

**John Larkinson**  
Chief Executive



Clive Maxwell CBE  
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Department for Transport  
Great Minster House  
33 Horseferry Road  
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29 January 2020

Dear Clive

### **Ability to charge an Investment Recovery Charge (IRC) for HS2**

Thank you for your letter dated 21 January 2020, regarding the prospect of charging an Investment Recovery Charge (IRC) on train operating companies running services on HS2.

You explained that the Department for Transport (DfT) is preparing for a “Notice to Proceed” for Phase One of HS2 and that clarity on the prospect of levying of an IRC is an important factor in that decision.

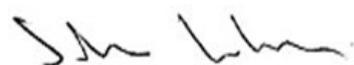
You asked whether the rationale set out in your letter is consistent with the legal requirements for an IRC, as set out in the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016 (the 2016 Regulations).

We have reviewed the rationale for an IRC to be levied on users of HS2, as set out in Annex A of your letter. We consider the rationale to be consistent with the legal requirements to be able to charge an IRC, subject to the provision of contemporaneous documentary evidence supporting all the points set out in paragraph 5(i)-(viii) of Annex A.

The annex to this letter confirms the legal requirements for levying an IRC and explains in more detail the types of evidence that would be required to meet the legal requirements.

I hope you find this helpful. A copy of this exchange of letters will be published on our website in due course.

Yours sincerely



**John Larkinson**  
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## **ANNEX**

### **Legal requirements for levying an IRC**

The principles of access charging are provided in paragraph 1 of Schedule 3 to the 2016 Regulations. The general principle of access charging is that charges must be set at the cost that is directly incurred as a result of operating the train service.

The ability of an infrastructure manager to levy an IRC is an exception to those principles. Approval of the ability to levy an IRC is subject to conditions set out in paragraph 3 of Schedule 3 to the 2016 Regulations. The provision permits an infrastructure manager to set higher charges on the basis of the long-term costs of a project, provided three criteria are met:

- 1) the specific investment project has been completed since 1988 or following the coming into force of the 2016 Regulations;
- 2) the project increases efficiency or cost-effectiveness; and
- 3) the project is one that could not otherwise have been undertaken without the prospect of such higher charges.

### **Determining whether DfT can levy an IRC for HS2**

A decision about whether an IRC is permitted to be levied for HS2 would be made in the context of setting the charging framework, which in the case of HS2, is not likely to be until the project reaches a later stage in delivery. ORR is required to establish the charging framework and the specific charging rules in accordance with Regulation 14 of the 2016 Regulations.

However, we recognise that the prospect of levying an IRC is an important consideration for DfT in making its decision about the future of the project.

### **Evidence required to meet the legal requirements for an IRC**

In determining whether DfT is able to levy an IRC for HS2, ORR will need to consider the evidence that the above criteria are met. Due to the nature of the criteria and the evidence that will be required, this assessment cannot be concluded until after the decision to proceed is made, because the documentation around that decision will form part of the evidence required.

It is important that there is sufficient evidence to demonstrate DfT's rationale that the project meets the three criteria to charge an IRC. We note that the first criterion is straightforwardly satisfied as HS2 will be constructed after 1988 and the coming into force of the 2016 Regulations. The second criterion can be evidenced through an appropriate business case, demonstrating the importance of the project to the efficiency or cost-effectiveness of the railway or the Government's wider transport objectives.



In respect of the third criterion, this requires evidence that when the decision is taken to proceed with a project, that decision could not have gone ahead without the prospect of levying an IRC.

Simple assertions that an IRC is required or analysis which post-dates the decision to invest is unlikely to be sufficient or relevant to establishing that the third criterion has been met. Such assertions will need to be evidenced. The strongest evidence is likely to be explicit evidence of the position contemporaneous to the investment decision. Explicit evidence would ideally focus on identifying:

- (i) the decision to proceed with the project; and
- (ii) the basis on which that decision was made.

That evidence should include and be supported by data and analysis that demonstrates the necessity of an IRC in relation to the HS2 project.



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Dear John

21 January 2020

DFT is preparing for a “Notice to Proceed” decision for Phase One of the HS2 programme. By Notice to Proceed we mean authorisation from Ministers for HS2 to enter into the Major Works Civils Contracts. This is the key go/no go decision for Phase One.

The ability of the Government to secure revenues derived from services run on the railway to defray the costs of construction will be an important factor in this decision. We consider that securing such revenues requires an ability to charge an Investment Recovery Charge (IRC), pursuant to paragraph 3 of Schedule 3 to the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016 (the “2016 Regulations”).

I am therefore writing to you to seek clarity on whether our rationale for charging an IRC on train operators running services on HS2 is consistent with requirements in the 2016 regulations.

As you will know, there is an independent review currently underway that will provide recommendations on whether and how we proceed with the HS2 project. This letter in no way prejudices the outcome of that review. While this review proceeds we are authorised to continue with preparatory work, to ensure that we are ready to proceed without further delay for the main construction stage of Phase 1 in the event that the Government chooses to continue.

