Catherine Williams
Deputy Director
Railway Markets and Economics

21 May 2018

Derek Provan
Chief Operating Officer
Heathrow Airport Limited

Dear Derek,

Consent to obtain recovery of costs incurred in operation of the Heathrow rail infrastructure

On 11 August 2017 Heathrow Airport Limited (HAL) applied to ORR for approval to levy a mark-up to access charges on the Heathrow Spur in order to recover its full costs. This letter confirms that we are now approving this request and sets out our reasons for doing so.

HAL owns and operates the Heathrow Spur[1], a stretch of railway infrastructure linking Heathrow Airport to the Great Western Main Line to Paddington. Crossrail services access the Heathrow Spur to take passengers to and from Heathrow Airport.

HAL's approach to charging for the Heathrow Spur is set out in its network statement. In line with the principles set out in Schedule 3 of the Railways (Access, Management, and Licensing of Railway Undertakings) Regulations 2016 (the Regulations), these charges currently only recover those costs that vary with short term use of the network (i.e. short run marginal costs). However, the legislation allows exceptions to this charging principle to allow an infrastructure manager (such as HAL) to recover other costs that do not vary with the short term use of the network (i.e. fixed costs[2]).

[1] The Heathrow Spur encompasses the track, tunnels, running lines and associated equipment (such as signalling and electrification equipment) and the associated stations.

[2] We use the term fixed costs in this context to mean costs that are not 'directly incurred' as set out in the Regulations. This includes long run marginal costs that may vary with capacity.

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Paragraph 2 of Schedule 3 sets out one such exception. This states that "in order to obtain full recovery of the costs incurred the infrastructure manager, with the approval of the Office of Rail and Road […] may levy mark-ups on the basis of efficient, transparent and non-discriminatory principles, whilst guaranteeing optimum competitiveness, in particular in respect of rail market segments". It goes on to explain that the effect of the mark-up "must not be to exclude the use of infrastructure by market segments 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".

HAL is seeking to recover fixed costs of an average £5.8 million per year for a ten year period, from 1 January 2019. It has asked us to either approve a maximum allowable yield from the mark-up at this level, or alternatively, set a per movement cap on the charges (based on scheduled train movements of both Heathrow Express ("HEX") and Crossrail services) designed to recover this amount.

HAL published analysis in support of its application on its website[3]. In order to determine whether the market can bear the proposed mark-up, HAL carried out a market-can-bear test. It identified the market segments and determined which of those segments should be subject to its proposed mark-up. It identified two market segments: a Public Service Contract (PSC) segment containing Crossrail, and, an Other Passenger Services (OPS) segment containing HEX. It considered whether these should be subject to the proposed mark-up by assessing their elasticity of demand and the extent to which the market completes with other transport modes. As a result of this analysis HAL is proposing to recover up to £3.5 million per year on average from the PSC segment and up to £2.3 million per year on average from the OPS segment. HAL concluded that its analysis demonstrated that the mark-up will not undermine optimum competitiveness and will not exclude HEX and/or Crossrail services (in the respective market segments) from the Heathrow Spur.

ORR has reviewed HAL's application and in so doing has sought views via a public consultation between 1 December 2017 and 8 January 2018.

Taking into account the information and analysis provided by HAL and the responses to our consultation, we are satisfied that the calculation and allocation of the proposed mark-up put forward by HAL is based on efficient, transparent and non-discriminatory principles.

We are also satisfied that HAL has correctly identified the market segments and that the identified market segment participants can bear a mark-up at the level proposed by HAL.

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[3] http://www.heathrow.com/company/company-news-and-information/rail-regulation

In accordance with paragraph 2(1) of Schedule 3 of the Regulations, we therefore approve the proposed mark-up of up to £5.8 million of fixed costs per year on average from 1 January 2019. No more than £3.5million per year on average is to be allocated to the PSC segment and no more than £2.3million per year on average from the OPS segment. The costs allocated to each segment should be maintained in this proportion in the event that actual costs are lower than £5.8 million.

We have set out in the attached annex that our approval is in relation to the ten year period proposed by HAL, and that new approval will need to be sought to continue beyond that period; we also set out how we expect HAL to keep the mark-up and market segments under review in accordance with the Regulations.

