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Dear Sirs,

Reasons document for the decision of the Office of Rail Regulation on an application from First ScotRail Limited under section 17 of the Railways Act 1993

Application

1. On 2 March 2006, First ScotRail Limited ("FSR") applied to the Office of Rail Regulation ("ORR") under section 17 of the Railways Act 1993 ("the Act"). In its application, it asked us to give directions to Glasgow Prestwick Airport Limited ("GPA") to enter into a station access contract in respect of Glasgow Prestwick International Airport Station where GPA is the station facility owner. The previous access agreement between GPA and FSR expired on 31 October 2005.

2. FSR made the application under section 17 of the Act because it could not reach agreement with GPA on that part of the station access charge relating to

- the capital cost of GPA meeting its obligations to continually renew the station to its "modern equivalent form"; or
- an appropriate return on capital for GPA.

Glasgow Prestwick International Airport Station

3. In this and the following section we set out the relevant background information on Glasgow Prestwick airport, the airport's railway station and the contractual arrangements between GPA and FSR, as we understand it from the representations we have received from the parties.

4. Glasgow Prestwick International Airport Station ("the Station") is the only independently-owned station in Scotland, i.e. it is not owned or operated by Network Rail or a franchised operator.

5. In 1991, the newly privatised British Airports Authority consolidated its portfolio of United Kingdom airports and in the following year sold Prestwick Airport to PIK Facilities Limited. The new owner decided to build a station on the adjacent Glasgow to Ayr railway line. As a result, the Station and a pedestrian overbridge linking the airport to the Station were constructed and opened for business in autumn 1994. The construction of the new station was funded with contributions from various public and private organisations¹, although there is uncertainty as to the exact sums involved (see paragraph 23 below).

6. In January 1998, Stagecoach Group acquired Prestwick Aviation Holdings, the ultimate parent company of PIK Facilities Limited. Stagecoach sold its holding in January 2001 to a consortium that included Infrastructure & Utilities NZ Limited, now Infratil Limited. In March 2004, Infratil Limited increased its holding to 100%. Infratil Limited remains the ultimate owner of the airport and station.

7. In September 1999, an agreement (the Discounted Travel Scheme Agreement) was entered into between PIK Facilities Limited, the train operator at the time (ScotRail Railways Limited) and Strathclyde Passenger Transport Executive. This agreement set up a system of discounted railway tickets for those passengers using the airport. In addition, under this agreement, there was a revenue share arrangement providing for PIK Facilities

¹These organisations include: Strathclyde Passenger Transport Executive (SPTEx), Ayrshire Enterprise, Kyle and Carrick Council, Prestwick Airport Limited and European Union.

Limited to receive 36% of the revenue collected by the train operator from airline ticket holders using the train service to and from the airport.

8. After struggling initially, the airport has grown since the introduction of services provided by budget airlines. In the last 5 years, passenger numbers have increased from 0.5 million to 2.5 million a year.

Access agreement

9. The airport owner entered into a station access agreement with the previous train operator (ScotRail Railways Limited) on 2 September 1994. FSR took over the franchise and the access agreement from ScotRail Railways Limited on 16 October 2004. The access agreement with the previous train operator expired on 1 December 2004. GPA then entered into an agreement with FSR on 8 December 2004, which purported to amend the expiry date of the previous access agreement, to allow access to the station while the parties negotiated the terms of a new agreement. There were a number of further short-term arrangements which ended on 31 October 2005 and the parties have since been seeking to put in place a new access agreement.

10. The previous access agreement contained bespoke terms because of the nature of the station. Unusually, it did not provide for an access charge. Instead, as explained in paragraph 7, we understand that there was a separate unregulated revenue share arrangement which provided revenue to the station facility owner as well as the train operator. ScotRail Railways Limited initiated the termination of this arrangement on 3 September 2004 and the agreement expired on 1 December 2004.

11. GPA estimates that if the revenue share arrangement had continued it would now be worth £494,725 in the 2005 / 2006 financial year.

Grounds for disagreement: the parties' proposals

12. The parties have agreed most elements of the new access agreement between each other. However, they have not been able to agree the level of the charge that the train operator should pay to the owner for access to the station.

13. More specifically, the parties have agreed the element of the charge to remunerate both GPA's maintenance and repairs costs, which are usually recovered through the

regulated long term charge (LTC)², and GPA's operating costs³ (plus a £20,000 management fee), which are usually recovered through the qualifying expenditure QX⁴ charge. The level of maintenance, repairs and operating costs has been agreed at £200,014 per annum. However, the parties have not been able to agree whether the long term charge should also provide GPA with a return on the capital value of the station and, if so, the level of such element of the charge. Therefore, on 2 March 2006 FSR made an application to us under section 17 of the Act and asked us to give directions to GPA to enter into a station access contract with a LTC which does not include any element remunerating GPA with a return on the capital value of the station.

14. The key issues that have been raised by FSR and GPA in this application are outlined in the rest of this section.

15. GPA has argued that it should be allowed to recover a return on its investment in the station, as well as recovering the costs of maintaining, repairing and operating the station.

16. However, FSR does not accept that GPA is entitled to a return on capital given that:

- (a) the majority of the capital used to ~~construct the~~ station was provided by third parties in the form of grants; and
- (b) the original small contribution by the airport owners to the construction costs has been remunerated through the benefits that the station brings to the airport.

17. In its application, FSR argued that GPA should only be remunerated for its ongoing operating, maintenance and repairs costs plus the renewals costs that it incurs over time.

² The long term charge (LTC) generally provides the station landlord with a capital return and covers the cost of its maintenance, renewal and repair obligations. For more information on the current structure of station charges see for example Chapter 2 in the April 2005 ORR document "The structure of station Long Term Charges", available at: <http://www.rail-reg.gov.uk/opaad.pdf#231.pdf>.

³ Including cost items such as insurance, security, regulatory inspections costs etc

⁴ Expenditure incurred by the Station Facility Owner in operating the station is recovered through a mechanism set out in the National Station Access Conditions and referred to as Qualifying Expenditure. Through approval of the access contracts incorporating those Conditions, we approve the cost elements that may be included in the station charges, but not the figures themselves. See paragraph 1 of annex 2 to the template station specific annexes <http://www.rail-reg.gov.uk/opaad.pdf#231.pdf>.

FSR believes that 2% of the Modern Equivalent Asset (MEA) value⁵ of the station - i.e. £70,680 - would be an appropriate remuneration for GPA's annual renewals costs in the circumstances. The LTC proposed by FSR is therefore [REDACTED] per annum. This figure includes remuneration for the agreed costs categories detailed above in paragraph 13 and also GPA's renewals costs (as estimated by FSR), which are generally recovered through the LTC but have not been agreed between the parties.

18. GPA also considers its proposals are consistent with our published Fair Deal⁷ guidance. It argues that the method it proposes to value the station will encourage its efficient use and encourage sufficient investment in new capacity. The proposed charge⁸ will, in its view, compensate GPA for bearing the station's capital costs, operating and maintenance costs (and relevant taxes) and provide a rate of return, which should reflect what investors could be earning by committing their funds to an alternative project of similar risk.

