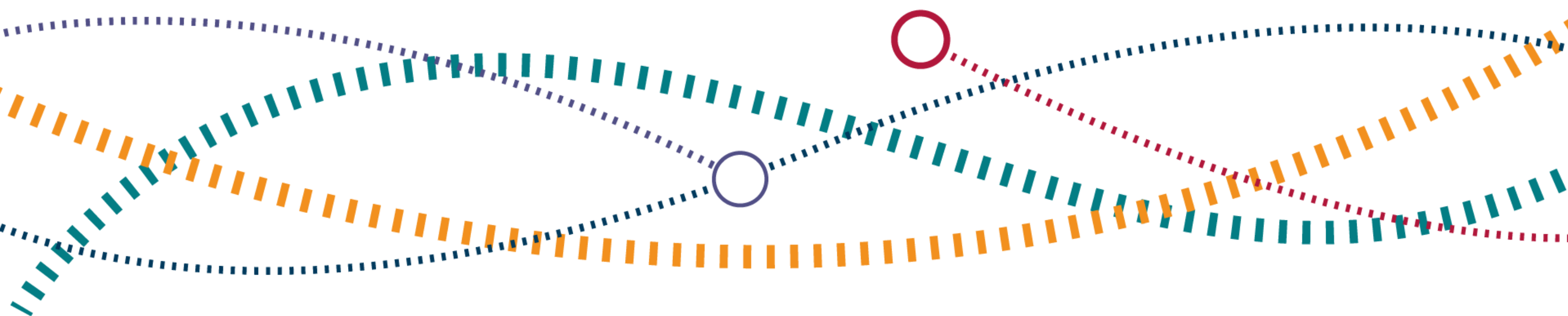
Investment Recovery Charge for Phase One of HS2

11 August 2022



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Executive summary

1. This document explains the Office of Rail and Road's (**ORR**) decision to allow the infrastructure manager (**IM**) of Phase One of High Speed 2 (**HS2 Phase One**) to levy an Investment Recovery Charge (**IRC**) on future rail users of the infrastructure, pursuant to paragraph 3 of Schedule 3 to the Railways (Access Management and Licensing of Railways Undertakings) Regulations 2016 (**the 2016 Regulations**). This decision will form part of ORR's determination of the charging framework for HS2, which will be determined nearer the start of operations[1].

2. This document sets out ORR's conclusions based on the evidence supplied by the Department for Transport (**DfT**) in meeting the legal requirements for the inclusion of an IRC for HS2 Phase One in that charging framework[2]. Although this is taking place well in advance of the start of operations, we consider it beneficial to assess the evidence now; not only to provide certainty for DfT and future operators on the network, but also to ensure that our evaluation is able to take into account evidence which is contemporaneous to the decision to proceed with the project.

3. The context for this decision is an exchange of letters between Clive Maxwell, Director General, High Speed Rail Group at DfT and John Larkinson, Chief Executive of ORR, dated 21 and 29 January 2020 and 1 November 2021, and an April 2020 Notice to Proceed issued by the Secretary of State for Transport, The Rt Hon Grant Shapps, following discussions with the Treasury and the Prime Minister. DfT considers that this Notice to Proceed marks the decision to proceed with Phase One of the HS2 project, for the purposes of the test set out in paragraph 3 of Schedule 3 to the 2016 Regulations (**the Paragraph 3 Test**).

4. ORR considers that the Paragraph 3 test is satisfied for the following reasons:

   - There was no realistic possibility that the HS2 Phase One project would have been approved without at least part of the long-term costs of the project being recovered from railway users. There was no other likely source of commercial funding, and the Government is clear in its Full Business Case (**FBC**)[3] and in

[1] The HS2 project is seen as a single project by its funders, who consider that Phase One does not exist in isolation from the subsequent phases. In a letter to DfT (dated 29th January 2020 on Ability to charge an Investment Recovery Charge (IRC) for HS2 - 29 January 2020 (orr.gov.uk)), ORR considered the rationale for an IRC to be levied on users of HS2 to be consistent with the legal requirements. ORR stated that assertions that an IRC is required will need to be evidenced and that the strongest evidence is likely to be explicit evidence of the position contemporaneous to the investment decision. The evidence submitted by DfT and considered in this document, is in support of the Notice to Proceed with Phase One of HS2. As such, this decision relates to Phase One of HS2. We anticipate that DfT will seek approval for an IRC in relation to subsequent phases of the project in the future.

[2] This document proceeds on the basis of the legal framework in place today. ORR's determination of HS2's charging framework will, however, be taken in the context of the legal framework applicable at the time.

[3] Full Business Case High Speed 2 Phase One Moving Britain Ahead

the approval of the project by the Secretary of State for Transport and the Treasury, that such approval was conditional on a significant contribution from surplus revenues towards the costs of the project.

- Sale of an infrastructure concession is an option that has been in the contemplation of DfT throughout the project, as set out in the FBC. The sale of an infrastructure concession would, in practice, require an IRC to make it a viable option. If, as DfT asserts, and as the FBC confirms, the availability of this option was necessary for approval of the project, so that there was no realistic possibility of the project being approved unless that possibility was preserved, then that in itself would be sufficient for the Paragraph 3 Test to be satisfied.

- Both a long-term operating franchise and an operating concession must allow for the possibility of non-discriminatory access to the HS2 network by another operator. As such, both would require an IRC in order to be commercially viable.

