset management decision making functionality was provided by the HS1 Ltd Asset Decision Support Tool (ADST). The level of understanding of asset lifecycle behaviour and, in particular, the heavy maintenance, refurbishment and renewal interventions that can be applied to different asset classes has increased since PR19. In developing the 40-year renewals work bank for PR24, NR (HS) will model asset deterioration and intervention requirements with different intervention levels set for each SAMP scenario to understand impact against the HS1 Ltd AMOs, which will be documented within the NR (HS) Specific Asset Strategies (SASs). The NR (HS) SASs will also demonstrate, through the response to the SAMP scenario options, how the AMOs, performance regime and asset stewardship obligations will be delivered.

2. **Cost efficiency and benchmarking: Do you have any comments or suggestions on how cost efficiency is assessed, including on our proposed approach to benchmarking?**

At the start of CP3, NR (HS) agreed with HS1 Ltd and the ORR a framework for reporting efficiencies. For route O&M, a high-level quarterly update is provided to HS1 Ltd against the NR (HS) 5YAMS committed efficiencies, and an annual fishbone is submitted directly to the ORR that provides a greater level of analysis linked to the outturn position each financial year. Given the commercial sensitivities with providing granular detail to HS1 Ltd, ORR provide assurance of the NR (HS) financial information on behalf of HS1 Ltd. For route renewals, project outturn costs are reported quarterly to HS1 Ltd including reasons for any variations, with an annual summary provided in the NR (HS) Asset Management Annual Statement (AMAS) to HS1 Ltd which is used for onward reporting to the ORR. At present there isn't a clear framework for stations, so NR (HS) would welcome the ORR setting out a framework for assessing efficiencies for stations renewals, but in doing so should consider the impact of additional time and resources required in implementing and delivering a new framework.

HS1 Ltd has commissioned an independent consultancy to carry out benchmarking for route and stations for PR24. The route exercise is underway and builds on benchmarking undertaken during previous periodic reviews. NR (HS) has welcomed the opportunity to have greater engagement in the benchmarking process, to ensure it provides a true representation of the cost drivers within the HS1 system and offer greater insights into comparator Infrastructure Manager's (IM) costs and approach. However, it should be noted that comparisons need to be meaningful, accounting for the differences in networks of other comparator IMs to ensure a fair, like-for-like comparison is derived. For example, the funding structure could vary between IMs providing different levels of ability to negotiate efficiency through economies of scale. To understand this further, the benchmarking exercise will also cover the structural initiatives to test and underpin the business cases. Working with HS1 Ltd, NR (HS) looks forward to gaining real value from the case studies to be explored with comparators and establishing relationships with other infrastructure managers to further learn and share best practice in the years to come.

The scope of the stations exercise is being finalised by HS1 Ltd and will look at unit costs for key assets (e.g. lifts and escalators) for a comparison with EU stations, NRIL stations and similar infrastructure managers such as airports. It is worth noting that whilst stations O&M is out of scope for the ORR's Periodic Review process, NR (HS) has also consistently generated additional savings for the operators through the best estimate process and passed this onto operators through the associated outperformance mechanism in 2021/22.

HS1 Ltd together with the benchmarking consultants have met with the ORR to explain the approach being taken for PR24 for route and stations; should the ORR have any comments or concerns with the approach it should raise this with HS1 Ltd as soon as possible so it can be factored into the engagement that has commenced.

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

NR (HS) agrees with the ORR that risks should be borne by those best placed to efficiently manage them; this was also a recommendation from the PR19 benchmarking exercise which HS1 Ltd are progressing. NR (HS) is keen to support discussions of system risk management with wider stakeholders to ensure its plans continue to manage risks that are within its control. This will be key in driving the right asset management decisions to support the sustainability of the network. A better understanding, management and mitigation of known and unknown system risks would benefit all entities of the HS1 system.