Yours sincerely,

Catherine Williams

Deputy Director – Railway Markets and Economics

Annex

Background

HAL applied for ORR's approval to levy a mark-up in order to obtain full cost recovery of fixed costs[4] incurred in operation of the Heathrow Rail Infrastructure for a 10 year period from 1 January 2019. In addition to the application, HAL identified the market segments and its intention to levy a mark-up, in its 2018 Network Statement. A mark-up was not charged within that period[5]. We understand that HAL had discussions with key stakeholders including Transport for London, MTR Crossrail, Heathrow Express and Heathrow Connect before submitting the application to ORR on 11 August 2017.

The legal framework

Under the Railways (Access, Management and Licensing of Railway Undertakings) Regulations 2016 (the Regulations), ORR is responsible for establishing the charging framework and the specific charging rules governing the determination of the charges to be set by infrastructure managers (regulation 14(1))[6]. ORR established the Charging Framework for HAL on 27 May 2016[7].

All infrastructure managers (such as HAL) are responsible for determining the charges for the use of their infrastructure in accordance with the applicable charging framework, the

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[4] We use the term fixed costs in this context to mean costs that are not 'directly incurred' as set out in the Regulations. This includes long-run marginal costs that may vary with capacity.

[5] We consider this meets the requirements the requirements of Schedule 3, paragraph 2 (8) of the Regulations: "Market segments in which railway undertakings are not currently operating but in which they may provide services during the period of validity of the charging system must also be defined; the infrastructure manager must not include a mark-up in the charging system for those market segments."

[6] Except HS1 and Eurotunnel, to which separate provisions apply

[7] http://orr.gov.uk/__data/assets/pdf_file/0018/22086/charging-framework-for-the-heathrow-spur-decision-may-2016.pdf

specific charging rules, and the principles and exceptions set out in Schedule 3 to those Regulations (regulation 14(2)).

The general principle is that charges for the minimum access package and for access to service facilities[8] must be set at the cost directly incurred as a result of operating the train service (Schedule 3 paragraph 1(4)). However, by way of exception to that principle, an infrastructure manager may levy an additional mark-up in order to obtain full recovery of its costs incurred (Schedule 3 paragraph 2(1)). It must have the approval of ORR to do this[9], and such mark-ups must be levied "on the basis of efficient, transparent and non-discriminatory principles, whilst guaranteeing optimum competitiveness, in particular in respect of rail market segments". The Regulations explains that the effect of the mark-up "must not be to exclude the use of infrastructure by market segments 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".

We have previously considered the requirements of the legislation in respect of Network Rail's price control. We have interpreted the requirements of the legislation as a test to be applied to determine relevant market segments, and which of those market segments should be subject to mark-ups. We refer to this as the market-can-bear test.

ORR's consideration

On 1 December 2017 ORR published a consultation seeking views from stakeholders on the proposed mark-up and the analysis underpinning it to inform our assessment. We received five responses, from: Transport for London (TfL); MTR Crossrail (MTR-C); Network Rail; Heathrow Southern Railway (HSR); and, the Department for Transport (DfT).

On 27 March 2018 Heathrow announced (amongst other matters) that GWR will run the operational aspects of the Heathrow Express service under a management contract from later this year[10]. GWR did not respond to our consultation, however, we have sought confirmation from HAL on how it would be affected by the introduction of a mark-up.

Our assessment of HAL's application and its supporting evidence focussed on the question of whether HAL's proposal meets the requirements set out in the Regulations to levy a mark-up. We considered the following:

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[8] Set out in paragraphs 1 and 2 of Schedule 2 of the 2016 Regulations

[9] Or in the case of HS1 the Secretary of State

[10] http://mediacentre.heathrow.com/pressrelease/details/81/Corporate-operational-24/9298

Whether the application correctly identified the appropriate market segments in accordance with Schedule 3 paragraph 2;

HAL's application identified two market segments, these were:

- Public Service Contract (PSC) segment (containing Crossrail services); and,
- Other Passenger Services (OPS) segment (containing HEX)

Respondent's views

HSR agreed that the market segments identified looked sensible. DfT and MTR-C did not make a specific comment on the market segments identified by HAL.