- Although it is arguable that an IRC would not be required under either the 100% Franchise model or the Public Operator model in order to ensure a contribution to long-term costs from rail users, we are satisfied that:

  - DfT would not be prepared to commit to a 100% Franchise model at this stage, and note that, under current legislation, the Secretary of State could not guarantee exclusivity to any incoming franchisee for the duration of the franchise contract; and

  - the project would not have gone ahead if the only option were to retain HS2 in public ownership for the foreseeable future.

- In view of the above, we have decided to permit the inclusion of an IRC for Phase One of the HS2 project in any future charging framework for HS2. Below, we set out the relevant legal test and our conclusions on the justifications and evidence advanced by DfT against that legal test.

1. Introduction

1.1 HS2 is a major rail infrastructure project comprising the construction of a high-speed rail line. The High Speed Rail (London-West Midlands) Act 2017 that authorised Phase One of HS2 was granted Royal Assent in 2018. The Government authorised the main construction work in April 2020 (Notice to Proceed). Phase 2a is planned to extend the line to Crewe and Phase 2b is planned to extend the line to Manchester, with connections onto the national network completed by 2035-2040.

1.2 The relevant statutory regime in relation to recovery of long-term costs has been in place for several years, however, in this case the legal test has to be applied to a very large and complex construction project that is still at a relatively early stage, and that will not be operational for some time to come. In particular, the charging framework for HS2 will not be determined until much nearer the start of operations. Nor has it yet been determined which precise operating model will be applied to HS2, in terms of IM and train operators, or indeed whether the IM (or operators) will remain in public ownership.

1.3 For the purposes of the Paragraph 3 Test, the key legal issue is whether the third criterion for approval is satisfied, which is that the HS2 project was "*one that could not otherwise have been undertaken without the prospect of [higher charges set on the basis of the long-term costs of the project]*": see Schedule 3, sub-paragraph 3(2)(b) of the 2016 Regulations. ORR accepts that the other two criteria are satisfied, for the reasons set out below.

1.4 We consulted on our proposed decision in March 2022. The consultation closed on 13 May 2022. In total, we received four responses, which can be found on our website[4]. Of those four responses:

- two responses (from High Speed One Ltd and Transport for London) supported our proposed decision;
- Two other responses (from Malcolm Griffiths and Deborah Mallender[5]) did not object specifically to HS2 charging the IRC but expressed concerns that the HS2 project's value-for-money may have been overestimated as relevant information may not have been considered in the HS2 project's business case. Specifically, Malcolm Griffiths questioned why sunk costs and Office for Budget Responsibility (**OBR**)'s revised GDP growth forecast

[4] Investment Recovery Charge for Phase One of HS2 – Consultation on proposals and invitation to comment | Office of Rail and Road (orr.gov.uk)

[5] On behalf of the Madeley Independent Residents STOP HS2 Action Group

from March 2018 to April 2020 were not accounted for in the business case, whilst Deborah Mallender was concerned that the cost of tunnelling through a coal field at Madeley in Staffordshire may not have been included in the costs of the project.

1.5 This document sets out our decision and gives reasons for that decision. In reaching our decision, we have considered the representations provided. For the reasons set out below, our view is that DfT has provided sufficient evidence to enable it to levy a charge to recover the long-term costs of the HS2 project.

2. Legal Framework

The role of ORR in setting the charging framework for charges to rail users

2.1 Regulation 14(1) of the 2016 Regulations requires ORR to "*establish the charging framework and the specific charging rules governing the determination of the fees*" which the IM must charge. Regulation 14(2) requires an IM to "*determine the fees to be charged for use of the railway infrastructure in accordance with the charging framework, the specific charging rules, and the principles and exceptions set out in Schedule 3*". The IM must then collect the fees from users of its infrastructure.

2.2 Regulation 31(2) of the 2016 Regulations provides that ORR is responsible for ensuring that the charges levied by the IM comply with the requirements of Part 4 (Regulations 14 to 18) and Schedule 3 to the 2016 Regulations.

2.3 Accordingly:

(a) It is for the IM to set fees for the use of that infrastructure that comply with both the framework and charging rules set by ORR, and the principles and exceptions set out in Schedule 3 of the 2016 Regulations.

(b) An IM is given discretion to determine the fees to be charged for the use of its infrastructure in the way it deems most appropriate to recover its costs, but it must exercise that discretion in accordance with ORR's charging framework and the specific charging rules, which must themselves comply with the 2016 Regulations' charging principles and exceptions.

(c) It is for ORR to be satisfied that the charges being levied comply with the requirements of the 2016 Regulations and to adjudicate on any appeals that may be brought by applicants in relation to such charges.

The test for recovery of long-term costs

2.4 The principles of access charging are set out in paragraph 1 of Schedule 3 to the 2016 Regulations. The starting point is that "*charges for the minimum access package and track access to service facilities... must be set at the cost that is directly incurred as a result of operating the train service*" (paragraph 1(4)).

2.5 Where an IM wants to levy charges to recover costs above those that are directly incurred, two exceptions apply:

(a) in order to obtain full recovery of the costs incurred, the IM may levy *"mark-ups"* on the basis of efficient, transparent and non-discriminatory principles (Schedule 3, paragraph 2); and

(b) for specific investment projects, where three criteria are fulfilled, the IM *"may set or continue to set higher charges on the basis of the long-term costs of the project"* (Schedule 3, paragraph 3).