With reference to section 3.21 of the consultation document, NR (HS) has considered the risk landscape when determining O&M cost risk for CP3 during the PR19 process. The outputs of both the risk factors and quantification of the O&M risk was made available to the ORR during PR19, and a breakdown of risk spend is provided to the ORR at the end of each financial year. Any remaining risk cost provision forms part of the outperformance mechanism with HS1 Ltd and operators in the last three years of each control period. To drive value in the process for PR24, one of the NR (HS) structural initiatives is a review of the Performance Regime to incentivise swifter operational recovery linked to contingency plans, placing risk where it is best managed or with the party incentivised to manage for the HS1 system.

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

The overall approach to risk and uncertainty for the HS1 system is set by the HS1 Concession Agreement. NR (HS) has a fixed price contract with HS1 Ltd which is indexed-linked, whereby inflation risk is passed onto HS1 Ltd and onwards to the operators. Forecast demand and external cost pressure factors do have an impact on HS1 Ltd and NR (HS). To support the HS1 system and reduce further cost burden on HS1 Ltd and operators, NR (HS) absorbed additional costs resulting from the Covid-19 pandemic as 'goodwill', whilst continuing to deliver on its committed efficiencies for CP3.

5. Escrow accounts: 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?

For renewals NR (HS) are, in the majority, the entity that delivers the renewals projects on HS1, however there is no incentive to outperform in this space under the outperformance mechanism in the HS1 Concession Agreement. The outperformance mechanism only exists between HS1 Ltd and operators. If NR (HS) underperforms it has to recover cost from its own profit, but there is currently no corresponding financial upside to NR (HS) outperforming renewals delivery, other than reputation and customer satisfaction. NR (HS) would welcome a review of the outperformance mechanism for renewals to better incentivise the business, that is linked to a portfolio view to generate greater efficiencies in delivery of the renewals work bank rather than on a project-by-project basis.

It should also be noted that any changes to arrangements on how renewals are funded could have an impact on O&M. Therefore NR (HS) may need to make provisions if changes are agreed or implemented post-submission of the NR (HS) 5YAMS to HS1 Ltd in 2023.

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

This question is similar to question 2, so our response above provides our views on assessing efficiencies.

As recognised in section 3.34 of the consultation document, NR (HS) has delivered on its O&M committed efficiencies in the first two years of CP3. It has also committed to additional O&M outperformance plans of circa £2.1m for the remainder of CP3, in response to the economic challenge faced by the operators. This is significant for NR (HS), both in terms of the plans it has shared at the October stakeholder workshop, but also delivering this additional efficiency on what is already a post-efficient CP3 of circa net £8.4m. However it is important to recognise the most challenging years of the efficiency delivery are in the last years of the control period which have yet to commence. This includes an additional efficiency to be delivered jointly with HS1 Ltd in the final year of CP3.

The ORR notes in section 3.34 the HS1 Ltd R&D programme to drive long-term efficiencies. Since PR19, a governance process has been implemented that includes representation from NR (HS), HS1 Ltd, train operators and UKPNS to monitor spend and track benefits. NR (HS) has supported and delivered a number of schemes already in CP3, including a Tunnel Vision initiative demonstrating the use of AI and Machine Learning analysis of video and laser scans to assess tunnel asset condition, significantly reducing the need for manual inspection. To support the delivery of additional outperformance plans as noted above, NR (HS) has self-funded a R&D project from its existing O&M cost base to implement hardware from a system supplier (Cordel) to capture imagery and Lidar data from planned MPV recording runs using modern cost effective and miniaturised sensors, automate large volumes of data processing using Machine Learning and deliver intelligent and actionable inspection results. This will enable NR (HS) to automate inspections and surveys of multi-disciplinary assets automatically across the entire HS1 network in near real-time. These are two great examples of R&D schemes that will deliver efficiencies for stakeholders across the HS1 system. For PR24, NR (HS) will align any R&D schemes to support OMR efficiencies where investment may be required, whilst also looking across to NRIL for wider opportunities that could be trialled on HS1.