19. As noted above, GPA has argued that, in addition to recovery of ongoing costs relating to the station agreed between the parties, it should also be allowed to recover a return on its investment in the station, by applying a weighted average cost of capital⁹ (WACC) of 9.3% to the estimated MEA value of [REDACTED] for the station. This would also

⁵ The MEA value of the existing station is the cost of constructing a modern equivalent station. A Modern Equivalent Asset in this context is a station that is similar to the existing facility and has the equivalent productive capacity, but is built using modern materials, techniques, and design. This MEA value has been independently estimated in April 2005 at £3.5m. Both parties agree on this figure.

⁶ £200,014 for operating, maintenance and repairs costs +£70,680 for renewals costs + £20,000 for the management fee.

⁷ <http://www.rail-reg.gov.uk/upload/pdf/76.pdf>

⁸ It should be noted that, in their representations, the parties refer to their proposed charge as an 'access charge'. In fact, the long-term charge is the only charge explicitly set out in the station-specific annexes to the station access conditions (i.e. a set of national standard terms and conditions incorporated by reference into each station access agreement). Therefore, the long-term charge can be considered, from a regulatory perspective, as the only proper station 'access charge'. Since the charges proposed by the parties remunerate a number of costs (e.g. operating costs) that are not generally recovered through a long-term charge, throughout this document we refer to these charges as 'the proposed charge' rather than 'the proposed access charge'.

⁹ The weighted average cost of capital is a financial term which measures a firm's cost of capital, i.e. the minimum expected rate of return needed by the firm to attract the required capital to fund their business.

remunerate any future renewals costs. GPA therefore disagrees with the LTC proposed by FSR and has argued that instead this charge should be **£637,616** per annum.

Table 1 Station Charges proposed by the parties (2005/06 prices)

	Annual revenue to GPA
First Scot Rail Station Charge proposal	£291K
GPA Station Charge proposal	£638K ¹⁰

20. Our consideration of this application has focused on the two issues outlined above: return on capital and recovery of efficient maintenance, repairs and renewals costs.

Process

21. In considering the various issues raised by this difficult application, we have been conscious of the need to give all affected parties the opportunity to make representations to us and provide us with relevant information. In particular, we have followed the process summarised below:

- On 7 March 2006, we invited GPA to make written representations on the application from FSR and directed it to furnish us with the names and addresses of every interested person, as required by paragraphs 3(1) and 4(1) respectively of Schedule 4 to the Act.
- On 29 March 2006, we held a meeting with FSR and GPA to discuss and explain our process for dealing with applications under section 17 of the Act, address any issues arising out of the application and give those involved the opportunity to ask questions and explore how we would reach our decision. At the suggestion of FSR, we invited a representative from Transport Scotland to our meeting.

¹⁰ Of which £418k represents the proposed return on capital.

- On 3 April 2006 and again on 26 June 2006, we invited FSR to make further written representations on the written representations received from GPA, as required by paragraph 3(2) of Schedule 4 to the Act.
- On 11 April 2006, as there were no interested persons as advised by GPA on 27 March and no other beneficiaries, we gave Strathclyde Partnership for Transport and Transport Scotland as interested parties (i.e. not as "interested persons" as defined in Schedule 4 to the Act) the opportunity to comment on the application.
- On 12 April 2006, 22 May 2006 and 26 June 2006 we invited GPA to answer various questions arising out of the application and representations received.
- Replies to questions and representations were copied to FSR and GPA, as appropriate.
- On 28 April 2006, we copied the consultation response from Strathclyde Partnership for Transport to FSR and GPA.
- On 16 May 2006, we copied the consultation response from Transport Scotland to FSR and GPA.
- On 25 September 2006, we consulted FSR and GPA on our draft decision and draft modifications.
- On 10 October 2006, we circulated a station plan, submitted by FSR, intended to be attached to the submitted contract. We emailed the plan to GPA and also posted it onto our website.
- On 18 October 2006, we met FSR, GPA and Transport Scotland to discuss our draft decision and draft modifications.
- We understand that following this meeting, there were various discussions with Transport Scotland. We received several requests to postpone our decision so that an agreed outcome could be reached. However, FSR, which is the applicant under Section 17, has subsequently requested that we proceed to reach a final decision.
- On 22 February 2007, we consulted FSR and GPA on our amended draft decision and draft modifications. We asked for responses to this decision by 28 February 2007.

- Following representations from the parties, we agreed to extend this deadline to 9th March. Again, in response to representations from the parties and TS, we further extended this to 16th March 2007. We were mindful of the fact that First Scotrail required a shorter timescale, and that GPA requested longer to consider their response. We felt that a period of 3 weeks to respond would be reasonable.

Consultation responses

22. We invited Transport Scotland and Strathclyde Partnership for Transport to comment on the application on 11 April 2006. Transport Scotland provided no substantive comments. Strathclyde Partnership for Transport said it was concerned that the public purse should not pay twice by paying access charges to use assets it had funded. We also invited Transport Scotland to make any representations on our draft final decision but received no comments.

Information discrepancies

23. Because of the change of ownership of the station, the change of franchisee and the period of time which has elapsed, it is perhaps not unduly surprising that the information provided to us has contained discrepancies. In particular, figures quoted in the application have been revised substantially in the answers we have received to our questions or in written representations. The third party funding contribution, for example, from Kyle and Carrick District Council has been variously reported as £360,000, £300,000 and zero. Similarly, the European Union funding contribution has been quoted as £550,000, £400,000 and £242,000. Neither party has produced conclusive evidence on the exact nature, terms and amounts of the contributions to the total construction cost made at the time by the various parties involved. The private sector's contribution varies in a range between 16% and 65% in the estimates provided by the parties.

24. The following table, reproduced from GPA's submissions received on 9 June 2006¹¹, summarises the various figures received from the parties:

¹¹ See Part 1 of Glasgow Prestwick Airport Limited's answers to further questions from ORR and further representations: http://www.gpa.co.uk/pressroom/PA_06062006.htm

Table 2 Contributions to the construction cost of the station

Source of contribution	FSR/SPTE's estimate	GPA's Previous estimate	GPA's Revised Estimate
	<i>Received: 2 March and 27 April 2006</i>	<i>Received: 2 May 2006</i>	<i>Received: 9 June 2006</i>
Prestwick Airport Limited	£360,000	£400,000 (Phase 1) £736,730 (including cost overruns)	£1,800,000 (including £450,000 of GPA's operating costs in the first 3 years of operation)
Grants –			
Ayrshire Enterprise	£420,000	£526,000	£426,000
Kyle & Carrick Council	£360,000	£300,000	£0
SPTE	£508,350	£375,00	£319,529
European Union	£550,000	£400,250 (i.e. 25% of the other grants)	£242,000
Grants - Total	£1,833,350	£1,601,250	£987,529
Total Project costs	£2,193,350	£2,001,250 (Phase 1) £2,337,980 (incl. cost overruns)	£2,787,529 (including £450,000 for GPA's operating costs)

25. We note that the decision we have reached on the application from FSR – particularly our decision on the return on capital to GPA - does not require us to come to a view on these uncertainties.

Decision

26. We have concluded that it would be appropriate for us to direct GPA to enter into a contract, though with certain modifications to the required access contract submitted with

FSR's application. Having consulted GPA and FSR, we have accordingly issued directions to that effect.