2.6 The second exception is the focus of this decision.

2.7 The full wording of the Paragraph 3 Test is as follows:

"(1) Subject to sub-paragraph (2), for specific investment projects completed--

(a) since 15th March 1988; or

(b) following the coming into force of these Regulations,

the infrastructure manager may set or continue to set higher charges on the basis of the long-term costs of the project.

(2) For sub-paragraph (1) to apply--

(a) the project must increase efficiency or cost-effectiveness; and

(b) the project must be one that could not otherwise have been undertaken without the prospect of such higher charges.

(3) A charging arrangement to which sub-paragraph (1) applies may incorporate agreements on the sharing of the risk associated with new investments."

2.8 ORR considers the first criterion of the Paragraph 3 Test to be clearly satisfied in the case of HS2 Phase One. Work began on Phase One of HS2 between London and Birmingham in 2018 following Royal Assent of the High Speed Rail (London and West Midlands) Act 2017. At the date the Notice to Proceed was authorised, the delivery into service of HS2 Phase One was scheduled to happen between 2029 and 2033.

2.9 The second criterion of the Paragraph 3 Test requires that the project increases efficiency or cost effectiveness. Paragraph 3 of Schedule 3 to the 2016 Regulations does not provide further guidance on how the efficiency or cost-effectiveness of a project is to be assessed nor against which benchmark the increase is to be measured. ORR considers that factors such as increased rail capacity, reductions in journey times brought about by the project, potential for the relief of congestion on roads or other modes of transport, and potential beneficial

environmental effects could be relevant factors in establishing that this criterion is met.

2.10 ORR also considers the second criterion of the Paragraph 3 Test to be satisfied in the case of HS2 Phase One based on the evidence DfT has presented. HS2 is predicted to have significant transport and economic benefits. The benefits described in the Phase One strategic case, and which DfT expects to be strengthened by future phases of the HS2 project, include:

(a) creating additional capacity along one of the UK's busiest rail corridors (i.e., the West Coast Mainline (WCML)) with thousands of extra seats [FBC §8, §10, §§1.8-1.28];

(b) increasing the capacity of the wider rail network (e.g., by providing high-speed inter-city services on dedicated lines, HS2 is expected to free up train paths and platforms across the heavily congested WCML) [FBC §12, §§1.8-1.28, §§1.44-1.51];

(c) improving connectivity by halving journey times between the centres of UK's largest cities [FBC §13, §10, §§1.8-1.28, §§1.62-1.64];

(d) acting as a catalyst for wider growth in the Midlands and the North [FBC §1.86; §§1.52-1.61]; and

(e) contributing to the government's net zero carbon objective including by taking passengers off domestic flights and reducing the demand for new roads [FBC §9, §14, §1.2, §§1.89-1.103].

2.11 The strategic case also examined several alternative strategies to deliver similar benefits and concluded that these would not provide a lasting solution. They would involve substantial costs, be massively disruptive for passengers over many years and result in a more overcrowded and less resilient network. [FBC §11, §§1.29-1.42]

2.12 In addition to the benefits described in the strategic case, the economic case in the FBC estimated that for every £1 invested in HS2 Phase One, it will create £1.20 in benefits [FBC, Table 2.1]. Although this was assessed as 'low' value-for-money according to DfT's value for money framework for economic appraisal, DfT considered that Phase One should be seen as an enabler to the full "Y" network. For the full HS2 network, every £1 invested will create £1.50 in benefits, delivering £94.7bn in benefits overall (including wider economic impacts) [FBC, Table 2.1].

2.13 We have carefully considered the concerns raised by two respondents in relation to the value-for-money assessment undertaken in relation to the HS2 project, including the specific issues raised by Malcolm Griffiths and Deborah Mallender.

2.14 The evidence submitted to us by DfT indicates that the value-for-money assessment was undertaken in line with the HM Treasury Green Book[6] and DfT's Transport Appraisal Guidance **(TAG)**. Specifically, the economic appraisal in the FBC relies on the latest TAG databook (May 2019), which had updated GDP deflator and annual GDP growth forecasts reflecting the latest updates by OBR at the time of analysis. The FBC also clarifies that costs incurred prior, up-to, and including December 2019 were not included within the economic appraisal as they are sunk (except for some costs relating to Land and Property which may be redeemable)[7] .

2.15 This assessment was subject to scrutiny by Government institutions with relevant expertise and authority. These include DFT's Investment, Portfolio and Delivery Committee (**IPDC**), the Government's Major Projects Review Group (**MPRG**[8]) and Ministers in DfT and HM Treasury.

2.16 Our view is that the output of the value-for-money assessment (and the Paragraph 3 Test more generally) should be considered as at the time of the analysis that supports the decision to proceed with the project. The fact that some further development may have happened after this analysis should not affect the validity of the assessment for the purposes of the Paragraph 3 Test.

2.17 On that basis, we have considered the value-for-money assessment as set out in the FBC to inform our decision. However, for the avoidance of doubt, we have not undertaken (i) our own detailed analysis in order to form an opinion regarding the appropriateness of this value-for-money assessment as at the time of the decision to proceed, or (ii) any attempt to update the analysis submitted by DfT. We consider the institutions identified above to be the appropriate bodies to make such a judgment in deciding whether the project continues to be offering value-for-money, including in respect of the issues raised in the responses to our consultation.

2.18 The third criterion of the Paragraph 3 Test requires that the project *"could not otherwise have been undertaken without the prospect of such higher charges"* (i.e., charges calculated on the basis of the long-term costs of the project).