With reference to section 3.36 and 3.37 of the consultation, HS1 Ltd published its Asset Information Strategy (AIS) in November 2020 and shared this with stakeholders. NR (HS) intends to publish an aligned AIS prior to the 5YAMS submission, in which objectives and timelines will be provided, however these will have some variance to the timelines published in the HS1 Ltd AIS. Since PR19, NR (HS) has more asset information and knowledge available to aid asset management planning. Additionally, a number of data related workstreams are moving from R&D to BAU over CP3 which will result in significant data maturity improvements. ORR's review of renewals volumes and cost should be proportionate and form an element of the progressive assurance plan that NR (HS) together with HS1 Ltd is preparing and would like to agree with the ORR, as explained at the beginning of this response letter.

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

NR (HS) welcomes ORR's acknowledgement that O&M costs are indexed by RPI through its Operator Agreement contract with HS1 Ltd, and therefore it is only considering the approach for indexing renewals costs. When considering the appropriate inflation index for renewals, it would be useful for the ORR to also consider the indexation used by operators to fund the renewals annuity, to ensure a consistent inflation index is used for all costs throughout the HS1 system where all other costs are index-linked to RPI. The ORR should also consider the difficulties and impact of changing the indexation for charges, as experienced by NRIL which changed from RPI to CPI for Control Period 6. NR (HS) would ask the ORR to engage with both NR (HS) and HS1 Ltd as it considers this matter.

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

No comments.

9. **Outperformance sharing: 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?**

As referenced in the response to question 6, NR (HS) has outperformed its O&M committed efficiencies in the first two years of CP3, and also committed to additional O&M outperformance plans of circa £2.1m for the remainder of CP3, in response to the economic challenge faced by the operators. Whilst stations O&M is out of scope for the ORR's Periodic Review process, it is worth highlighting that NR (HS) has also consistently generated additional savings for the operators through the best estimate process and passed this onto operators through the associated outperformance mechanism in 2021/22.

As explained in response to question 5, for renewals NR (HS) are, in the majority, the entity that delivers the renewals projects on HS1, however there is no incentive to outperform in this space under the outperformance mechanism in the HS1 Concession Agreement. If NR (HS) underperforms it has to recover cost from its own profit, but there is currently no corresponding financial upside to NR (HS) outperforming renewals delivery, other than reputation and customer satisfaction. NR (HS) would welcome a review of the outperformance mechanism for renewals to better incentivise the business, that is linked to a portfolio view of the renewals work bank rather than on a project-by-project basis.

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

NR (HS) has supported and provided input to the HS1 Ltd Structure of Charges review, by assessing the direct and indirect split of its O&M costs as set out by NR (HS) and approved by the ORR for CP3; the outputs of which are contained in the phase 3 consultation document issued by HS1 Ltd in November 2021. As the costs emerge for CP4 over the coming months, NR (HS) will further assess the direct and indirect split in preparation for the 5YAMS submission.

11. Other comments

Performance Regime

NR (HS) is keen to support with review of the performance regime as ultimately it is responsible for the majority of HS1 Ltd.'s obligations in this regard. As referenced in the response to question 3, one of the NR (HS) structural initiatives is a review of the Performance Regime to incentivise swifter operational recovery linked to contingency plans, placing risk where it is best managed, or parties are incentivised to manage for the HS1 system. For this initiative to be effective, NR (HS) needs operators to create, model and maintain operational contingency plans to manage the train service during times of perturbation. Risk should then sit with operators following the deployment of their continency plans during an incident, with NR (HS) responsible for infrastructure failures up to the point that continency plans are implemented. NR (HS) is looking to work with stakeholders for PR24 to take this initiative forward and incentivise all parties to improve and recover from performance delays to benefits passengers and customers. This may require changes to contractual agreements (e.g. Passenger Access Terms) to implement this initiative.

southeastern

Susan Ellis
Track Access & HS1 Contracts Manager
SE Trains Limited

Debbie Daniels
Delivery Manager, Capital Investment Team
Office of Rail & Road

11th November 2022

ORR Initial Consultation on PR24

Dear Debbie

Thank you for the opportunity to review the Initial Consultation for PR24.

Please find below our feedback to the specified questions.

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?

