

# **Executive summary from DAC Beachcroft's report on the contractual basis for cost allocation between Passenger Operators on HS1**

As part of our review of HS1 stations, we commissioned consultants with legal expertise in property contracts (DAC Beachcroft) to provide a summary of how costs are allocated. The full report contains commercially sensitive information so we are only publishing the Executive Summary (Section 3, Pages 6-9) of the report alongside the PR24 Draft Determination.

### 3. EXECUTIVE SUMMARY

#### Recovery of costs for maintaining, etc the Stations

- 3.1 HS1 Co is obliged under the HS1 Lease to keep the Stations in good and substantial repair and condition. HS1 Co can recover the majority of its renewal, repair and maintenance costs from the Passenger Operators through the operation of the SAC. Costs relating to maintenance and repair are calculated in accordance with the SAC and are recoverable as **Qualifying Expenditure**. Costs relating to lifecycle replacement and renewal at a Station are calculated in accordance with the HS1 Lease Schedule 10 and the SAC and are recoverable as the **Long Term Charges or LTC**.
- 3.2 The definition of what comprises the "Station" is also key and this differs for the calculations for Qualifying Expenditure and Long Term Charge. Station for the purposes of Qualifying Expenditure is defined in the SAC and by reference to Appendix 7 to Annex 1 of the SAC. Station for the purposes of Long Term Charge is defined in the HS1 Lease which refers out to the CA.
- 3.3 The documentation is complicated and it is not straightforward to determine what is to be included within the computations for Qualifying Expenditure and for Long Term Charges, the relevant definitions and contract terms for each of which are contained across a number of different documents but which ultimately need to be read together to arrive at the answer.

#### Calculation of the overall Qualifying Expenditure and Long Term Charge

- 3.4 Annex 2 of the relevant SAC for each Station sets out what qualifies as **Qualifying Expenditure** for that Station and also what is excluded from qualifying as Qualifying Expenditure. Items can be excluded from Qualifying Expenditure both because they are specifically excluded under Annex 2 or because they relate to an area which is not within the definition of Station.
- 3.5 What qualifies as Qualifying Expenditure includes all costs relating to the provision by HS1 Co of Common Station Amenities and Common Station Services to Passenger Operators, plus a contribution towards maintenance and repair of specified equipment and elements of the Station. Where a cost or expense to be incurred by HS1 Co relates to the whole of a Station area the definition of Qualifying Expenditure makes it clear that only the proportion as can be properly attributed to the provision of services for the carriage of passengers by rail can be charged to the Passenger Operators through the relevant SAA. Qualifying Expenditure does not include any costs incurred by HS1 Co for **Renewals** which are instead recoverable under the Long term Charge mechanism.
- 3.6 The **Long Term Charge** is a fixed charge levied by HS1 Co on the Passenger Operators and which is reviewed on a five yearly basis (or sooner in specified circumstances, including if and when there is a change in the number of Passenger Operators at a Station or there is a material change in the number of Vehicles a particular Passenger Operator operates).
- 3.7 Schedule 10 to the HS1 Lease sets out the process for the ORR agreeing with HS1 Co the new Long Term Charge each five years including which Station Assets are subject to the renewals and replacement programme and therefore will form part of the Long Term Charge. In each subsequent year of each five-year period the Long Term Charge is indexed. What comprises the Station is determined by a specific definition for each station (e.g. "London St Pancras Station") and these definitions are contained within the CA and are specific as to what is included and excluded from the definition of the relevant Station.

#### What is payable by each Passenger Operator?

- 3.8 Each SAA sets out the basis upon which HS1 Co charges the relevant Passenger Operator for its use of the relevant Station. Each SAA refers to the SAC which in turn provide further detail as to how the charges are to be calculated. The SAC and its 'Annex to the Station Access Conditions' for the relevant Station are fully incorporated into and form part of each SAA.
- 3.9 The charge for permission to use a Station that each Passenger Operator pays HS1 Co each Accounting Year is called the **Access Charge**. This is defined in each SAA as being the aggregate of (i) the **Common Charges** and (ii) the **Exclusive Charges**.
- 3.10 Exclusive Charges, and the Exclusive Station Services to which they relate, are specified in Schedule 2 of the relevant SAA. Out of the SAAs we have seen for the Passenger Operators it is only EIL which has any liability to pay **Exclusive Charges**, and these are for the provision of Exclusive Station Services at St Pancras, Ebbsfleet and Ashford Stations. .

### **CALCULATION OF THE COMMON CHARGES**

- 3.11 The overriding principles for the calculation of the Common Charges are common across the Passenger Operators and the Stations. Part 17 (Access Charging) of the SAC sets out in detail how the **Common Charges** are calculated – which in simple terms is comprised of each individual Passenger Operator's proportion of (i) the **Qualifying Expenditure** and (ii) the **Long Term Charge**.