2.19 The requirements and application of the Paragraph 3 Test were considered in the case of *Heathrow Airport Ltd v Office of Rail And Road* [2017] EWHC 1290 (Admin) (26 May 2017), in relation to a decision of ORR that the owners of

[6] The Green Book is guidance issued by HM Treasury on how to appraise policies, programmes and projects. It also provides guidance on the design and use of monitoring and evaluation before, during and after implementation.

[7] See Full Business Case, para 2.32, page 52.

[8] MPRG is a scrutiny panel for major central government projects and programmes, sponsored by HM Treasury and coordinated by the Infrastructure Projects Authority (IPA).

Heathrow Airport (**HAL**) had ***not*** satisfied the Test in respect of a proposed IRC relating to the Heathrow Spur linking the Airport to the main rail network.

2.20 That judgment affirmed ORR's approach in respect of the nature and application of the Paragraph 3 Test, and also made a number of findings as to the nature of the test:

(a) The test is to be interpreted *"on a plain English reading of the legislation and principles of EU law, together with our overall understanding of the purpose of the Regulations and European Directives"* [§23].

(b) The test does not require the full project costs actually to be recovered from the project users; the long-term costs set a maximum level of charges if the infrastructure manager decided to make use of the exception. The exception did not require the actual cost recovery to have matched any expectation of cost recovery forecast at the outset of the project [§24].

(c) The IM must be able to demonstrate that the project could not have gone ahead without the prospect of levying charges on rail users that made at least some contribution to the *"long-term costs of the project"* [§26].

(d) However, the 2016 Regulations do not require an IM to demonstrate that the project could not have gone ahead unless the higher charges imposed were sufficient to recover ***all*** the long-term costs of the project from rail users, if it is to be permitted to levy ***any*** higher charges under this exception [§25].

(e) The operative requirement is that the undertaking of the project was contingent on the prospect of higher charges being levied [§25].

(f) The phrase *"could not"* does not require proof of an impossibility. The mere fact that a piece of rail infrastructure could in principle have been publicly funded could not have been intended to preclude reliance on the exception. Likewise, in a commercial setting, the theoretical possibility of private commercial funding should not cause the exception to be disapplied [§26]. Accordingly, a realistic commercial standard should be applied.

(g) The relevant question is whether the IM has shown that, when the decision was taken to approve the project, there was no realistic commercial possibility of the project going ahead without the prospect of levying charges on rail users that contributed to the historical long-term costs. The burden of proof is on the IM [§26].

(h) The best evidence would be explicit contemporaneous evidence, focused on identifying the decision to proceed with the project, and the commercial basis upon which that decision was made. However, all the evidence has to be

considered in the round, which means drawing inferences from all the available evidence. Subsequent evidence could also cast light on the basis for the original decision, including commercial conduct showing an expectation of long-term cost recovery from rail users and actual recovery of higher charges from rail users [§27].

(i) The question is not whether the project might not or even would not have gone ahead without the prospect of an IRC – the test is whether it has been shown that there was no realistic commercial possibility that the project **could have** gone ahead without a prospect of some infrastructure cost recovery from rail users [§64].

2.21 As such, the application of the test is highly fact specific and requires the exercise of judgment by ORR.

Application of the third criterion of the Paragraph 3 Test to HS2 Phase One

2.22 As noted above, the overall test applied by ORR to the HAL decision was that "*there was no realistic prospect of the project going ahead without at least some, but not necessarily all, of the Historical Long-Term Costs being recovered from charges levied on rail users. This would mean HAL showing that at least some part of those costs could not be recovered from the other identified source of finance*" [§62].

2.23 We have applied the test to the present facts, in order to determine whether DfT has shown that, when the decision was taken to approve Phase One of the HS2 project in April 2020, there was no realistic commercial possibility of HS2 Phase One going ahead without the prospect of levying charges on rail users that made at least some contribution to the long-term costs of the project.

2.24 DfT has not yet determined which precise operating model will be applied to HS2, in terms of IM and train operators, or indeed whether the IM (or operators) will remain in public ownership.

2.25 In the evidence that DfT has produced, it has identified five possible options under which HS2 could, in principle, operate. We have therefore considered the test in relation both to the project as a whole, as well as to each of the possible options:

(a) The FBC has been calculated by reference to two simplified models:

(i) Public Operator; and

(ii) 100% Franchise;

(b) DfT's paper "Investment Recovery Charge – Department for Transport evidence paper" (the **DfT evidence paper**[9]) identifies three alternative models:

(i) Infrastructure Concession;

(ii) Franchise plus Open Access Competition; and

(iii) Operating concession.

The recovery of higher charges

2.26 ORR notes the following points:

(a) The construction of HS2 Phase One has been funded by general taxation and borrowing and without any obvious alternative source of commercial funds. Given the scale of the project, it has been accepted throughout that it could not be funded by the private sector, or any equivalent to the recovery of long-term costs from airport users available to HAL. While there are a number of strategic benefits identified in the FBC, there is no obvious commercial beneficiary or class of beneficiaries that could be expected to make a substantial contribution to, let alone cover the entirety of, the very high long-term costs of the HS2 project. In reality, the only commercially realistic options for covering the long-term costs of the project appear to be the general taxpayer or the future users of the new HS2 services.