27. In particular, after careful consideration and review of all the parties' representations, we have decided for the reasons set out below that the LTC in the access contract should be set so that GPA can recover its efficient maintenance, repairs and renewals costs but not a return on the capital value of the station. In addition, a separate fixed charge should be set so that GPA can recover its operating costs, plus a management fee.

28. The directions stipulate that the contract must be entered into not later than 16.00 hrs on 18th June 2007. Our directions have been issued separately to GPA and will be published on our website after we have considered any representations made on any matters referred to in section 72(3) of the Act (<http://www.rail-reg.gov.uk/>).

29. We have made a number of relatively minor amendments to the access contract submitted by FSR including:

- (a) The defined term of "Access Charge" was amended to "Charge". This is to reflect the fact that the charge in the contract now includes certain elements that are generally recovered outside the LTC;
- (b) Updating changes have been made to reflect changes made by the Railways Act 2005 and recent safety legislation;
- (c) The standard conditions precedent from our template station access contracts have been inserted into the contract at clause 2;
- (d) Payment provisions have been inserted at clause 11. These were omitted in error by the parties and have been inserted by agreement with them;
- (e) Schedule 1 Part 1 now contains a specific commencement date, which is also the date by which the conditions precedent must be satisfied;
- (f) FSR's address for service has been updated;
- (g) Indexation provisions have been inserted in Schedule 1 Part 4;
- (h) A mechanism to make the charge payable from 17th October 2004 (as agreed between the parties), as in Schedule 1 Part 4. This mechanism takes into account that our determination of the charge is in 2005/06 prices; and
- (i) FSR had omitted to provide a plan outlining the precise area of the station with the submitted contract. Following a request from us, FSR provided a plan and.

subsequently, an amended plan for inclusion in the contract. We forwarded this plan to GPA for their comments on 10 October 2006 and also posted it onto our website.

30. The rest of this letter focuses on the material issues we have considered, particularly in respect of charging.

31. A deltatview comparison of the directed contract against the one submitted by FSR is attached as Annex A.

The Railways Act 1993

32. This section provides an overview of the relevant legislative provisions.

33. Under the Act, anyone seeking access to a station, which is subject to access regulation, for or in connection with the operation of trains, must enter into a contract directed by us. If not, section 18(1) provides that the access contract will be void. Where an applicant for access cannot agree the terms of access with a facility owner it is entitled to apply to us under section 17 to direct those terms. The Railways Infrastructure (Access and Management) Regulations 2005, which enable an applicant to appeal various access matters to us, provide that where directions may be sought under section 17; the applicant must lodge its appeal under this section.

34. When we exercise our functions under Part 1 of the Act, we are governed by our statutory duties, most of which are set out in section 4 of the Act. These duties are not in any order of priority and it is for us to decide how to balance our duties in reaching a decision. In considering the application and in reaching our decision as to appropriate directions in this case, we have had regard to our duties under section 4 of the Act as amended, complied with the statutory procedures, and adhered to the process and timescales set out in Schedule 4 to the Act.

35. We have considered all of our duties in reaching our decision on this application. Section 4 requires us to balance all our duties and, in balancing these duties, we necessarily have to exercise our judgment to achieve the right balance, taking into account the particular circumstances of each case.

36. In relation to this case and for the reasons set out below, we have given particular weight to:

- Section 4(1) (a) otherwise to protect the interests of users of railway services:

- Section 4(1) (b) to promote the use of the railway network in Great Britain for the carriage of passengers and goods and the development of that network, to the greatest extent that we consider reasonably practicable;
- Section 4(1) (ba) to contribute to the development of an integrated system of transport of passengers and goods
- Section 4(1) (c) to promote efficiency and economy on the part of persons providing railway services; and
- Section 4(1) (g) to enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance.

37. Section 4(5) (aa) and (ab) require us to give appropriate weight to the extent (if any) to which any guidance issued by the Scottish Ministers relates to matters in respect of which expenditure is to be or has been incurred by the Scottish Ministers. At the time of our draft final decision we had not received any such guidance from the Scottish Ministers. We have subsequently received guidance from Scottish Ministers.¹² We have had regard to this guidance in reaching our final decision and this does not alter our decision in this matter.

38. We also consider that our value for money duty which has recently been commenced is particularly relevant. We consider, for the purposes of Section 4(5C), that this decision affects the interests of users or potential users of railway services and persons providing railway services and we have had regard to the value for money issues raised. We consider that this decision represents the appropriate outcome in value for money terms, for reasons set out in paragraphs 55 and 57.

Details of our decision

Policy framework

Investment framework

39. We have established a policy framework for investments¹³ with the objective of facilitating efficient, appropriate investment in the rail network. The investment framework

¹² <http://www.railreg.gov.uk/consultations/2005/05/20050501.htm>

¹³ Our policy conclusions were published in October 2005 and are available at <http://www.railreg.gov.uk/policy/policy.htm>

emphasises the importance for all stakeholders in an investment scheme of establishing transparent, appropriate allocation of risks for the construction and operation of the investment. Paragraph 1.10 of our October 2005 policy conclusions notes that "A key principle [of the investment framework] is that the responsibilities, risks and funding arrangements for all schemes should be clear to all stakeholders as early as possible in scheme development."

40. As we point out below, in this case private sector organisations have negotiated terms for access (including allocation of risks) to the station and agreed revenue sharing arrangements through an unregulated income stream. Throughout the period until the termination of the revenue share agreement in October 2004 an access contract with a zero access charge was in place.

41. Another relevant principle of the investment framework is that commercial parties who wish to enhance the railway should be free to negotiate terms and to agree an appropriate risk allocation, price and remuneration with all parties (or other relevant stakeholders). A corollary of this principle is that where third parties¹⁴ negotiate the terms of an investment (and its subsequent operation) between themselves, we would generally not expect to be involved, except insofar as the negotiation may require the exercise of one of our functions or have an impact on our duties under Section 4 of the Act. For example, where the access rights of beneficiaries other than the stakeholders in the scheme may be affected, it may be appropriate for us to seek information from the stakeholders on the effect of the scheme on such access rights.

Station Charges

42. Both parties have referred to our "Fair Deal" guidelines. In our 1998 document "Fair Deal", we provide guidance on station access charges, which includes guidance on adjustments to these charges resulting from investment in station enhancements, particularly those investments at stations owned by Network Rail¹⁵.

43. That document remains relevant, but needs to be read in the context of our subsequently published policies applicable to setting station access charges, in particular in the context of a station enhancement. The level and structure of station charges in place in 1998 has been modified by our 2000 periodic review of Railtrack's revenue requirements and access charges. Our final conclusions on station charges are presented in Chapter 13 of the October 2000 document "Periodic review of Railtrack's access

¹⁴ Third party: means any organisation other than Network Rail or Government

¹⁵ Railtrack PLC at the time of publication of this policy.

charges: Final Conclusions”¹⁶. Our 2003 access charges review did not amend the level or structure of station charges.

44. The current policy on station access charges is also described in the following documents:

- (a) the April 2005 document “the Structure of Station Long Term Charges”¹⁷; and
- (b) the June 2006 document “PR08: The structure of track and station charges”¹⁸.

