



Neutral Citation Number: [2006] EWHC 1942 (Admin)

Case No: CO/4232/2006

IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
ADMINISTRATIVE COURT

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 27/07/2006

Before :

THE HONOURABLE MR JUSTICE SULLIVAN

Between :

GREAT NORTH EASTERN RAILWAY LIMITED

Claimant

- and -

THE OFFICE OF RAIL REGULATION

Defendant

HULL TRAINS COMPANY LIMITED

Interested Parties

GRAND CENTRAL RAILWAY COMPANY LIMITED

MR RABINDER SINGH QC and MISS JESSICA SIMOR (instructed by **RICHARDS BUTLER LLP**) for the **Claimant**

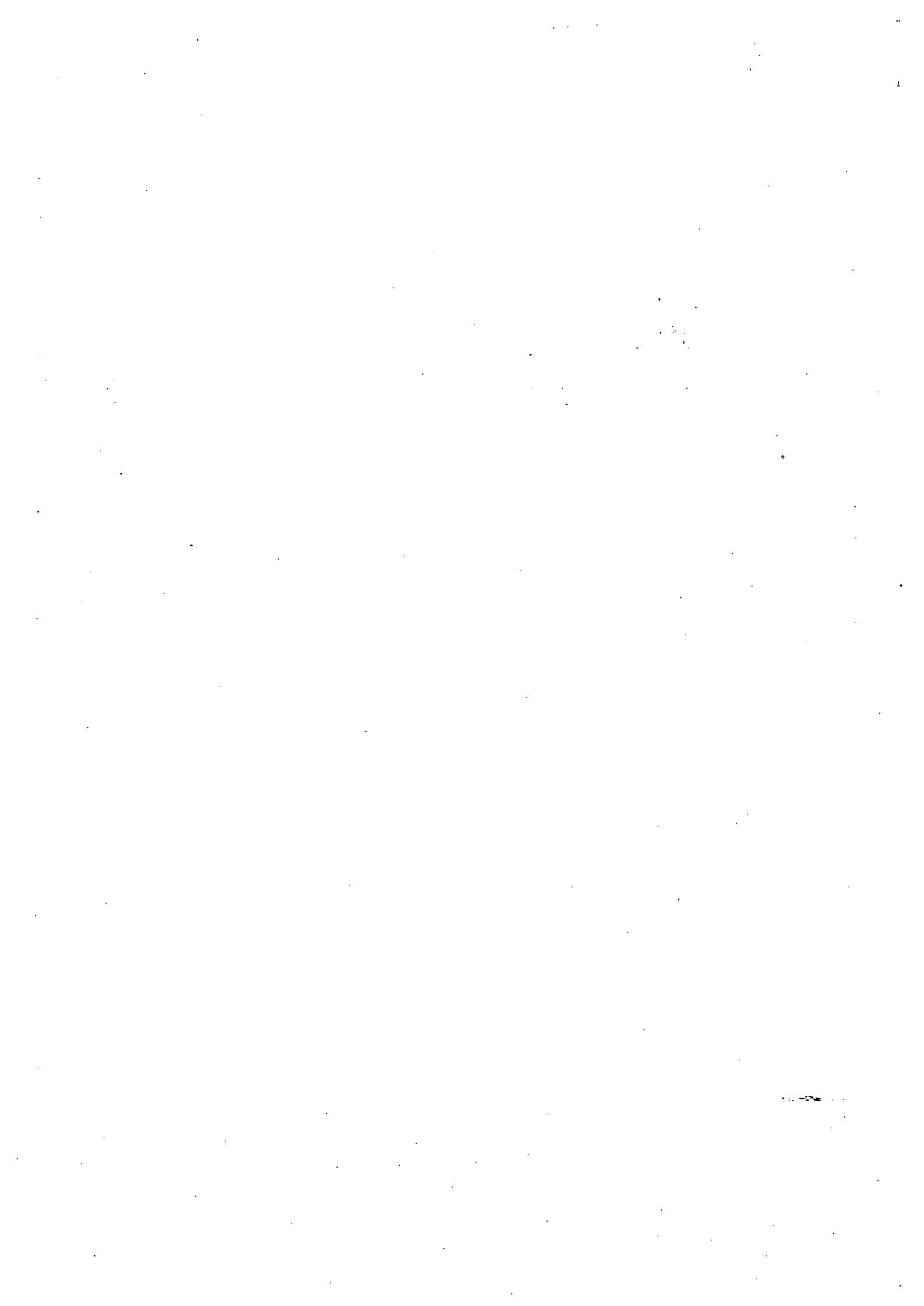
MR RHODRI THOMPSON QC, MISS HELEN MOUNTFIELD and MR JULIAN GREGORY (instructed by **NORTON ROSE**) for the **Defendant**