(b) It is clear from the FBC that the calculation of HS2 costs was predicated upon being able to return *"surplus revenues"* to Government following completion. This assumption underpinned the *"value for money assessment"* in the FBC, which is required by HM Treasury for the expenditure of public funds. HM Treasury's requirement is set out in its "Guidance on Approvals Process for Programmes and Projects", paragraph 1.2:

"HM Treasury (HMT) scrutinises and approves any project and programme spending that is outside Delegated Authority Limits (DAL) set by HMT. This is to ensure that all spending proposals reflect the priorities of the government of the day and meet the four criteria for the use of public funds, as documented in Managing Public Money (MPM): regularity, propriety, value for money and feasibility. Because the value for money criterion is often the most difficult to demonstrate, all spending proposals must be developed and presented in accordance with central guidance – in particular the Green Book

[9] Investment Recovery Charge – Department for Transport evidence paper (December 2020)

and supplementary business case guidance, and the government's Functional Standards."[10]

(c) As set out in the DfT Evidence Paper, the Government's approach since it first announced its intention to build HS2 in the 2010 Command Paper has been that the project must be underpinned by a robust business case. The 2010 Command Paper outlined the strategic case for HS2 and also included a value for money assessment.[11]

(d) Since 2010 DFT has taken a staged approach to business case development, culminating in the April 2020 FBC. The FBC includes a Financial Case, which sets out that the project is affordable, and the Economic Case, which sets out that the project is value for money.

(e) The analysis in both cases depends on an assumption that the surplus revenues from HS2 operations will be available to Government. As set out in Annex A of the letter from Clive Maxwell[12] to John Larkinson, of 21 January 2020:

"(ii) Ministerial agreement for the Notice to Proceed will also require that the project is supported by an acceptable business case, as required by Managing Public Money. This includes an economic case demonstrating that the project is value for money and a financial case demonstrating that the project is affordable.

"(iii) Both the value for money and the affordability assessments in the business case rely on the operating surplus from HS2 being returned to government. The economic case relies on these revenues being received by Government to offset initial construction costs, while the financial case relies on these revenues being available to Government to pay for additional support to the classic rail network".

(f) This assertion is borne out by the FBC, which was in turn a critical element in the approval of the project both by DfT itself and by HM Treasury. The costs

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[10] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/567908/Treasury_approvals_process_guidance_final.pdf

[11] 2010 Command Paper. The Strategic Case is set out in Chapters 2 and 3. The value for money assessment is summarised in Table 5.1
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/228887/7827.pdf

[12] 21 January 2020 letter from Clive Maxwell to John Larkinson – Referenced text can be found on page 6.
https://www.orr.gov.uk/sites/default/files/om/investment-recovery-charge-irc-for-hs2.pdf

which informed the economic assessment and the Net Present Value Assessment (**NPV**) were both calculated by reference to deducting revenue arising from rail users from the costs of construction:

"2.14 The economic assessment includes the expected costs to the Government of the programme which are presented in Net Present Value (NPV) terms. This includes the capital costs of constructing the railway, and the operating costs of running it. ***The revenue arising from additional rail passengers is deducted from those costs to calculate the net impact to the public sector.***

2.15 This assessment relies upon the operating surplus from HS2 services reverting to Government, to offset in part the initial construction costs" (bold emphasis added).

(g) Likewise, the benefits costs ratio (**BCR**) of the project was calculated on the assumption that there would be a contribution from rail-users to capital costs. The BCR analysis for the Parliamentary Powers Network i.e., Phase One only (FBC table 2.3) and the Statement of Intent Network i.e. Phase One and 2a (FBC table 2.6) both calculated BCR by reference to capital costs and revenues. Net costs to Government are calculated by reference to total costs (capital costs, renewals and operating costs), minus the revenues. The BCR for the full network[13] is calculated in the same way (table 2.9). The current BCR for Phases One and 2a is 1.2 (low value for money), and the BCR of the full network is 1.5 (low to medium). It is apparent that any significant impact on the revenue figure will impact the BCR and in turn the value for money (**VFM**) assessment.

(h) The series of calculations shows the scale of the assumed revenues, and their importance to the BCR calculation. The assumed revenues for the Full Network are £45.4bn (FBC table 2.9), which is around 42% of the total cost of the project. The calculation is clearly underpinned by the assumption that significant surplus revenues will be generated from HS2 services and that those surplus revenues will be received by Government, to offset in part the costs of constructing the railway.

2.27 Overall, ORR is satisfied that the key assessments of the FBC regarding BCR and VFM assessment are predicated on the prospect of recovery of at least part of the capital costs from surplus revenues, and that approval of the FBC was a pre-

[13] ORR notes that the Government's integrated rail plan for the North and the Midlands (**IRP**) was published in November 2021, stating that the plans for the full HS2 network have changed. However, the decision as to whether the Paragraph 3 Test is met focusses on the evidence available at the time the decision to proceed was made, which is April 2020.

requisite to Government authorising HS2 Ltd to issue Notices-to-Proceed to its Main Works Civils Contractors [DfT Evidence Paper §16-28][14].

2.28 As such, ORR considers that DfT has shown that there was no realistic commercial possibility that HS2 Phase One could have been approved without the realistic prospect of “surplus revenues from rail users” contributing to the long-term costs of the project. Further, we consider that DfT has shown that “at least some part of those costs could not be recovered from the other identified source of finance”. As noted above, there is no identified alternative source of private funding for HS2, and we accept that the project could not realistically have proceeded if the entire cost of the project had fallen on general taxation, with no contribution from rail users.

2.29 However, in considering the evidence put forward by DfT, ORR has also considered whether it is appropriate to equate recovery of “surplus revenues from rail users” more generally with the “higher charges” required by the Paragraph 3 Test. We have examined whether those surplus revenues could be obtained by the owner or funder of HS2 **without** the IM levying any “higher charges on the basis of the long-term costs of the project”, i.e., without an IRC actually being levied.