45. In summary, our policy on station charges is that the regulated long-term charge for a station should recover the efficient costs of maintenance, repair and renewals at that station. In addition, the long term charges set in the 2000 periodic review include a return element on the capital value of the stations owned by Network Rail. In the case of future station enhancements, we would also expect to allow Network Rail or any other owner of the station funding the enhancement to recover its efficient additional costs resulting from the enhancement, including a return on its investment, through an appropriate increase in the long term charge.

Return on capital

46. We have reviewed the parties’ representations and in particular have considered GPA’s approach to calculating a return on the capital value of the station assets, including its proposed rate of return.

47. As noted above, GPA has argued that the rate of return should be 9.3% using a WACC¹⁹-based approach. We have reviewed GPA’s proposed methodology for estimating the components of the WACC and consider it is a reasonable approach to estimating a rate of return.

48. However, we believe for the reasons set out below that GPA should not be allowed to recover any return relating to the capital value of the station through the long-term charge.

¹⁶ <http://www.railreg.gov.uk/road.pdf.115-orig%2.pdf>

¹⁷ <http://www.railreg.gov.uk/road.pdf.231.pdf>. See in particular Chapter 2.

¹⁸ <http://www.railreg.gov.uk/road.pdf.231.pdf>. See in particular Chapter 2.

¹⁹ Weighted Average Cost of Capital

Reasons for our decision on return on capital

49. Under a regulated station access agreement, we would expect to allow a third party investor funding a *new* capital investment in the network to receive an appropriate return on this investment through an appropriate increase in the long term charge, provided they wish to recover their additional costs resulting from the enhancement in this way.

50. In this decision we have considered the particular circumstances of the case, having due regard to the policy principles set out in our Investment Framework and the final conclusions of the Periodic Review 2000, the guidance in the “Fair Deal” document, as well as our statutory duties. As explained above, we would generally not expect to be involved when commercial parties who wish to enhance the railway negotiate terms and agree outside the regulatory framework:

- (a) an appropriate risk allocation;
- (b) a price for use of the enhanced assets; and
- (c) a method of remuneration.

51. In this case, private sector organisations have negotiated terms for access (including allocation of risks) to the station and agreed revenue sharing arrangements which were presumably intended to enable the owner to recover its costs (including investment costs) through an unregulated income stream. We would expect a commercial third party to negotiate charges that allowed recovery of the incremental costs associated with operation of the station and an appropriate mark up. In a competitive market, GPA would therefore set its overall price for access to the station as a forward-looking estimate of incremental cost plus a mark up that the market could bear. This mark up would be designed to permit the recovery of capital costs, including a return on investment.

52. Initially, the terms of access to the station were subject to commercial negotiation between the airport owner and the first train operator at the time the station was opened. Throughout the period from 1994 until the termination of the revenue share agreement in October 2004 an access contract with a zero access charge was in place. So despite the availability of a cost recovery mechanism under the regulated access regime, the parties instead chose to contract through an unregulated revenue share agreement, allowing the airport owner to remunerate its incremental costs and earn a return on its investment.

53. We assume Infratil (GPA's current parent company) made a commercial decision to continue with the unregulated revenue share agreement at the time it acquired the station, without apparently considering revisions to its station access agreement. Also, the company made the acquisition based on the risk allocation agreed at that time with the

train operator under the station access agreement and the revenue share arrangements. At that time, Infratil took over ownership of the station and paid for the station assets based on the value it presumably estimated to be extractable from the station.

54. Our statutory powers in respect of the regulation of access are summarised above. It is not our role, nor do we have the powers to do so, to disturb arrangements entered into by the parties following commercial negotiation outside the statutory access regime contained in the Act, including the arrangements entered into at the time of acquisition of the station. Nor is it appropriate for us, having regard to all of our statutory duties, to protect Infratil's investment and ensure that it can continue to earn a return on its investment going forward through a regulated charge simply because its original arrangements for extracting value have terminated.

55. We also understand that ORR was not involved in, or aware of, the terms of the arrangements previously put in place by the airport owner to recover sunk²⁰ investment costs, including the terms of the investment made by Infratil when it acquired the station. Given this, and in the absence of robust information on the extent to which sunk investment costs funded by the private sector have already been recovered, it would be extremely difficult for us (assuming we concluded it was appropriate) to establish a charge to remunerate those sunk investment costs. Any such charge would risk over-recovering those costs, with the consequence that the customer could end up paying twice (i.e. by paying for costs already remunerated) and thus provide GPA with a windfall gain to the detriment of railway customers and funders.

56. As mentioned above, we consider that our statutory duties under Section 4(1) (b), 4(1) (c), 4(1) (g) and 4(5C) of the Act are particularly relevant.

57. We believe that allowing GPA to recover its efficiently incurred, incremental long-term costs for operating, maintaining, repairing and renewing the station (including a reasonable management fee) through the station access charge is consistent with these three statutory duties as it should:

- (a) provide adequate cost recovery to pay for continued operation of the station;
- (b) provide sufficient incentives for GPA to manage its assets in an efficient way; and
- (c) prevent the risk that FSR pays for costs that have already been recovered by GPA.

²⁰ Sunk costs in this context means costs incurred in the past, the amount of which will not be affected by any decision made now or in the future.

58. In its representations, GPA has drawn on comparisons with how Network Rail recovers capital costs at stations. However, Network Rail is a regulated monopoly that can generally only earn a return on capital through an allowed return on its RAB²¹ determined by us. Moreover, if Network Rail were to enter into an agreement for an investment scheme under which it is remunerated by other means²², we would not expect retrospectively to alter any aspect of agreed arrangements if Network Rail claimed that its investment had not been fully remunerated.

59. Given the previous commercial decisions by GPA to enter into and maintain an access contract with a zero access charge, we believe that the sunk costs of the station should be treated as ring-fenced outside the regulated charging regime in perpetuity. This means that if GPA wished to dispose of the station to a third party, we would not expect to approve an access charge including an allowance for a return on the current capital value of the station, even if the third party purchaser proposed it in advance of its investment in the station. However, if GPA disposed of the station following a future enhancement, any return allowed to GPA for that enhancement would be automatically transferred to the new owners of the station (see paragraph 64 below).

60. In principle, the axiom that risks should be allocated clearly at the outset and borne by the party best able to manage them would suggest that GPA should not now be allowed to recover its ongoing maintenance, repairs and renewals costs at the station through a regulated charge following the collapse of an unregulated commercial agreement. GPA should therefore have ensured that it had adequate mechanisms to allow it to recover these costs under its unregulated agreement. As mentioned in paragraph 54, it is not our role, nor do we have the powers to do so, to disturb arrangements entered into by the parties following commercial negotiation outside the statutory access regime contained in the Act.

61. However, in considering whether to allow the owner of the station recovery of its costs, which might include those incurred in remedying the original build defects, we have had regard to our statutory duties.

62. In particular, we need to take into account any effect that not allowing recovery of future maintenance, repairs and renewals costs at the station through a regulated charge

²¹ The Regulatory Asset Base (RAB) is our valuation of the Network Rail assets, on which Network Rail is allowed to earn a return.