MR CLIVE FLETCHER WOOD and MR IAN TUCKER of **BURGES SALMON LLP** for the **First Interested Party**

MR AIDAN ROBERTSON (instructed by **WHITE & CASE LLP**) for the **Second Interested Party**

Hearing dates: 11th, 12th, 13th & 14th July 2006

Approved Judgment



Mr Justice Sullivan :

Introduction

1. In these proceedings the Claimant challenges the Defendant's decision under the Railways Act 1993 (the Act) to grant the two Interested Parties track access rights which will enable them to operate passenger services on the East Coast Main Line (ECML) on which the Claimant operates the passenger services franchise.
2. The Defendant's decision was notified on 23rd March 2006 (the decision) and very detailed reasons, extending to 108 pages (the Reasons Document), were given on 6th April 2006. The Claimant applied for permission to apply for judicial review on 22nd May 2006.
3. The claim form sought:
 - (a) "An order quashing the decision, and
 - (b) A declaration that the charging regime is unlawful, in particular as being (i) discriminatory, contrary to the 2005 Regulations, (ii) a state aid under Article 87 of the EC Treaty, which has not been notified to the European Commission, (iii) in breach of Article 86 of the EC Treaty and (iv) in breach of the ORR's own policy".
4. The Defendant and the Interested Parties contended that permission should not be granted and/or that no relief should be granted because although the claim was, in form, a challenge to the decision, it was in substance a challenge to the lawfulness of the charging framework first adopted by the Defendant in October 2000, and was therefore very much out of time.
5. All the parties were agreed (albeit for different reasons) that the case raised an issue of considerable importance for the railway industry, and that a decision was urgently needed before the Long Vacation. On 12th June I ordered that there should be a "rolled up" hearing of both the application for permission to apply for judicial review and the substantive application for judicial review, expedited the hearing, and set a timetable which enabled the Court to hear both applications in the week beginning 10th July.

The Parties

6. The Claimant is a long established train operating company (TOC) which has, since March 1996 been providing passenger services on the ECML pursuant to franchising agreements, made initially with the Office of Passenger Rail Franchising (OPRAF), and most recently with the Strategic Rail Authority (SRA) on 18th March 2005. The SRA's functions in this respect were transferred to the Department for Transport (DfT) by the Railways Act 2005.
7. The Defendant is the Office of Rail Regulation (ORR). The ORR is an independent statutory body which, since 5th July 2004, has been charged with regulating the railway industry. These regulatory functions, which include taking decisions on

applications for track access, such as the decision in these proceedings, were previously carried out by the Rail Regulator appointed under the Act.

8. The First Interested Party, Hull Trains Company Limited (Hull Trains), is an "open access operator" which has been operating passenger services on the ECML under a series of supplemental agreements modifying its track access contract which commenced on 22nd September 2000. The decision granted Hull Trains one additional contingent right each way (Monday to Sunday) for services between King's Cross and Hull until the end of its current contract in June 2010. The additional service has been running since June 2005, and the decision effectively extended the expiry date from December 2006 to June 2010.
9. The Second Interested Party, Grand Central Railway Company Limited (Grand Central), is a new entrant to the railway industry, and wishes to operate open access passenger services on the ECML. The decision granted Grand Central three rights each way (Monday to Sunday) for services between King's Cross and Sunderland, to take effect no earlier than December 2006.
10. Although it did not appear as an Interested Party, Network Rail Infrastructure Limited (Network Rail), is the successor to Railtrack PLC (Railtrack), and is the monopoly provider of the railway infrastructure, comprising the track, stations, signalling and other installations, over which both franchise operators, such as GNER, and open access operators, such as the Interested Parties, provide their passenger services.