2.30 As such, not only did we consider alternative sources of funding for the HS2 project, as set out above, but we also went on to consider whether, in the models proposed by DfT:

(a) some contribution to long-term costs had to be obtained from rail users (whether directly or indirectly); and

(b) the levying of an IRC (or some form of access charge that was equivalent to an IRC) by the IM was necessary for condition (a) to be satisfied.

2.31 Our consideration of these issues focused on three areas:

(a) an IRC in relation to an infrastructure concession;

(b) the public operator and 100% Franchise models; and

(c) the legal context and need for non-discriminatory access.

[14] DfT has provided evidence that services provided by OAOs would have a potentially significant adverse impact on the BCR analysis, and that the higher the number of services provided by OAOs the fewer the number of services run by franchisees and the lower the value of the franchise. According to the DfT analysis, the effect of services run by OAOs would cut the net surplus available to government by between 19-57% (based on only one hourly service run by an OAO rather than a franchised operator) and would result in government facing a net deficit position if three trains per hour were run by non-franchised operators. This would affect the BCR, reducing the BCR for the Full Network from 1.5 to 1.3 with wider economic impacts (WEIs) or 1.2 to 1.0 without WEIs. This would in turn affect the VFM assessment, changing the assessment from low to poor (§§64-5 DfT Evidence Paper, Annex A §§5-6, 8 Table 4).

Infrastructure concession

2.32 For the purposes of an infrastructure concession (the option set out at §2.25(b)(i) above), ORR is satisfied that an IRC would be required in order for an infrastructure concession model to be a viable mechanism by which to ensure that rail users make a contribution towards capital costs.

2.33 This is the model that was adopted for High Speed 1 Limited (**HS1**), with a 30-year concession being sold shortly after completion of the HS1 project. The advantage of such a model is that the concessionaire makes a substantial contribution to the infrastructure costs at an early stage (and prior to the commencement of services) on the basis that it will then recoup that payment from the train operating companies (TOCs) by means of an IRC.

2.34 As noted at §§ 86-88 of the DfT Evidence Paper, this has been an option that has been in the contemplation of DfT throughout, including in the 2013 Financial Case:

"… the specific option of seeking to monetise the up-front investment by way of one or more operating concessions following completion of HS2 and the start of passenger operations, as was the case with HS1. This would not help with the up-front capital requirement from the taxpayer, but would mean a capital lump sum, potentially a significant one, flowing back to the taxpayer to offset part of the initial construction costs".

2.35 ORR is satisfied that the analysis provided by DfT demonstrates that the value of a concession sale without an IRC would be only a small fraction of the value of a concession sale with an IRC, as the ability to levy an IRC forms a very significant part of the estimated revenue for any IM bidding for a concession [§§92-3 DfT Evidence Paper].

2.36 As such, ORR accepts that an infrastructure concession without an IRC would not be a credible commercial option. We do not consider that there is a realistic possibility that DfT would have been willing to proceed with the project on the basis that a prospective purchaser of a long-term infrastructure concession would be unable to levy an IRC. It follows that, if the preservation of this option was a necessary condition for approval of HS2 Phase One, so that there was no realistic possibility of the project being approved if this option was not available, then the Paragraph 3 Test is satisfied.

2.37 Further, ORR considers that, even if we had concluded that there is insufficient evidence to demonstrate that retaining the option of an infrastructure concession was a condition precedent for the project proceeding (i.e. that DfT had not demonstrated that there was no commercial possibility of the project being approved unless the possibility of an infrastructure concession was retained), then

a public operator, franchise or Operating Concession model also require an IRC or a charge equivalent to an IRC in order for there to be a realistic commercial possibility for recovering the construction costs from rail users in the way envisaged in the FBC, for the reasons set out below.

The Public Operator and 100% Franchise Model

2.38 The FBC modelling assumes that the Government will either have all services run by a single public operator on HS2 infrastructure (the Economic Case) or have a franchise type agreement with a single TOC operating all HS2 services (the Financial Case) [DfT Evidence Paper §41] (the options set out at paragraph 2.25(a) above).

2.39 ORR has considered whether the inclusion of these possibilities in the FBC undermines DfT's ability to satisfy the Paragraph 3 Test and supports an argument that the Paragraph 3 Test is ***not*** satisfied, on the basis that:

(a) If the operator were publicly owned, all surplus revenues would automatically return to Government, whether or not an IRC was levied.

(b) In the case of a single exclusive franchisee, the franchisee would pay an annual premium directly to Government (on the assumption that a surplus would be anticipated when the franchise agreement was reached). The level of that premium would vary depending on the anticipated costs of the franchisee, including its anticipated liability for access charges.

2.40 However, ORR does not consider that these two possibilities are sufficient to show that the Paragraph 3 Test is not met. This is for a number of reasons:

(a) We consider it is reasonable to conclude that the premium payable by a franchisee directly to HMG is an alternative way of obtaining finance from rail users and reflects the balance between anticipated costs and anticipated revenues. The only reason why an exclusive franchisee would be prepared to pay a premium is because they are confident that their exclusive long-term rights over the relevant part of the network will generate profits. On that basis, a premium payment levied on such operators in lieu of an IRC is not to be regarded as a commercial alternative that results in the Paragraph 3 Test being failed, in that such an alternative is, in reality, equivalent to an accelerated lump-sum payment of an IRC. That is clearly the assumption that was made in respect of HS2: [DfT Evidence Paper, §§45-46]. If an IRC were not levied on an exclusive franchisee, then the increased premium payable by the franchisee would, in effect, be an additional lump-sum payment (or series of lump-sum payments) contributing to the capital costs directly to

Government rather than by paying a higher level of access charge to the IM which is then passed on to Government indirectly.