²² e.g. there is no proposed addition to the RAB, for example, a scheme that is grant funded with staged payments to Network Rail.

may have, by potentially incentivising the owner of the facility to close the station. In this respect, we have had particular regard to the following statutory duties:

- (a) the interests of users of railway services (section 4 (1) (a));
- (b) the promotion of use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent which we consider economically practicable (section 4 (1) (b)) ;
- (c) the development of an integrated system of transport of passengers and goods (section 4 (1) (ba));
- (d) the ability of GPA and FSR to plan the future of their businesses with a reasonable degree of assurance (section 4 (1) (g)).

63. We consider that allowing recovery of the efficiently incurred future maintenance, repairs and renewals costs represents the appropriate balance of our statutory duties for the following reasons:

- (a) it should provide an appropriate incentive for GPA to continue to provide rail access services at the airport;
- (b) as mentioned in paragraphs 13 and 17, both parties agree that the access charge should remunerate GPA for its maintenance, repairs and operating costs (plus a management fee) and FSR accepts that GPA should be remunerated for its renewals costs over time.

64. Therefore, we direct that the LTC should be set so that GPA can recover its efficient maintenance, repairs and renewals costs but not a return on the capital value of the station. However, we would expect to approve an appropriate increase in the LTC for any future enhancements carried out by GPA (or any future owner) at the station. We would expect that FSR (and any other future beneficiaries) would be properly consulted and their views taken into account in connection with any such enhancement proposal. As mentioned above in paragraph 59, if GPA disposed of the station following any such future enhancement, we would expect to continue to allow a return on that investment to the new owner of the station.

65. This decision takes into account the particular circumstances at GPA's station and should not necessarily be taken as setting a precedent. In general, we would expect to allow third party investors to receive an appropriate return on their capital investment in the

network through access charges³, although we would normally expect to approve the changes in access charges resulting from an investment *in advance* of the investment being completed, to give all parties certainty. We have previously approved such changes to access charges, one example being Project Evergreen 2, a project promoted by Laing Rail Projects and Chiltern Railways.

Calculation of the Long Term Charge and other charges

66. We address renewals costs separately from maintenance and repairs costs, as the methods proposed by the parties for estimating and recovering renewals costs differ from other cost categories.

Renewals costs

67. The parties disagree on the costs of renewing the station in modern equivalent form and how to recover them.

68. FSR has argued in its application and other submissions that renewals costs should be recovered through a specific allowance for renewals in the access charge. FSR proposes an allowance of between 1% and 2% of the estimated Modern Equivalent Value of the Station, in addition to the agreed £220,014 allowance for operating, maintenance and repairs costs and the costs of internal management.

69. GPA instead argues that renewals costs should be remunerated as and when they arise through the charge they propose, which includes an element for recovery of GPA's cost of capital in addition to an allowance for operating, maintenance and repairs costs and the costs of internal management. GPA has not included a specific allowance for past or future expected renewals costs in their calculation of the charge. GPA also states in its submissions that it has not incurred any renewals costs since its full acquisition of the airport, i.e. after 2002/03.

70. As discussed in paragraph 64 above, we have decided that the LTC should be set so that GPA can recover its efficient renewals costs at the station. In reaching this conclusion we have taken into account several factors as discussed in paragraphs 57 and 63 above.

71. We have estimated the efficient annual renewals costs of the station at [REDACTED]⁴ per annum. This figure is the result of a detailed "bottom up" assessment carried out by our

³ See for example paragraph 2.2 in the April 2005 ORR document "The structure of station Long Term Charges" available at: <http://www.orr.gov.uk/stations/20050427/2005042701.pdf>

⁴ excluding the link bridge between the airport and the station

internal asset management experts, based on information submitted by the parties, a typical asset count, standard annual rates of activity, average unit rates and comparison with costs at other Scottish station projects.

72. For these reasons, we believe this is a more accurate assessment of renewals costs than the approach proposed by FSR, although we accept that the range of renewals costs proposed by FSR is not unreasonable. In fact, the figure we obtain falls within the range considered appropriate by FSR, i.e. between £35,340 (1% of £3,534,000) and £70,680 (2% of £3,534,000).

73. GPA has argued in its response to our draft final decision that they believe the bridge linking the station to the airport to be an integral part of the station access and egress facilities for the following reasons:

- (a) they state that the Cleaning Specification set out in Appendix 1 of the proposed Station Access Agreement requires the cleaning of the “skywalk and waiting rooms (including the footbridge)”;
- (b) the definition of Common Station Amenities and Services at 1.1 includes “Access to and egress from the railway station and the airport”; and
- (c) absent the station the link bridge would not be needed.

74. GPA has therefore asked us for an explanation of why costs associated with the maintenance, cleaning and refurbishment of the link bridge have been excluded from the calculation of the charge.

75. In this respect, we first note that the proposed Station Access Agreement was originally submitted by FSR without a plan identifying the exact area of the station. We therefore asked FSR on 13 September 2006 to provide us with the agreed plan they intended to append to the contract. FSR provided the plan on 3 October 2006. We shared the plan with GPA on 10 October 2006 and they did not raise any concerns. We therefore concluded that both parties agreed that the exact limits of the station exclude the link bridge connecting the station to the airport (but include the footbridge between the two platforms). We therefore calculated the access charge accordingly. The treatment of the footbridge is consistent with the manner in which the footbridge has been treated in earlier access contracts. We are content that this is the correct treatment.

76. Responding to the points made by GPA:

- (a) the Cleaning Specification set out in Appendix 1 of the proposed Station Access Agreement states the following: “The skywalk and the waiting rooms (including the

footbridge) will be cleaned as part of the Terminal Building, and will be included in the Terminal Building schedule of cleaning." We do not think that the cleaning arrangements are a determinative factor. As a reflection of the relationship between the airport and the station, certain cleaning arrangements have been included in the Terminal Building arrangements. We note that this includes the waiting rooms which do come within the station plan and the footbridge which does not.

- (b) It is correct that Common Station Amenities include "Access to and egress from the railway Station and the airport". However, the plan of the station does not include the link bridge. The definition of Common Station Amenities and the treatment of the footbridge in the plan is consistent with earlier access contracts. We do not therefore consider that it is now possible to argue on this basis that the link bridge forms part of the station.
- (c) GPA also points out that absent the station the link bridge would not be needed. However, we do not consider this a sufficient argument for concluding that the link bridge should be part of the station, because:
 - (i) Principally, as already explained above, the plan of the station does not include the link bridge
 - (ii) It would be equally possible to argue the opposite, i.e. that absent the airport and its passengers the link bridge would not be needed by FSR.

Treatment of future expected renewals costs

77. As mentioned in the previous section, GPA has not included a specific allowance for future expected renewals costs in its proposed charge and has also stated that it has not incurred any renewals expenditure since it took full ownership of the airport in financial year 2002/03.