#### **(i) Qualifying Expenditure**

- 3.12 The Qualifying Expenditure aspect of the Common Charges is made up of the **Fixed Charge** and the **Residual Variable Charge**.
- 3.13 Each Station is divided into Zones which are identified on the Station Plans forming part of the relevant SAC. These comprise the Common Zone (which are the communal areas used by all Passenger Operators) and the individual Zones attributed exclusively to the Passenger Operator(s) using that Zone.
- 3.14 The total Qualifying Expenditure is divided across these three Zones and the Common Zone by HS1 Co to give figures for Common Zone QX, International Zone QX, Domestic Southbound QX and Domestic Northbound QX for each Passenger Operator. The SAC provides that this should be by such allocation methods as are fair and equitable including by reference to relative size of each Zone and the level of services provided within each Zone. The SAC are not prescriptive as to how this allocation is undertaken.

#### **Fixed Charge**

- 3.15 A Passenger Operator can elect (but is not obliged) to pay for parts of the Qualifying Expenditure by way of an annual **Fixed Charge**. This is in relation to payments for the Common Station Amenities and Common Station Services (these are set out in the tables at Annex 1 of the SAC for each Station). If agreed by HS1 Co the Passenger Operator will pay a fixed charge for those chosen parts of the Qualifying Expenditure, and no further calculation or adjustment is required in relation to the provision of those amenities and services and these will not form part of the charges paid as part of the Residual Variable Charge.
- 3.16 We understand from HS1 Co that no Passenger Operator has ever exercised this right and therefore they have never had to calculate and agree such a Fixed Charge in practice.

#### **Residual Variable Charge**

- 3.17 The second element requires the Passenger Operator to pay a specified proportion of all other Qualifying Expenditure not being paid for by way of a Fixed Charge, and this is referred to as the **Residual Variable Charge**. The Residual Variable Charge is calculated by deducting any Fixed Charges from the **Total Variable Charge**. Therefore, if no Fixed Charge is being paid by a particular Passenger Operator then the Residual Variable Charge will equal the Total Variable Charge.
- 3.18 The **Total Variable Charge** for each Passenger Operator is calculated by taking the total Qualifying Expenditure attributed to a Zone (Common Zone QX, etc – see above) and multiplying that by a specified percentage for that Passenger Operator. Each Passenger Operator will pay for their own share of the individual Zone they use plus a proportion of the Common Zone QX. As there is currently only one Passenger Operator per individual Zone then each pays 100% of their individual Zone. The original specified percentages for the Common Zone QX and Domestic Northbound Zone QX, Domestic Southbound Zone QX and International Zone QX are set out at Schedule 1 to the individual SAAs, and those are then recalculated by HS1 Co on a yearly basis based on the proportion of Vehicles which a Passenger Operator runs when compared to the number of Vehicles using a Station as a whole in accordance with the SAC.

#### **(ii) Long Term Charge**

- 3.19 The Long Term Charge aspect of the Common Charges is divided between the Zones with the percentage attributable to each Zone being set out in the respective definitions of Common Zone LTC, Northbound Zone LTC, Southbound Zone LTC and International Zone LTC. These are contained within the SAC as fixed figures.
- 3.20 The amount payable by each Passenger Operator for each Zone is then determined in the following way:-
- 3.20.1 For the Common Zone, the Common Zone LTC is multiplied by the percentage set out in Schedule 1 of the SAA for that Passenger Operator; and
- 3.20.2 For the individual Zone relevant to the Passenger Operator (e.g. Northbound Zone LTC), the LTC applicable to that individual Zone is multiplied by the percentage set out in Schedule 1 of the SAA for that Passenger Operator.

These percentages may also be adjusted if events specified in Condition 100 of the SAC occur.

#### **Total Common Charges**

- 3.21 The total Common Charges payable by a Passenger Operator for a Station each year is then the aggregate of:
- 3.21.1 The Fixed Charges (if any); plus
- 3.21.2 The Residual Variable Charge; plus
- 3.21.3 The Passenger Operator's share of the Common Zone LTC; plus
- 3.21.4 The amount for the Passenger Operator's individual Zone LTC.

#### **Provision of information to Passenger Operators about Common Charges**

- 3.22 There is an obligation under Condition 90.2 of the SAC for HS1 Co to provide not later than 60 days prior to the start of each Accounting Year a notice setting out its "best estimate" of the Total Variable Charge (plus details about any Fixed Charges). Condition 90.3 requires that this notice contains a detailed breakdown of the Qualifying Expenditure together with full details of the methodology HS1 Co has used to attribute each "individual element" between the Zones. This is required to be done on a "fair and equitable basis" and should include details of specifications and other assumptions applied. Notwithstanding the Periodic Review and the ORR's role in this, there is no analogous "fair and equitable basis" provision for the calculating of or division of the Long Term Charge between Passenger Operators where the percentages to attribute the Long Term Charge between Zones are predetermined.
- 3.23 HS1 Co is also obliged under Condition 97 (Accounts) to keep accounts in such a way as to enable all material revenue and expenditure to be clearly distinguished and analysed by category or item in respect of the Common Station Services, Common Station Amenities, Exclusive Station Services and each Zone and to identify the contribution by any person towards the cost or expense of these.
- 3.24 We have prepared the following diagrammatic representation showing the method of calculating the payments to be made by a Passenger Operator to HS1 Co. This should be read in the context of the whole report and not as a standalone document.