(b) In the case of a Public Operator, the return of supplemental revenues to Government would be the means by which a contribution from rail users was obtained. Even where HS2 remained in public ownership, the legislation requires separation between the IM and operating companies and the preparation of accounts that separately identify income from infrastructure charges and other sources, including state funding. As such, essentially the same issue would arise as in respect of a 100% franchisee – the state-owned operating company would either pay an IRC to the IM (whether or not state-owned) or would contribute an equivalent sum directly to the Secretary of State. In either case, any direct payment to the Secretary of State would be in lieu of, and commercially equivalent to, an IRC levied by the IM.

2.41 Moreover, even if these options did present a realistic alternative to an IRC and provided the means to secure surplus revenues from rail users, we do not consider that there is a realistic possibility that the Secretary of State would have approved the HS2 Phase One project if the only two options were that HS2 were operated either under State control or as a 100% Franchise. Indeed, for the reasons we set out below, exclusivity of access rights is not permitted under the 2016 Regulations, so the only option left would be for HS2 to be run permanently under state control, with surplus revenues recovered directly from passengers by the Public Operator. We do not consider that the Secretary of State would have approved the project and that HS2 Phase One could have gone ahead if the only possibility for obtaining a contribution from rail users, as envisaged in the FBC but without levying an IRC, would have been to retain the project permanently in public ownership.

The legal context and need for non-discriminatory access

2.42 In reality, we do not consider that the public operator and 100% franchise model would be compatible with the 2016 Regulations. Under those Regulations, there must remain at least the possibility of access rights being granted to other operators on non-discriminatory terms, which would rule out the grant of exclusive rights either to a Public Operator or to a franchisee (or indeed to an exclusive operating concession).

2.43 When considering the Paragraph 3 test for the purposes of the options set out at §2.25(a) above (public ownership and 100% franchise), ORR considers that it must be considered in the full legal and factual context applicable to HS2. In particular, a realistic commercial approach must take account of the legal

framework governing access to rail networks and the requirement that any operator, including open access operators (OAOs), must be allowed access to the network on equitable, non-discriminatory and transparent conditions.

2.44 Under the current regulatory regime (at least prior to the exceptional measures adopted in response to the Covid 19 pandemic), the majority of rail networks are franchised. However, legislation provides for any operator to apply for access to run services, and open access services currently account for around 2% of total UK rail revenues. Under current legislation, any model for the future operation of services on the HS2 infrastructure would need to allow for the possibility of on-rail competition.

2.45 Regulation 6(1) of the 2016 Regulations requires an IM to "*supply to all railway undertakings, in a non-discriminatory manner, the minimum access package described in paragraph 1 of Schedule 2".* The minimum access package includes track access.

2.46 This right of access can only be limited in specific circumstances. ORR applies the Not Primarily Abstractive Test when considering OAO applications which compete with a franchise. As such, although there is an economic test that currently limits the possibilities for competition from OAOs, such a test can only be applied at the point that access to the network is sought. The starting point for considering access to the network must be the statutory requirement of non-discriminatory access for all operators.

Exclusive access rights

2.47 As noted above, the possibility of granting exclusive access is critical to any mechanism to recover surplus revenues without levying an IRC. If HMG could grant *exclusive* long-term rights over the HS2 network, then it could, in principle, require an exclusive franchisee or operating concessionaire to make a substantial contribution to the long-term costs of the network by way of an up-front premium (similar to the likely sale value of an infrastructure concession entitling the new IM to levy an IRC on future users). However, the fact that the current legal framework does not allow HMG to grant exclusive access to the network means that there is no guarantee that surplus revenues could be recovered from operators in this way. Where an OAO was given access to HS2 without an IRC being levied, there would be no mechanism to recover the long-term costs of the network from that OAO, which would in turn undermine the rationale for a long-term franchisee or concessionaire to pay a substantial contribution to long-term costs.

2.48 As such, we do not consider that an operating model predicated on a single operator is in fact achievable under the governing legislation for HS2. Although those models were used in the FBC for the purposes of assessing the anticipated costs and revenues, they both rest on an assumption that there would be a single

operator of services on the HS2 network, i.e., an operator enjoying *exclusive* rights.

2.49 However, we consider that this is best regarded as a simplifying assumption used for the assessment of the FBC – in practice, we do not consider that this assumption is the correct basis to apply the present test. That follows from the fact that, when services commence operation on HS2, whilst it is possible that there will only be a single operator of services the governing legislation for HS2 currently requires that services should, in principle at least, be open to on-track competition. As set out above, the Notice to Proceed issued in April 2020 constitutes the decision to proceed with HS2 Phase One. We think that any decision to go ahead with the project on a realistic commercial basis would have to be taken on the basis of the legal framework in place at that time (i.e., in April 2020) and as such, in the absence of new legislation, there could be no guarantee of exclusivity for the HS2 operator.

Non-exclusive access

2.50 Given the statutory requirement to allow non-discriminatory access to the HS2 network, any franchise or operating concession model would in reality, be a model of non-exclusive operators potentially exposed to on-track competition from other operators (options set out at paragraph 2.25(b)(ii) and (iii) above).