78. However, GPA argues in its submissions that it expects to incur a total cost of £2,513,988 in what the company defines as "renewals" works between the period 2006/07 and 2008/09. In fact, GPA explains that these works are required to re-build major portions of the existing facility due to original build defects. GPA claims that in late 2004 an examination of the facility established that fabric and materials originally used in the construction of the building were inappropriate for the site of the station.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

79. FSR does not regard these anticipated re-building costs, which are required due to defects arising from the original construction project, as an appropriate renewals cost that can reasonably be passed to the station beneficiary through the LTC. FSR believes it was a responsibility of the airport's owners at the time of construction to protect themselves adequately in the construction arrangements against the risk of assets which were not fit for purpose.

80. We have decided not to include remuneration for these future expected re-build costs in our current calculation of the LTC. We note that GPA did not include a specific allowance for these re-build costs in its calculation of the LTC.

81. However, we are aware that discussions have been taking place between the parties on this issue and, more generally, on the future of the station since we produced our draft decision in September 2006. In its submission dated 18 July 2006, FSR expressed its concerns on the potential consequences of failure to carry out the required works and the long-term future of the station in absence of the necessary funding for these works. At our meeting with the parties on 18 December 2006, GPA noted that bringing the station back to a proper state would require a major investment for the airport owners and that it would be difficult to justify such spending for the company without receiving any return on the asset and no additional funding for remedying the original build defects. GPA stated that in such circumstances it might be forced to close the station.

82. We therefore think that it is appropriate for us to clarify in this document what we would expect the charging position to be going forward if GPA, or any other future owner of the station, including Network Rail, remedied the latent defects and brought the station back up to an acceptable modern standard which is fit for purpose. We consider that this clarification should ensure that all interested persons should be better placed to make properly informed decisions about the station.

83. We would expect to approve any future proposed increase in the LTC remunerating GPA (or any other owner of the station) - over the remaining asset life of the station - for the costs efficiently incurred in remedying the original build defects. Any such approval would be subject to our current policy on LTCs and guidelines on changes to LTCs. However, we would strongly encourage that the relevant parties discuss this issue with ORR at an early stage.

34. We would expect any such approval to be conditional on, at least, the following:

- a) all the works required to remedy the original build defects and bring the station back up to an acceptable modern standard being satisfactorily completed;

- (b) the efficiency of the costs incurred by GPA (or another owner) to remedy the build defects being verified by independent advisors and only recovery of costs efficiently incurred being allowed;
- (c) appropriate contractual mechanisms being put in place ensuring in the future an adequate asset stewardship regime.

85. If GPA intends to carry out significant works at the station both FSR and the ORR should be consulted and agree to any changes which amount to a change in the contract terms, including remedying the original build defects at the station. FSR questioned whether this was a matter requiring agreement between the parties (see further paragraph 108(a)). The contract submitted by FSR states that changes to the Common Station Amenities or Common Station Services at clause 8.1 are to be agreed between the parties and approved by ORR. These provisions are based on those included in earlier access contracts for the station.

86. In the unfortunate circumstance that the parties were unable to reach agreement, it is assumed they would consider various options, which on the part of GPA might include closing the station. We would hope that in practice before any formal steps were taken the parties would have engaged with Transport Scotland and us.

87. We understand FSR's view that the airport's owners at the time should have protected themselves more adequately in the construction arrangements against the risk of assets which were not fit for purpose. However, in considering whether to allow the owner of the station recovery of its future costs, which might include those incurred in remedying the original build defects, we would have to have regard to our statutory duties and published policy²⁵.

88. In particular, we would need to take into account any effect that not allowing recovery of costs incurred in remedying the original build defects may have, by potentially incentivising the owner of the facility to close the station. We would expect the following statutory duties to be particularly relevant:

- (a) the interests of users of railway services (section 4 (1) (a));
- (b) the promotion of use of the railway network in Great Britain for the carriage of passengers and goods, and the development of that railway network, to the greatest extent which we consider economically practicable; (section 4 (1) (b));

²⁵ In particular, in line with our published policy framework for investments, we would only allow recovery of efficient costs.

- (c) the development of an integrated system of transport of passengers and goods (section 4 (1) (ba)); and
- (d) the ability of GPA and FSR to plan the future of their businesses with a reasonable degree of assurance (section 4 (1) (g)).

89. We consider that allowing recovery of the efficient costs incurred in remedying the original build defects would represent the appropriate balance of our statutory duties as it should:

- (a) provide an appropriate incentive for GPA or any alternative owner to provide a fit for purpose modern station; and
- (b) allow GPA and FSR to continue and improve the rail services they provide.

90. We also reiterate that, as stated in paragraph 64, we would expect to approve an appropriate increase in LTC for any future enhancements²⁶ carried out by GPA (or any future owner) at the station.

Maintenance, repairs, and operating costs

91. In its application, FSR states that the parties agree on the costs of maintaining and repairing the station and their recovery through the inclusion of a specific allowance into the LTC. FSR states that the level of maintenance and repairs costs has been agreed at a level of £200,014 per annum.

92. GPA has provided us with a breakdown of the estimated maintenance, repairs and operating costs underlying this £200,014 figure. The figure is calculated as an annual average of actual expenditure incurred by GPA over the period 2002/03 to 2004/05 in a number of cost categories. Table 3 below provides a breakdown of the figure:

²⁶ Investments in the station, typically involving construction, that improve its capacity or capability (e.g. enabling an increase in the number of rail services available). They are not simply renewals of the station assets in a modern equivalent form.

Table 3 Estimated Maintenance, repair and operating costs (provided by GPA)

	FY2002/03	FY2003/04	FY2004/05	Average
Maintenance				
Lifts, escalator	4,000	695	-	1,565
Development works	-	-	485	162
Miscellaneous	4,859	11,170	6,831	7,620
Total Maintenance	8,859	11,865	7,316	9,347
Repairs				
Platform door repairs	2,885	-	-	962
Escalator repair	-	11,955	-	3,985
Works recommended from annual inspection	-	-	2,478	826
Storm damage	-	-	16,644	5,548
Total Repairs costs	2,885	11,955	19,122	11,321
Operating costs				
Insurance	109,735	109,735	109,735	109,735
Security	5,385	4,160	4,160	4,568
Mandatory detailed structural examinations / Regulatory inspections	11,985	-	-	3,995
Rail consultant	16,000	16,000	16,000	16,000
Audit	4,000	4,000	4,000	4,000
HMRI fees	3,333	3,333	3,333	3,333
Lease	7,715	7,715	7,715	7,715
Rates	30,000	30,000	30,000	30,000
Total operating costs	188,153	174,943	174,943	179,346
Total M&R and Opex	199,897	198,763	201,382	200,014

Note: all figures in nominal prices

93. From the breakdown provided it is clear that GPA's operating costs have been included in the component of the LTC agreed by the parties to recover the cost of maintaining and repairing the station facility.

94. As mentioned above in paragraph 45, our published policy²⁷ on the objective and structure of the LTC is that the level of the charge should be set in such a way to allow the Station Facility Owner to recover the efficient costs of meeting its contractual obligations in

²⁷ See for example paragraph 2.17 in the CRR's June 2006 document "Structure of track access and station long term charges", available at: <http://www.rail-reg.gov.uk/20060628/2010101>

respect of ongoing maintenance, repairs and renewals at the station. Operating costs, however, should be excluded from the calculation of the LTC, and are generally recovered through contractual mechanisms between the beneficiaries and the Station Facility Owner.

