

10th April 2019

James Mackay
Head of Regulation and Customer Relationships
HighSpeed1

Dear James

HIGHSPEED 1 CP3 CHARGING PROPOSALS

I refer to the letter of 8th April from the ORR setting out further options and a short further consultation in relation to the Periodic Review 19 process. That letter advises that, whilst these further proposals are being consulted upon, "Eurostar and HS1 should also operate on the basis of an additional step...pending our board's reconsideration of these issues". The reference to an additional step implies a first opportunity to respond within the existing consultation process due to conclude today.

As you will know, Eurostar has made it clear to HS1 and other stakeholders in recent months that there has in effect been no opportunity for Eurostar to engage substantively in the current PR19 consultation process ahead of the currently proposed publication date of HS1's final 5YAMS. This has been due to the quite exceptional and unprecedented regulatory and commercial challenges that Eurostar faces (in many aspects uniquely) and has had to deal with to ensure continued operation of Eurostar services outside the territory of the UK to take into account (ongoing) Brexit uncertainty. It has been inevitable that these challenges have drawn upon the same regulatory and legal resources as would otherwise be committed to the PR19 process.

Eurostar is the largest access customer of HS1 on risk and HS1 charges make up a major part of our cost base. Eurostar is also the only fully commercial operator which means that we also represent the most direct and immediate connection between access charges and the interests of passengers. Eurostar has been clear that without our considered input at the 5YAMS draft consultation stage – and ahead of the further consideration by ORR, our interests and those of passengers will be prejudiced and the process flawed.

Eurostar believes that the further options outlined in the ORR letter of 8th April do offer the potential to address these issues, if they are interpreted as providing the opportunity for Eurostar to undertake a considered response to the current consultation prior to HS1 finalising the 5YAMS. Eurostar will therefore be engaging with that additional process consultation accordingly.

In the meantime, the challenge of the existing process remains. Clearly Eurostar is unable to provide a proper considered response to the draft 5YAMS by today (which is the basis of our concern). Nevertheless, at this stage, it is already clear that there are some areas of obvious and crucial concern within the draft 5YAMS proposals. Our best available current but preliminary view of these is set out below. Whilst it is incomplete, at this stage it is intended to indicate the nature, range and importance of just some of the issues raised by the draft 5YAMS and the importance for

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Eurostar and passengers of being able to undertake the full and detailed work necessary to develop and further substantiate these points and others.

To conclude, these points do not constitute a full consultation response of the type demanded by proper process and the serious nature of our concerns with the draft 5YAMS. Eurostar therefore wholly reserves its rights in respect of making full submissions once it has completed its review and to challenge any process which does not provide for this. However, the latest proposals from the ORR do offer a potential way forward with which Eurostar will engage constructively, reserving its rights in the meantime.

For obvious reasons, the work by Eurostar on Brexit was also essential to the continued relevance of the current draft 5YAMS and indeed, the viability of the HS1 concession in its present form. Given that HS1 in its draft 5YAMS document specifically notes the importance of stakeholder engagement and consultation, Eurostar asks HS1 to reconsider the nature of its engagement with our process proposals to date and that of the ORR. We urge you to adopt a more pragmatic approach in the wider interests of the railway and the passengers who use it.

We have copied this letter to both the DfT and to the ORR

Yours sincerely


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**HIGHSPEED 1 CP3 CHARGING PROPOSALS
PRELIMINARY VIEWS FROM EUROSTAR (SUBJECT TO FULL RESPONSE ONCE EUROSTAR
HAS BEEN ABLE TO CONSIDER AND ASSESS FULLY THE DRAFT 5YAMS)**

Strategic Risk

Since 2011, the first full year of Eurostar's operating as a single commercial entity, the average yield on Eurostar (representing the price customers are willing to pay in a competitive near-Europe market) has fallen by nearly 10%. Over the same period the average charge for each Eurostar train on HS1 has risen by 12% (real) as have other infrastructures charges.

Given that infrastructure is already over 60% of total costs, this means that Eurostar faces a strategic squeeze – unable to raise yields or find sufficient controllable costs to offset infrastructure price-hikes. First this will damage the ability of the business to invest in the development of services and capacity (such as station enhancements); then it will put pressure on prices – pricing off many customers; and eventually it threatens the continuation of services altogether.

Against these strategic pressures, it is essential that there is rigour and ambition from Infrastructure Managers in the efficiency and justification of charges. The HS1 draft 5YAMS entirely fails in this regard. It is weak on efficiency; it seeks at all stages to transfer risk and ramp up contingencies and fees; it provides no confidence of forecasting.

Eurostar believes the proposals need radical revision to strike the right balance between sustainability of funding (against robust forecasts) and the interests of passengers and future sustainability and development of rail services.

Efficiency

The proposals are not sufficiently ambitious on efficiency.