Under the 2016 Regulations ORR must establish the charging framework and the specific charging rules governing the determination of the fees to be charged by an infrastructure manager for use of railway infrastructure. In respect of HS2, DFT intends, subject to approval by the ORR, that the charging framework should include the ability for HS2 Ltd to charge an IRC to train operators using HS2 infrastructure. I recognise that the charging framework for HS2 will not be determined until much nearer the start of operations. However, a clear understanding of the ORR’s position on this issue is a necessary pre-condition for the Government’s Notice to Proceed decision.

Under the 2016 Regulations, charges must be set at the cost that is directly incurred as a result of operating the train service. The IRC is an exception to this principle and permits the infrastructure manager to levy higher charges if three conditions are satisfied.

We consider that the proposal to charge an IRC for the use of HS2 infrastructure will satisfy the three conditions set out in regulations and that therefore an IRC should be permitted. Annex A to this letter set out our reasons.

The advice to Ministers on whether to proceed with HS2 will need to include advice on whether or not an IRC is expected to be permitted. I would therefore be grateful if you could provide confirmation that from ORR's perspective our rationale outlined at Annex A would be consistent with the requirements set out in the 2016 Regulations. We understand that the rationale will need to be supported by sufficient supporting evidence.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Clive Maxwell', followed by a period.

**Clive Maxwell**

## Annex A

1. Under paragraph 3 of Schedule 3 to the 2016 Regulations, an Infrastructure Manager (IM) is permitted for to set or continue to set higher charges on the basis of the long-term costs of the project provided that three conditions are met:
  - the higher charges must relate to a specific investment project completed since 1988 or following the coming into force of the 2016 Regulations;
  - the project must increase efficiency or cost effectiveness;
  - the project must be one that could not otherwise have been undertaken without the prospect of such higher charges.

### Investment completed post 1988; or following the coming into operation of these regulations

2. Work on Phase 1 of HS2 between London and Birmingham began in 2018 following Royal Assent of the High Speed Rail (London-West Midlands) Act 2017. Although design work on the project is well advanced and preliminary enabling works are being undertaken, approval to commence construction has not yet been given.
3. Phase 2a is planned to extend the line to Crewe and Phase 2b will extend the line in a 'Y' shape to Manchester in the west and Sheffield and Leeds in the east, with connections onto the national network completed by 2035-2040.

### Project increases efficiency or cost effectiveness

4. HS2 will form the new backbone of our national rail network, providing new capacity and better connections to our major cities, whilst creating more space for commuter and freight trains on our busiest lines. HS2 is predicted to generate significant transport benefits and economic benefits across the UK, having a transformational effect on the country by supporting growth and increased productivity, particularly in the North. It will improve connectivity, free up space on our crowded rail network, promote regeneration, boost local skills, generate tens of thousands of jobs and help secure the UK's future prosperity.
5. DFT has set out our case on the benefits that the project will bring to the UK in the Strategic Case for HS2, last updated for Phase 2 in July 2017, and which will be further updated in a Final Business Case ahead of Notice to Proceed.

### The project could not be undertaken without the prospect of charges based on the long-term recovery of costs

6. The key decision to undertake HS2 Phase One will be when the notices to proceed are issued. A positive decision is dependent on the prospect of the charges for use of HS2 infrastructure including a charge based on the long-term recovery of construction costs, i.e. an IRC. This is for the following reasons:
  - i. The decision to issue the Phase One Notice to Proceed is contingent on the project being agreed by DFT ministers and securing all necessary approvals across Government. In particular HM Treasury's approval is required.

- 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.
- iv. For a project of this scale and duration to be approved, Ministers must be confident that the benefits of the project will be resilient to long term changes in Government policy and the wider commercial environment. This means that there must be maximum flexibility regarding the potential future operational and commercial models for HS2; we have been clear in particular that this must include the possibility of sale of a concession to manage HS2 infrastructure in order to provide early recovery of a significant proportion of the costs incurred.
- v. The ability to charge an IRC is essential in this respect, as it provides an income to the IM that is over and above the direct costs it incurs. Crucially, our analysis shows that without an IRC the sum that could be raised in an infrastructure concession sale would be negligible, effectively ruling out this route as a commercially viable option.
- vi. The consequence of not charging an IRC would be to restrict Government to a limited range of models in which it could rely on recovering surplus revenues via the operator in a franchise-type arrangement, precluding the introduction of alternative models on HS2.
- vii. Further, the absence of an IRC would allow the possibility of open access operators operating services without contributing to the costs of construction because there would be no contractual mechanism by which the Government could charge a “premium” as it currently does in relation to franchised services.
- viii. DFT has assessed the potential revenues to Government under a range of potential commercial models if an IRC were not permitted. This analysis shows that under some commercial models the business case would no longer be able to rely on surplus revenues being returned to government, which would mean that the project would no longer be considered affordable or value for money. This presents a risk that the project may not go ahead without the prospect of an IRC.