95. We believe that GPA is entitled to recover operating costs incurred at the station, as agreed with FSR. However, we also believe that these costs should be excluded from the calculation of the LTC in order to maintain a consistent approach to the calculation of the LTC across stations. This will make it easier for all parties to ensure that charges are not unduly discriminatory.

96. We recognise that GPA has agreed with FSR to recover operating costs in the same way as maintenance and repairs costs, that is through a fixed amount paid annually by the beneficiary. Therefore, we have decided to allow operating costs to be recovered through a fixed charge which is separate from the LTC set out in the contract but subject to the same indexation over the term of the contract.

97. It should be noted that this fixed charge for operating costs is conceptually different from the QX charge mechanism as set out in the National Station Access Conditions and the Stations Code²⁸. It is a unique mechanism that we believe is appropriate in the particular circumstances of this station. The QX charge is currently under review by the industry and alternatives are being considered, including the option of the Station Facility Owner absorbing operating costs. This decision is taken without prejudice to our future approval of any new proposals for the treatment of operating costs at other stations.

98. Finally, we have estimated the efficient annual maintenance and repairs costs at the station at [REDACTED] (excluding the link bridge between the airport and the station – see paragraph 75 and 76 above for the reasons for its exclusion). This estimate is again (similarly to the estimate of renewals costs) the result of a bottom up assessment carried out by our internal asset management experts, based on information submitted by the parties, a typical asset count, standard annual rates of activity, average unit rates, prices from other Scottish station projects and Network Rail information.

99. Table 4 compares the figures proposed by the parties with our estimates²⁹:

²⁸ See footnote 4 for further explanation on the QX charge.

²⁹ The figures proposed by the parties are in nominal prices while the ORR estimates are in 2005/06 prices.

Table 4 Summary of estimated annual costs¹⁰

	GPA FSR proposal	ORR estimate (excl bridge)
Maintenance	£9K	
Repairs	£11K	
Operating costs	£179K	
M&R	£21K	
M&R + Operating costs	£200K	
Renewals	N/A	

100. We believe our estimates represent a more appropriate assessment of future efficient maintenance and repairs costs than the approach proposed by GPA and accepted by FSR because:

- (a) it is based on a long term view of maintenance and repairs activity, whereas GPA's approach is based on actual expenditure incurred in a relatively short period of three years; and
- (b) it is based on what we consider to be an efficient mix of planned and reactive expenditure for maintenance and repairs activity, whereas GPA's maintenance and repairs expenditure in the past three years appears to have been mostly reactive.

101. Following our estimate of maintenance and repairs costs, we have also reviewed the level of operating costs to be recovered by GPA. We have accepted the figures proposed by GPA for operating costs based on an annual average of actual expenditure incurred in the period 2002/03 to 2004/05 in a number of operating costs categories. We consider that the particular categories of operating costs considered (e.g. insurance costs, security, HMRI fees etc.) are less variable from one year to another than maintenance and repairs costs. Moreover, we do not approve the level of the QX charge through which Station Facility Owners generally recover their operating costs and therefore we have limited information available for the benchmarking of operating costs. Therefore, we do not have any reasons to believe these operating costs are unreasonable. However, we have revised the total allowance for operating costs proposed by the parties in order to:

- (a) avoid any overlapping with our maintenance and repairs estimates – and consequently any double-recovery by GPA¹¹; and

¹⁰ The parties' estimates of renewals costs are not directly comparable with our estimate, as explained in various sections of this decision.

Table 5 Total annual charges (2005/06 prices)

	Level of the charge
Long Term Charge (LTC) – for GPA's recovery of maintenance, repairs and renewals costs	██████████
(Fixed) Operating Costs charge – for GPA's recovery of operating costs and the cost of internal management	██████████ + ██████████ = ██████████
Total charge	██████████
LTC proposed by FSR	██████████
LTC proposed by GPA	£637,616 ³²

105. Both the LTC and the fixed charge for the recovery of operating and internal management costs will have the standard indexation mechanism based on RPI described in Condition 23 of the Stations Code³³.

Representations received from the parties on the draft final decision

106. As mentioned above, on 22 February 2007 we gave the parties and TS the opportunity to make representations on the draft final decision and accompanying documents, including the factual basis of our reasoning and our decision to make the modifications to the access contract described above.

³² Of which £417,602 represents the proposed return on capital.

³³ See in particular page 152-153 in the Station Code: <http://www.rail.gov.uk/stations/stationscode.htm>

- (b) make the price base consistent with the other estimates.

Internal Management costs

102. In its application, FSR states that the parties agree on the annual cost of internal management of the station facility, estimated at £20,000.

103. We have decided to accept this cost and include it in the fixed charge for recovery of operating costs. ~~We recognise it is usual practice to include a management fee as one component of the operating costs at stations.~~

The total charge

104. The total initial charge that FSR will pay to GPA will therefore include two elements: the LTC and a separate fixed charge for ~~recovery~~ of operating and internal management costs. The level of these charges is set out in the table below, along with a comparison with the long-term charges (to recover the same elements of cost) proposed by the parties:

Structural examination costs (with a proposed annual allowance of £3,999) are generally considered a maintenance cost and therefore have been removed from the allowance for operating costs and are expected to be remunerated through the component of the LTC allowed for maintenance.

FSR comments

107. We received responses from FSR and GPA on 16 March 2007. As we noted above, Transport Scotland did not provide any representations.

108. FSR made the following two points in their response:

- (a) FSR asked for clarifications on the process that GPA and FSR would have to follow for making a change to the LTC following any rebuild works at the station to rectify latent defects³⁴. In particular, FSR asked for clarifications on the timing of this process, especially if they object to such increase. FSR's understanding is that such possible future increase in LTC would arise only where either agreement was reached between FSR and GPA or on the replacement of the Station Access Agreement at the end of the current FSR franchise.
- (b) FSR expressed concerns at the strength of expectation being offered to GPA on future LTC amendments following any rebuild works that GPA may carry out. FSR expects that a range of circumstances should be taken into account in approving the revised LTC. These circumstances include: further assessment of the background to the requirements for these additional renewals works; an assessment of the contribution of the station to the airport business; the possibility of remunerating less than GPA's full rebuild costs; and the legitimate requirement of FSR for certainty.

109. FSR confirmed that it was content with the terms of the Station Access Agreement attached to these directions, which we have previously circulated to the parties.

110. We addressed the first point raised by FSR in paragraph 85 and 86 above.

111. In respect of the second point raised by FSR, we explained in paragraph 83 that any future approval of changes to the LTC would be subject to our current policy on LTCs and guidelines on changes to LTCs at the time. In addition, we explained that we would expect to verify the efficiency of the costs incurred by GPA (or another owner) to remedy the build defects through independent advisors and to allow recovery only of costs efficiently incurred. We agree that in view of the unusual circumstances prevailing at this station we would need to take into account all of the relevant circumstances at the time. Again, in view of the background to this issue and the unique position of Prestwick, it is assumed that the parties would approach ORR in advance (and indeed we would strongly

³⁴ For further background on these rebuild works please refer to paragraphs 73 to 84 above.

encourage them to do so) so that there was as much clarity as possible and that decisions were made with a full and proper understanding of the relevant issues at the time. For example, as paragraph 84 makes clear we could only at this stage provide an indicative list of potential conditions.