HS services are the highest yield for Southeastern and carry the highest fares. Our requirements are for the absolute safety of our passengers and for journey times to be maintained. On top of this, Southeastern need significantly lower charges. Southeastern consider that the emphasis is on HS1 as the infrastructure owner to drive further efficiencies and optimise their maintenance operations whilst ensuring a consistent asset performance and level of safety that can be relied upon.

No Southeastern passenger journeys start or end solely on the Highspeed network. Journey quality for our passengers is a priority. We are facing significant speed restrictions on the domestic network which result in services having clocked delays before they reach HS track. Southeastern urge the ORR to consider their regulation of the overall passenger experience in their review as currently journey quality for our passengers travelling from North Kent or Ashford onto HS is reduced due to poor punctuality. The below demonstrates the scale of delays that migrate onto HS from the NR network.

- Of all the incidents that caused delays to HS services, only 6% of those incidents originated on HS1 infrastructure
- Similarly to incidents, just 10% of reactionary delay to HS services originated on HS1 infrastructure
- Current levels of HS delay are 28% higher than the five-year baseline, with the incident locations having the greatest impact being at Ramsgate, Ashford and between Faversham and Margate
- Over the last 4 years, we saw 35% of HS reactionary delays originating on the Mainline North infrastructure, 29% on Mainline South, and 26% on Metro or external, with 10% originating on HS1 infrastructure.

- Mainline North impact on HS is currently very high due to a number of speed restrictions between Sittingbourne and Ramsgate and some large incidents north of Ashford of which earth slip and trespass are the largest components - (c.5,000 of 8,000 HS minutes in P8 originated in Mainline North area - 109% above baseline).

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

The HS network can no longer be classed a new railway. After more than 13 years of operations, we consider that HS1 should know the condition of their assets inside out. The continued use of benchmarking is only useful if the outputs are to drive asset efficiency and to drive down costs. Southeastern do not support the use of external parties carrying out multiple benchmarking exercises at operator's expense. Put simply, Southeastern consider that HS1 should have sufficient in-house knowledge of their assets to deliver year on year improvement and cost efficiencies without the need for the use of external consultants. We urge the ORR to consider if the outputs they are seeking cannot be sufficiently provided by HS1.

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

The financial framework holds little incentives for efficiencies due the nature of the pass-through cost arrangements that applies to most elements of HS1 charges. The ORR state that risks should be borne by those best placed to efficiently manage them. Events in recent years have led to unprecedented changes to travelling behaviours of the public. Whilst the risk profile and costs associated have been well established in past Periodic Reviews, they are based on a vastly different railway and now is the time to readdress this as it is making the railway unaffordable.

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

As per above, we are experiencing unprecedented changes in travel demand which leaves the industry in a state of uncertainty. The HS1 System has attempted to look at ways of making the operation of trains on the network more affordable for operators and its is disappointing that despite large scale efforts from all parties, we have yet to see any successful changes.

This rigid approach to current levels of uncertainty has led to Southeastern reducing their December 22 timetable by approximately 4% (see below table of removed services) and there remains a significant risk that a further reduction will be required for May 23.

1528 FAV-STP
1628 FAV-STP
1728 FAV -STP
1816 MDW - STP
1828 FAV-STP
0648 STP -MDW
0855 STP -FAV

Let's talk

1650 STP – MAR via CBW
1955 STP -FAV

Risk from high inflation levels is passed through to operators and adds a further burden to the HS1 cost base on Southeastern's books. The increase in overall HS costs this year (£21.7m for FY22/23 - figure includes the Aug 22 and forecast Feb 23 indexation impact on IRC)) and those forecast for next (not yet finalised- part of our ongoing Annual Business Plan) continue to make current service levels unachievable. Whilst we appreciate the contractual mechanisms allow for inflationary increases, Southeastern seek confirmation that HS1 or its investors are not in the position to profit from an increase that they had never expected to see in their financial forecasts. HS1 should be able to demonstrate that their costs have increased by the levels of the charges they intend to levy on operators for the coming years and the next Control Period and that the economic architecture of HS1 does not allow for profit in a period of low use when Southeastern strongly feel that the contractual mechanism means that we are having to overpay. We urge a review of the approach to the risks set out in the Concession Agreement.