In general, TfL agreed with HAL's approach to satisfying the Regulations. However, it did observe that the proposal was made in light of the services that currently use the Heathrow rail infrastructure. Although TfL considered Elizabeth Line services do fall within HAL's definition of a PSC, TfL considers that the Elizabeth Line services are sufficiently different from any other potential PSC services as to merit being included within a separate segment. TfL's rationale for this view is:

- TfL has a statutory duty under the GLA Act 1999 which will inform the setting and structure of fares;
- Elizabeth Line services will traverse the networks of Network Rail, Rail for London (Infrastructure), and the Heathrow Spur. The revenue from the Elizabeth Line needs to contribute to financing the construction of the Crossrail tunnel and improvements to the Network Rail network facilities;
- TfL operates other transport modes to Heathrow airport. Rail passengers will abstract passengers from those modes;
- TfL will no longer receive a central government grant towards its operating costs. TfL is therefore unable to fund any mark-up that cannot be recovered through fares;
- For some or all of the geographic markets served, the mix of journey purposes and the range of alternative travel options may differ for Elizabeth Line services as compared to other potential PSC services.

TfL considered these factors in reaching its conclusion that the Elizabeth Line could bear the proposed mark-up. It considered that this position would need to be reconsidered in the event of a change in utilisation of the Heathrow Rail infrastructure (including any increase in Elizabeth Line services from the current proposed 6 trains per hour (tph)).

Network Rail made a wider observation on segmentation, setting out its view that it can be challenging and complex.

MTR-C sought reassurance that the market segments will be reviewed if a significant change to the pattern of rail services to Heathrow occurred.

Our assessment

We consider that HAL has correctly identified the market segments based on the currently forecast use of the infrastructure and we consider this to be a proportionate approach. We note TfL's view that Crossrail should represent a sub-set within the PSC segment. However, at this time, Crossrail is the only operator within the segment and introducing a more granular segmentation would make no material difference. We note that the Regulations require HAL to review the market segments every five years and therefore any changes to the market segments or operators within those segments can be addressed as part of this review.

Whether HAL has properly explained the methodology it has used to identify the costs incurred as IM to be recovered through the mark up, given that the effect of any mark-up must not be to enable the infrastructure manager to obtain more than full recovery;

HAL has identified fixed costs of £5.8 million per year on average it wishes to recover through a mark-up. HAL has provided us with a copy of the model it has used to calculate its proposed charges. This model includes forecast operating expenditure (for example staff costs) as well as forecast renewals spend (for example the tunnel control system) for the ten year period up to December 2028. Renewals costs have been annualised in the model to avoid a 'lumpy' profile.

Respondent's views

Most respondents to our consultation did not provide specific comments on the basis for the costs HAL is seeking to recover. However, Heathrow Southern Railway did undertake a comparison of Heathrow's costs (based on its proposed charges) with those of HS1 noting that HAL's cost rate is higher. In light of this Heathrow Southern Railway asked ORR to be certain that the Track Charges proposed by HAL are efficient and transparent, and cover only the costs of HAL infrastructure operations, maintenance and renewal, and do not seek to recover the cost of past investment.

Our assessment

We have carried out a proportionate review of HAL's model. We consider that HAL has provided sufficient justification for the proposed charges.

In May 2016 we decided that HAL should not be able to levy charges relating to the historical costs of constructing the Heathrow Spur[11]. HAL has confirmed that all historic investment costs have been excluded from its analysis and we have found no evidence to the contrary. We are therefore satisfied that the proposed mark-up does not seek to recover the cost of historic investment.

We note Heathrow Southern Railway's suggestion that in coming to a decision on the proposed mark-up we should consider whether the costs and associated charges are efficient. However, we consider the Regulations to mean our role in this matter is limited to the efficiency of the charging principles rather than the efficiency of the costs themselves. This is different than the wider role we have relating to Network Rail's charges through the price control process. As such we have not carried out an assessment of the underlying efficiency of the costs but rather have focused on the principles being used to set the charges.

We recognise that HAL has smoothed its costs to avoid a lumpy profile. However, we note that under the Regulations charges are limited to the costs actually incurred. HAL will therefore need to keep this under review to ensure that in the event that spend varies from the forecast amount, it does not over-recover against its costs.