2.51 If exclusive rights cannot be granted, i.e., if rights must be made available to OAOs on a non-discriminatory basis, as the current legislation requires, ORR considers that an IRC is the only viable mechanism for the recovery of surplus revenues as a contribution to the long-term costs of HS2. Without an IRC, OAOs granted access to the HS2 network would be under no obligation to pay any premium in order to use the rail network, and in particular would not be under any obligation to pay an enhanced premium to contribute to the long-term costs of HS2.

2.52 However, if third party operators were not required to pay an IRC this would have a number of important consequences:

(a) Franchisees would be at a commercial disadvantage in comparison to OAOs if they were asked to contribute to long-term costs. This could potentially have an adverse impact on the value of the franchise and/or undermine the willingness of the franchisee to make *any* contribution to long-term costs. Similarly, it would have a direct impact on the value a TOC concessionaire was prepared to bid for an operating concession.

(b) In the absence of an IRC, the only alternative mechanism for increased access charges above direct operating costs is for ‘mark-ups’ pursuant to Schedule 3, paragraph 2, to the 2016 Regulations. However, unlike

paragraph 3, 'mark-ups' are not specifically directed towards the recovery of long-term costs (as against a wider category of operating costs). Further, the ability to levy 'mark-ups' is constrained by the fact that they must not have the effect of excluding market segments (here most likely OAOs) *"which can pay at least the cost that is directly incurred as a result of operating the railway service, plus a rate of return which the market can bear".*

2.53 Whilst the level of any premium or concession sale could in theory be decreased or increased in these circumstances to take account of the presence or absence of an IRC, we do not consider that concessionaires would be willing to pay an increased premium to compensate for the lack of an IRC if they were exposed to competition from OAOs who did not have to pay an IRC and were also facing decreased profitability of the concession as a result of OAOs' access to the network.

2.54 In summary, although we accept that an ***exclusive*** franchisee or operating concessionaire might have been prepared to pay a substantial premium directly to DfT if it had been exempted from an IRC, so that an IRC would not in practice have been strictly necessary to recover surplus revenues from the exclusive franchisee or concessionaire, we do not think that this was a commercially realistic possibility for a ***non-exclusive*** contract. As such, given that any commercially realistic decision to proceed with HS2 Phase One would have been based on the assumption that the legal regime would preclude the grant of either an exclusive franchise or operating concession, we consider that:

(a) there would have been no realistic commercial possibility of HS2 Phase One obtaining approval without the possibility of a (non-exclusive) Franchise or Operating Concession that made a contribution to long-term costs;

(b) the ability of an IM to levy an IRC (whether or not the IM remains in public ownership) is crucial to recovery of the amount of surplus revenues as set out in the FBC, without which the project would not have been approved; and

(c) in any operating model involving at least the possibility of on-track competition, an IRC is the only mechanism by which HMG can guarantee:

(i) recovery of any contribution to long terms costs from OAOs;

(ii) a significant contribution to the long-term costs can be obtained from all rail users on a non-discriminatory basis; and thus

(iii) that surplus revenues (whether or not precisely equivalent to the amounts underpinning the BCR calculations in the FBC) are returned to HMG.

2.55 On that basis, we are satisfied that HS2 Phase One was approved in reliance on recovery of the surplus revenues set out in the FBC. As such, ORR does not consider that there was a realistic commercial prospect that HS2 Phase One could have been approved if the option to levy an IRC on a non-discriminatory basis in a franchise / public operator / operating concession model were not available, as without it the BCR analysis underpinning the FBC would be fundamentally undermined.

3. Conclusion

3.1 ORR has carefully considered the above arguments in reaching its conclusion, in the exercise of its regulatory discretion, that the Paragraph 3 Test is satisfied in this case. While the arguments and legal issues are complex, reflecting both the scale and complexity of the project and the fact that the operating model has not yet been determined, it appears to us that the Paragraph 3 Test is satisfied for the following reasons:

(a) There was no realistic commercial possibility that HS2 Phase One would have been approved without at least part of the long-term costs of the project being recovered from railway users.

(b) There was no other likely source of commercial funding and the Government is clear in its FBC and in the approval of the project by the Secretary of State and HM Treasury that such approval was conditional on a significant contribution from surplus revenues towards the costs of the project.

(c) Sale of an infrastructure concession is an option that has been DfT throughout the project, as set out in the FBC. The sale of an infrastructure concession would in practice require an IRC to make it a viable option. If, as DfT asserts and as the FBC confirms (see §§3.39-3.40), the availability of this option was necessary for approval of the project, so that there was no realistic possibility of the project being approved unless that possibility was preserved, then that would in itself would be sufficient for the Paragraph 3 Test to be satisfied.

(d) Although it is arguable that an IRC would not be required under either the 100% Franchise model or the Public Operator model in order to ensure a contribution to long terms costs from rail users, ORR is satisfied:

(i) that the project would not have gone ahead if the only option were to retain HS2 in public ownership for the foreseeable future; and

(ii) under the legislative regime applicable to HS2 today, and which was applicable at the date the decision to proceed was taken (which any commercially realistic assessment would have taken into account in approving the project), all the commercially realistic models do in fact require an IRC, either:

(1) to preserve the value of an infrastructure concession; or else

(2) to ensure that there could be non-discriminatory access to the HS2 network on terms that allowed the recovery of surplus

revenues to contribute to the long-term costs of the project, as envisaged by the FBC.

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