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 renewal annuity on operators?

The current approach to the renewal annuity is the most expensive for operators and the recent reluctance to deviate from this approach has led to Southeastern taking the difficult decision to reduce its service levels on the HS network. The renewals annuity remains a key issue for PR24 and therefore it is disappointing once again to see that the 40 year fully funded approach is the only approach being considered for Control Period 4. The Concession Agreement was drafted in vastly different times and Southeastern do not feel that the interpretation of the 40-year funding cycle or the domestic underpin are driving the right behaviours for the here and now. The underpin is literally resulting in the payment of something for nothing and all the time the commercial operation is protected we are unlikely to see any kind of reform to address the economic impact of what has happened in the last few years.

We note that the ORR have stated there is a degree of flexibility in how the annuity is recovered however we are naturally reluctant to undertake any further work to assess the relationship between HS1 charges and train volumes without the ORR clearly setting out the parameters it is willing to explore.

For example, for Southeastern to offset inflation and meet treasury targets we could either consider cutting approx. 50% of our classic services or just. 15% of our highspeed services. To further highlight the significant cost of HS1 compared to our classic services, if we consider the 'revenue less the cost of access and EC4T' metric, Southeastern is forecast to earn an approx. £430k *positive contribution* on its £660 forecast revenue from classic services in 23/24, but to produce a *loss* of approx £70m on its forecast highspeed £200m revenue This demonstrates the vast disparity in charges between the two areas of our business. This is not sustainable. HS1 cost per mile is 29 times higher than conventional railway. It has to be within the gift of the HS1 System to unlock this issue with the ORR leading to protect the integrity and value of the system.

Can the ORR please clarify the levels of likely underfunding to CP3 following the pandemic and the impact this may have on CP4?

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

Southeastern consider that reporting in this area could be increased. It would be useful to have a plan on proposed efficiencies in advance and have the ORR hold HS1 to account in such a way that the operators can easily monitor if HS1 are delivering sufficiently to plan. This should heavily feature stations as we have experienced a large number of performance issues in recent months that need to be a key focus going forward as they have a detrimental impact on our customers experience of HS.

For example, recent overhaul of escalators has been extremely lengthy which does not appear efficient. Transparency on this would allow for a greater understanding of the process itself and may present the opportunity to share best practice.

Another aspect we would be keen for HS1 to consider is the potential of efficiencies between other infrastructure owners (NR). For example, do NRHS have their own tamper machine? If so, this could be utilised on the domestic network to ease issues that may be causing delays to services before they enter the HS network.

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

In terms of inflation, Southeastern would ideally like to see the cost risk being borne by those best placed to manage it. In addition to that, the inflation index that best marries up with the underlying cost element should be applied to that cost element.

Southeastern began shifting away from RPI in contracts in 2020 following the ONS advice. The DfT has also recently given guidance that their latest Policy on all TOC contracts are that CPI should apply where that is possible. This would align with the ORR's use of CPI for Network Rail.

In summary, the various elements of the charges should have the most appropriate index applied to them so as to mirror the cost base, and for maintenance/renewals works undertaken by NR HS we do not consider this to be RPI. CPI would align with other NR Track access arrangements.

In summary, the various elements of the charges should have the most appropriate index applied so as to mirror the cost base and for maintenance/renewals works undertaken by NR HS we do not consider this to be RPI. CPI would align with other NR Track access arrangements. Ideally a blend of indices (maintenance/wages/etc) would seem best but that is more and possibly overly complex.

Whichever method is applied for inflation, Southeastern believe that a cap/upper limit should be applied to prevent any form of profiteering. All parties are suffering because inflation is at a level we have not seen in a generation and those costs are just flowing through to the indexation clauses in the contract and on to the operators. Consideration should be given to producing a demonstration of the actual costs incurred by HS1 versus the costs recovered from operators.