Whether the identified market segment(s) can bear the additional costs which HAL proposes should be levied by way of the mark-up.

HAL's analysis of this point considered whether the market segments it identified should be subject to the proposed mark-up by assessing their elasticity of demand and the extent to which the market competes with other transport modes. As a result of this analysis, HAL is proposing to allocate up to £3.5 million per year on average to the PSC segment and up to £2.3 million per year on average to the OPS segment. HAL concluded that its analysis demonstrated that the mark-up will not undermine optimum competitiveness and will not exclude HEX and/or Crossrail services (in the respective market segments) from the Heathrow Rail Infrastructure.

Respondent's views

TfL considered that from the prices in the Price List accompanying the 2019 Network Statement the Elizabeth Line service will be charged a mark-up of £2.49m when it operates a 4 trains per hour service to Terminal 4 rising to £3.66m when the service is extended to operate a 2 trains per hour service to Terminal 5. TfL stated that the proposed Elizabeth

[11] Ibid footnote 7

Line services can bear the mark-up at this level of charge, but noted that this is subject to due consideration of its comments relating to how HAL will respect productivity increases and whether the mark-up can be applied whilst CAA control period Q6 remains in force. We have considered these issues, below, under the heading 'Other matters raised by consultees'.

MTR-C told us that in principle it supports the proposed mark-up.

Although GWR did not respond to the consultation, we did ask HAL to confirm whether it would be exposed this element of track access charges. HAL confirmed that at no time will GWR be responsible for the Track Access contract or costs as these will continue to be paid by Heathrow Express Operating Company (HEOC).

Network Rail, although not a participant in either market segment did provide its high-level view that if operators are able to afford to do so, it is reasonable to expect them to pay the proposed mark-up in addition to directly incurred costs. Network Rail noted that absent of such an approach, someone else (such as users of the airport) would need to bear the costs.

Our assessment

On the basis of the evidence provided, we consider the analysis carried out by HAL was proportionate and not inconsistent with the analysis undertaken in respect of other infrastructure managers where we have considered a mark-up.[12] The consultation responses also support the view that the participants in the market segments can bear the proposed level of mark-up. We therefore agree with HAL's analysis that the specified market specified segments can bear a mark-up at the level applied for by HAL.

We note that HAL is proposing a flat rate charge per train movement across the ten year period that is designed to recover an average of £5.8million per annum. As the number of train movements varies over the period this would mean them recovering less than £5.8million in 2019 and slightly more in subsequent years. We are content with this approach (as it allows for consistent charges over the period), provided the average cost recovery does not exceed £5.8million per annum.

Frequency of review of the mark-up

HAL requested that the ORR approve a mark-up for the ten-year period commencing 1 January 2019.

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[12] http://orr.gov.uk/rail/economic-regulation/regulation-of-network-rail/price-controls/periodic-review-2018/pr18-consultations/consultation-on-changes-to-charges-and-incentives

Respondent’s views

HSR considered that reasoned justification for a 10 year duration had not been provided, and instead supported a duration of five years. It also asked that a re-opener be included to review the mark-up decision in the event that the Spur ceased to be owned by HAL.

Network Rail told us that it was concerned that concluding on a user’s affordability for 10 years could be challenging.

MTR-C supported the principle of the proposed duration and sought reassurance that the mark-up would be reviewed if there were a significant change to the pattern of rail services to Heathrow, for example: the construction of new rail links.

TfL largely agreed with HAL’s proposal for a 10 year duration. At the time of its response to the consultation, it was seeking a 10 year track access contract to the Spur for its concessionaire’s services and considered that the mark-up matching this duration would provide certainty of charging for that access contract. TfL further suggested that the duration could be set to May 2028, in order to match the length of the track access contract that it was seeking. TfL also agreed with HAL (as set out in paragraph 8.8 of its application) that the mark-up should be subject to review in certain circumstances and considered that these circumstances should be set out in track access contracts.

Our assessment

We note that the Regulations require that, once ORR has given its approval to a mark-up, that mark-up must then be levied on the basis of efficient, transparent and non-discriminatory principles, whilst guaranteeing optimum competitiveness, in particular in respect of rail market segments. As set out above, HAL has clearly set out its fixed costs in its mark-up application, identified the market segments and, demonstrated that those segments can bear the cost of the proposed mark- up to recover the full costs of the infrastructure manager.