The draft 5YAMS proposes c. 0.7%pa efficiencies on O&M costs. It chooses to use RPI as a benchmark compared to CPI, which has been adopted by ORR for Network Rail. This is less than the 6% imposed by ORR for CP2, and less than HS1's own commissioned report from Rebel. Eurostar has achieved up to 17% opex efficiencies since 2011 and a further 5% reduction in staff costs. It is unclear why Eurostar and its passengers should pay for HS1 to be less efficient than we are.

Risk

Inefficiency is compounded by contingency and risk-transfer.

On O&M HS1 are paying 10% to NR(HS) for a "fixed price" contract. This is recovered from charges. Since a regulatory determination is essentially a "fixed price" for customers anyway, there is no benefit to RUs from this arrangement – HS1 are simply charging us to hedge the regulatory risk that should be theirs.

On the 40 year forecast of renewals, there is the inclusion of 30% contingency further compounded by the charge of 10% fees on top. In addition, the closing balance – which in effect represents a further contingency – peaks at £350m, resulting in both higher charges and the inefficient

stagnation of cash that could more productively be used to, e.g. expand stations and develop services.

Forecasting

We are not confident in the quality of the forecasting which is driving these significant cost increases.

The PR19 process started over a year ago. However, until the end of January there was a variance of £88m vs £133m between HS1 and NR(HS) projections for CP3 renewals costs. The variance between forecast costs on total 40 years' renewal spend from CP2 to CP3 has been 95%. The variance in stations (CP2 to CP3) is between 53% and 80%.

It is notable that HS1 bears little or no risk from a wrong "high estimate" and can always see a low one adjusted in a future settlement, whereas the impacts on RUs and their passengers are immediate. Overly conservative forecasts lead to lower usage and investment. A key responsibility – and inherent concession risk for HS1 – is the quality of their asset management strategies and stewardship. Accurate forecasting is a key element of that but there appears to be no mechanism that exposes HS1 to risk from inaccurate (and particularly excessive forecasting).

Eurostar believes that strategically significant step changes in charges cannot and should not be permitted whilst there are such uncertainties around the quality of forecasting. In particular, Eurostar believes it is impossible to justify a charging regime that monetises forecasts up to CP10 in a context whereby until very recently there was a 66% range of disagreement over what the CP3 numbers should be.

Escrow

The escrow model is fundamentally not fit for purpose. It unnecessarily exposes RUs and passengers to the long term forecast risks identified above. It does not include robust efficiency assumptions. Nearly half of the proposed cost increases are attributable to contingencies and charges – on top of an inefficient level of carrying balance and 60% of the forecast spend falls beyond the current concession period.

It is also flawed in scope. A significant element of the increase in direct costs is attributable to ERTMS. This should not be classified as escrow but dealt with as a specified upgrade. In doing so the view of Eurostar is that this should be treated akin to the initial capital costs of construction with Government bearing a proportion of the costs/risks. Without this international high-speed rail passengers from the UK will be fundamentally disadvantaged compared to any other rail passengers on any other European network, to the lasting detriment of service development and usage.

Whilst the Concession Agreement requires a 40 year "look forward", it does not require a 40 year "pay forward". NR(HS) itself does not even look forward more than 10 years and Bechtel have highlighted the fundamental difficulties in doing so. Such an approach is inefficient (given the level of forecasting risk – unless HS1 is willing to take this?) and disproportionate/unnecessary. On all other European networks (including the private Channel Tunnel concession) the pay forward period is between 1 and 5 years.

Stations

There is a track record of poor forecasting - or, until recently, no forecasting at all – in relation to stations. Asset management has not been strong. In this context price increases of up to 238% (Ashford) are wholly unjustified. HS1 must demonstrate more accurate forecasting and understanding of station assets before any proper view can be formed. Eurostar's view is that **no** increase (0% nominal) should be permitted on stations charges unless and until HS1 has demonstrated effective management of these assets.

In addition, there are fundamental problems of cost allocation. Not only does this apply to the fact that there is no allocation to Thameslink but it particularly applies to the commercial estate. Last year HS1 earned an operating margin of 60% on its retail units yet these businesses make zero contribution to long term costs. This represents a cross subsidy from rail passengers and a fundamental misallocation of the rail funding envelope.

Broader Issues

Eurostar needs to further review O&M charges (and deteriorations in network performance); EC4T charges which are forecast to increase by 46% when proper metered allocation has not yet been established and concerns remain about whether RUs are funding excessive levels of transmission loss (and who should carry the cost risk for any fundamental infrastructure design failures in this regard).

Eurostar notes that there appears to be a significant change in allocation between EIL service and those of LSER despite the reduction in the Eurostar timetable. We are not able to provide any assessment of this – and would not have been able to, even if the original consultation timetable had been achievable – because the cost charging model necessary to understand the reallocations was not provided until 5 working days before the close of the consultation period.