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

Southeastern are not party to the framework set out in the Concession Agreement however understand that it is restrictive and can limit HS1's ability to maximise the returns on the monies within the escrow accounts. It is our understanding that a change is needed to the Concession Agreement to allow for the use of other investment types and uses. Southeastern support this as it is sensible to maximise the returns on this large sum of money as opposed to having it sit idly in escrow where its value is being rapidly eroded through the combination of generational high inflation levels and low interest rates.

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?

Southeastern support the proposed review of the outperformance of the route escrow account as we recognise that in its current form there is no incentive on the party (NRHS) that is responsible for the delivery of the outputs. Southeastern would welcome a proposal to remove the performance regime on temporary (or permanent) basis if it resulted in a cost saving.

The majority of savings made on monies that have been input into the system by Southeastern should be returned as this money belongs to the taxpayer.

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

As per our response to the Structure of Charges Review, Southeastern would like to see more detail on the imperative and incentive on HS1 to reduce its OMR costs for their assets during their tenure following the financial targets imposed on operators, NR and the industry as a whole following the Spending Review.

Additional Comments

Southeastern support the review of incentives in relation to the Performance Regimes. Southeastern would be open to discuss the merits of these regimes and if they are working to incentivise in the right way as it is unclear if the regime in its current form is delivering what is expected.

Southeastern have been supportive of the ORR taking on the regulation of Stations for the HS network and are disappointed to see a lack of specific detail in relation to this area in the initial consultation. We hope that as the PR24 process continues that the necessary focus will be given to this key area especially as we are starting to see some asset failures that are having a detrimental impact on our customers satisfaction. Southeastern would like to see how the ORR intend to hold HS1 to account and ensure that the circa £19m per annum is being used to get high quality station provisions against the current situation of obsolete customer information screens, out of service escalators with lengthy refurbishments, single passenger lift at St Pancras and disused kiosks at Ebbsfleet.

We look forward to working with you as PR24 progresses.

Yours sincerely,

[redacted]

Susan Ellis
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Let's talk

se

Transport for London

Transport for London
Palestra
London
SE1 8NJ

11th November 2022

Dear Sir/Madam,

Periodic Review 24: Initial Consultation

Thanks for offering us the opportunity to comment on this matter. I can confirm that TfL is content for any part of its response to be made public. Our comments are provided below.

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?

We recognise the need to reduce charges to encourage use of HS1 by freight and passenger services. This has become more acute due to the impact of the Pandemic which has had a severe adverse impact on the financing of international passenger services, leading to their retrenchment with an exclusive focus on core routes and stations to the exclusion of others, including Stratford International. It is important that everything possible is done through the review to encourage better service provision, in terms of serves frequencies, journey opportunities offered and stations served to increase usage and maximise the economic benefits delivered by the services using the route as well as their financial performance.

Any compromise agreed in terms of asset performance needs to be planned carefully to ensure that it does not undermine confidence in the performance of the railway as this would detract from the usage and value of the service provided, compromising the objectives described above. Cost savings achieved from lower levels of asset performance need to be measured against the journey time disbenefits generated by any forecast worsenment of performance to ensure they offer good value. The focus should always be on maximising efficiency to reduce costs rather than just accepting worsening levels of performance as the only route to cost reduction.

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

We have no comment to make.

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

We have no comment to make.

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

Regarding forecast demand it would be best to review the extent to which demand has now recovered post pandemic on the international services and use this as the baseline for forecasting future demand. Additional demand generated by potential enhancements to services needs to be considered carefully as part of this process, given the retrenchment in previous service levels that has occurred since the pandemic struck.

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?

This needs to be considered in the context of keeping the charges levied affordable to the operators concerned, to ensure that the usage of the route can be increased as the economy continues its recovery from the Pandemic.

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

We have no comment to make.

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

Clearly it would be desirable to minimise the effect of inflation on charges going forward given the financial constraints facing operators on the route. Network Rail now generally use the CPI for their regulated costs rather than RPI which gives a lower rate of increase so it would appear sensible for HS1 Ltd to follow this approach to minimise future costs.

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

We have no comment to make.

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?

We have no comment to make.

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

We have no comment to make.

Yours sincerely,

Alan Smart,
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