In terms of what this decision means for future reviews of the mark-up, we set out the position as follows:

- We are approving the request to levy a mark-up, at the sums identified above and on the market segments identified above;
- Given that the calculations provided by HAL extend for 10 years, HAL will need to produce a recalculation if a mark-up is to be levied after that time (if not before, for example, in the event that there is a change to the calculation of the costs);
- The Regulations require HAL to publish the list of market segments in its annual network statement, and also to review the list at least every five years. We also

interpret the Regulations to mean that HAL must review the ongoing ability of those segments to bear the mark-up at the same time;

- Any new operator providing a service on the HAL network before that five year review takes place will need to be allocated to one of the two existing passenger segments; if that segment is not appropriate, HAL will need to review the list of segments accordingly.

The conclusions of any of the reviews identified above should be brought to the attention of the ORR. Where the review results in any changes to either the market segments, or the market-can-bear test, ORR's approval for the continuation of the mark-up should be sought.

Other matters raised by consultees

Respecting productivity gains.

TfL and MTR-C highlighted in their responses that Elizabeth Line services will use lighter trains and they told us that they would have a reduced impact on the infrastructure thus incurring a lower 'directly incurred charge'. Under HAL's proposal to recover the mark-up through a per movement charge, a similar discount would not be received on the mark-up. TfL considered that the mark-up would therefore not recognise "productivity increases" (as referred to in paragraph 2 (4) of Schedule 3 of the Regulations) of the Elizabeth Line services.

We have considered the interpretation of this paragraph 2(4) reference as we have previously applied it in the context of mark-ups levied on users of Network Rail's infrastructure. We consider that this paragraph 2(4) must be read within the context of the charge to be calculated being based on a market segment's ability to bear, rather than that of individual operators. This paragraph 2(4) protects efficient individual operators in the sense that infrastructure managers are not permitted to levy a higher mark-up on operators who are more efficient than the average (or who become more efficient (productivity increases) over the course of the control period) within the overall market segment. It does not permit the infrastructure manager to argue that such an operator is now able to afford more by way of mark-up compared to less efficient operators within that market segment; conversely, it does not allow the infrastructure manager to levy a lower mark-up on operators within the same market segment as some form of reward for efficient operation.

Effect of CAA control period

TfL and MTR-C queried whether the mark-up can be levied whilst the current CAA control period (Q6) remains in force. TfL has highlighted that currently the non-directly incurred costs are funded by the operating surplus of HEX and this was recognised by the CAA in its

Q6 price control determination to 31 December 2018. Q6 has subsequently been extended to 31 December 2019.

TfL considered that to allow the mark-up to be applied at the same time as the provisions of the Q6 determination are in force, would represent a windfall gain to HAL. TfL therefore suggested that the application of the mark-up should be deferred until after the end of Q6.

We sought views on this from HAL. It confirmed that in the current control period all rail costs and revenues were considered in the single till framework. We understand this to be in accordance with the CAA's surface access policy to ensure that "the direct users of surface access facilities defray the costs to be recovered through airport charges to the maximum extent practicable".

HAL set out its view that the introduction of Crossrail will mean revenues from these rail services will reduce due to competition. It expects this to leave a gap in revenues compared to the assumption made when the price control was set.

We therefore consider that, although there is uncertainty over the impact on Heathrow Express revenues of the introduction of Crossrail services, there remains a possibility that application of a mark-up could result in a windfall gain to HAL. We do not consider that this is a matter that ORR is required to address. If the described circumstances were to arise they would represent a variance between forecast and actual inputs to the single till in the airport price control. As such, that would be a matter for the CAA to consider.

Statutory duties under the Railways Act 1993.

In reaching this decision, and granting our approval, we have considered our section 4 duties in accordance with regulation 31(1) of the Regulations. In particular, we note the following sections as relevant to the issues raised in this decision: section 4(1)(a) (protect the interest of users of railway services); section 4(1)(b) (promote the use of the railway network for the carriage of passengers); section 4(1)(c) (promote efficiency and economy on the part of those providing railway services); and section 4(1)(g) (enable persons providing railway services to plan the future of their businesses with a reasonable degree of assurance).