GPA Comments

112. GPA made the following points in their response:

- (a) *Approach adopted:* GPA argues that the approach adopted in the decision is a significant departure from the principles that ORR and other regulators have adopted in other cases and inconsistent with a number of ORR's statutory duties.
- (b) *Signals sent to future investors:* GPA argues that the decision represents a serious deterrent for infrastructure providers to enter future commercial (non-regulated) arrangements that have the potential to both increase investment in integrated transport and use of train services.
- (c) *Relevance of funding sources and corporate structure:* GPA argues that the historic sources of capital funding for the construction of the station and/or changes in the ownership structure for GPA should be irrelevant in setting access charges.
- (d) *Treatment of previous commercial agreements:* GPA argues that the reasonable expectations of both parties at the time of the revenue share agreement being signed was that any future arrangements would enable GPA to recover the full cost of its investment and possibly any under recovery during the establishment period, irrespective of any regulatory consideration and ORR's current practices. GPA believes that it is unreasonable to assume that:
 - (i) either party in the revenue share agreement believed that the revenue share arrangements would continue indefinitely;
 - (ii) GPA's owners at the time (or any subsequent owners) would have expected to recover the entirety of their investment in the early years of the operation of the station;
 - (iii) the rail operator (assuming it continued to use the station) would have expected not to have to remunerate GPA for its investment beyond the expiry date of the revenue sharing agreement.

- (e) *Value of existing capital:* GPA argues that it must be able to earn a return at a minimum on the written down value of its past expenditures and preferably on the optimised depreciated replacement cost.
- (f) *Treatment of the link bridge:* GPA argues that the bridge linking the station to the airport is an integral part of the station access and egress facilities and asks for an explanation on why costs associated with the maintenance, cleaning and refurbishment of the link bridge have been excluded from the calculation of the charge.

113. GPA confirmed that other than the issue of the footbridge and the level of charges, it found the agreement generally acceptable.

114. Except for the treatment of the linkbridge, these objections are substantively points which have previously been made by GPA at various stages during this application. Therefore in addressing each of the above points raised by GPA in their response we often refer to other parts of this decision document:

- (a) *Approach adopted:* We explain above in paragraph 49 that we would expect to allow a third party investor funding a *new* capital investment in the network to receive an appropriate return on its investment through an appropriate increase in the LTC. However, as explained in paragraph 50, in this decision we have considered the particular circumstances of the case and, among other things, the fact that we would generally not expect to be involved, many years after an investment has been made, when commercial parties negotiated and agreed terms outside the regulatory framework and these original contractual arrangements were later terminated. As explained above, we consider this decision satisfies our statutory duties.
- (b) *Signals sent to future investors:* As explained in paragraph 65, this decision takes into account the particular circumstances at this station and should not necessarily be taken as setting a precedent. In general, we would expect to allow third party investors to receive an appropriate return on their capital investment through access charges, although we would normally expect to approve the changes in access charges resulting from an investment in advance of the investment being completed. As explained in paragraph 64, we would expect to approve increases in the LTC allowing a return on any future enhancements carried out by GPA (or any future owner) at the station.
- (c) *Relevance of funding sources and corporate structure:* First, as noted in paragraph 25, the decision we have reached on the application from FSR – particularly our decision on the return on capital to GPA - does not need to rely on the level of

funding contribution provided by the airport's owner at the time of the station construction. However, we note that, as explained in paragraph 2.11 of our "Fair Deal" guidelines, where the capital costs of an investment scheme are partly met by parties other than the station owner (e.g. grants from Government or Local Authorities), such contributions should be netted off the capital costs of the scheme reflected in the LTC increase. Second, we recognise that, in general, changes in investors' ownership structure should not affect the level of investment costs they are allowed to recover through increases in LTCs. However, as explained in paragraph 53, we assume that Infratil undertook what it considered to be an appropriate level of due diligence prior to taking over ownership of the station and purchasing the station assets. We also assume that the price paid for purchasing the station assets was based on the value it presumably estimated to be extractable from the station and reflected the risk allocation agreed at that time with the train operator under the station access agreement and the revenue share arrangements. At the time, Infratil made a commercial decision to continue with the unregulated revenue share agreement, without apparently considering revisions to its station access arrangements. As explained in paragraph 54, it is not our role, nor do we have the powers to do so, to disturb arrangements entered into by the parties following commercial negotiation outside the statutory access regime contained in the Act.

- (d) *Treatment of previous commercial agreements:* As we explain in detail in paragraphs 52 and 53, whatever expectations parties had at the time of the revenue share agreement being signed, they chose to contract through an unregulated revenue share agreement with a unilateral termination clause and not the cost recovery mechanism under the regulated access regime.
- (e) *Value of existing capital:* The reasons why we consider that GPA should not be allowed to recover any return relating to the capital value of the station, however calculated, through the regulated long-term charge are provided above in paragraphs 49 to 65.
- (f) *Treatment of the link bridge:* We have provided in paragraphs 75 and 76 above an explanation of why costs associated with the maintenance, repairs and renewals of the link bridge have been excluded from the calculation of the charge.

115. GPA, in particular, states that our approach is arguably inconsistent with a number of our statutory duties and in a number of places explains why GPA considers that our decision is unreasonable. As we explain in paragraphs 34 to 38, our statutory duties set out a number of public interest issues which we are required to consider when making decisions on station access applications. When taking such decisions it is necessary for us to exercise judgment, taking into account the particular circumstances of each case.

and having regard to the full range of matters which we must take into account. Guidance has been given by the Court of Appeal in *Winsor v Bloom* [2002] EWCA Civ 955 [2002] 1 WLR 3002 (applied by Mr Justice Moses in *R on the application of London and Continental Stations and Property Ltd v Rail Regulator* [2003] EWHC 2607) on this point:

"In giving directions, and in performing his other duties, the Rail Regulator is required by section 4 to exercise his powers in a way which furthers the national and public interest in having an efficient and effective railway system."

116. Further guidance in relation to regulatory functions such as ours is given by Lightman J in *R v Director General of Telecommunications ex p Cellcom and others* [1999] ECC 314. This case concerns decisions taken by the Director General of Telecommunications. Section 3(2) of Telecommunications Act 1984, like section 4 of the Act, required the Director General to take account of a range of considerations when coming to a decision. At paragraph 25 of *ex parte Cellcom*, Lightman J said:

"In my view it is plain that the various duties imposed by [the section] may pull in different directions and may conflict... The Director is not paralysed because such a conflict arises: rather he is given a choice how that conflict is to be resolved and to decide priorities, and so long as he bears in mind the entirety of his duties, has a predisposition to fulfil all the duties so far as this is practicable and with those duties in mind makes a decision which promotes one or other of the objectives specified (and is rational) his decision stands and is not open to challenge."

117. GPA, in particular, has challenged our consideration of specialised economic issues. For the reasons set out above we consider that our decision is a fair and reasonable one having taking into account the various complexities which have arisen during our consideration of this case.

Yours sincerely



Brian Kogan

ANNEX A – Comparison of the directed access agreement against contract submitted by First Scotrail