The Issues

11. In their letter before claim dated 13th April 2006 the Claimant's Solicitors made numerous criticisms of the decision, including allegations of irrationality and procedural unfairness. The Defendant responded to these allegations in a letter dated 28th April.
12. The Claim Form challenged the lawfulness of the decision on five grounds:
 - (1) the Decision is contrary to the Railways Infrastructure (Access and Management) Regulations 2005 (SI 2005/3049) ("the 2005 Regulations") and Directive 2001/14 on the allocation of railway infrastructure capacity and the levying of charges for the use of railway infrastructure and safety certification ("the Directive"), which the 2005 Regulations implement, and is otherwise discriminatory and contrary to the general principles of European Community law;
 - (2) the charging regime proposed in the Decision amounts to an unlawful grant of state aid in favour of Grand Central and Hull Trains;
 - (3) the ORR has acted in breach of the principles of the EC Treaty and in particular the principles set out in Articles 3 (1) (g), 10, 82 and 86 (1);

- (4) the ORR breached its own policy in granting access to Grand Central and Hull Trains on routes for which GNER previously had the highest level of Moderation of Competition protection and where the proposed new services will not have as their main effect the generation of new patronage but rather will abstract significant revenue from GNER; and
 - (5) the ORR has failed to comply with its duties as laid down in section 4 of the Act”.
13. On the second day of the hearing Mr Singh QC, who appeared on behalf of the Claimant, withdrew ground (4). He had previously confirmed that:
- (a) Ground (3) was simply a different formulation of the “Discrimination” argument advanced in ground (1); and
 - (b) Ground (5) was parasitic upon grounds (1) – (3).
14. There are therefore, two remaining issues on the substantive application:
- (a) Is the charging regime contrary to the 2005 Regulations and/or the Directive because it unlawfully discriminates between franchise operators such as GNER and open access operators such as the Interested Parties?
 - (b) Does the charging regime amount to an unlawful grant of state aid in favour of open access operators?

The Charging Regime

15. Although the decision responds to the Claimant’s criticisms of the charging regime (see paragraph 42 below), and it is clear that the charging regime will be applied when track access agreements are entered into between Network Rail and the Interested Parties, the decision neither establishes the regime, nor is it directly concerned with it. As mentioned above, those aspects of the regime which are in issue in these proceedings have been in existence in the same, or substantially the same form since October 2000.
16. They were left unchanged in the Rail Regulator’s “Criteria and Procedures for the Approval of Passenger Track Access Contracts: Third Edition”, June 2003. That document explains that there are different track access charges for franchised operators and open access operators (paragraph 5.2).
17. The charges for the former comprise the following elements (paragraph 5.3):

- “(a) fixed track charge;
 - (b) variable track usage charge;
 - (c) traction electricity charge;
 - (d) capacity charge;
 - (e) incremental output statement charge;
 - (f) railway safety charge; and
 - (g) change of law charge”.
18. The charges for the latter comprise:
- “(a) a variable track usage charge;
 - (b) a traction electricity charge (where applicable); and
 - (c) a capacity charge”.
19. Although there is a very considerable amount of documentary material (contained in no less than 30 volumes, including authorities) the Claimant’s complaint is, in a nutshell, that the Interested Parties will not have to pay the fixed track charge. The Claimant contends that the fixed track charge amounts to approximately 60% of its overall track access charges. In 2005/2006 it amounted to £60.5 million, and this will increase to £127.5 million (equating to £10.81 per train mile) in 2006/2007.

The 2005 Regulations

20. The 2005 Regulations implement, albeit belatedly, the provisions of the Directive. The relevant national law should have been brought into force by 15th March 2003 (Art.38). In the event, the 2005 Regulations came into force on 28th November 2005 following a judgment of the European Court of Justice on 7th October 2004 in infraction proceedings brought by the Commission (Case C - 483/03).
21. While it is necessary to have regard to some of the fifty recitals in the Directive, it is not otherwise necessary to consider the Directive in any detail, since there is no dispute that its requirements have been properly transposed by the 2005 Regulations.
22. Part 4 of the 2005 Regulations deals with infrastructure charges. Regulation 12 provides, so far as relevant:
- “(1) (i) Subject to paragraph (3), the Office of Rail Regulation must establish the charging framework and the specific charging rules governing the determination of the fees to be charged in accordance with paragraph (5).

(ii) Subject to paragraphs (3) and (7), the infrastructure manager must –

(a) determine the fees to be charged for use of the infrastructure in accordance with the charging framework, the specific charging rules, and the principles and exceptions set out in Schedule 3;

(5) Subject to the provisions in paragraphs (1) to (4), the infrastructure manager must –

(b) charge fees for use of the railway infrastructure for which he is responsible; and

(c) utilise such fees as are received to fund his business”.

23. Network Rail is the “infrastructure manager” for the purposes of the 2005 Regulations: see the definitions in regulation 3. Before turning to Schedule 3 it is convenient to mention regulation 13 (1), which provides:

“13.(1) The Office of Rail Regulation through the access charges review...must lay down conditions, including where appropriate advance payments, to ensure that, under normal business conditions and over a reasonable time period, the accounts of an infrastructure manager shall at least balance –

(a) income from infrastructure charges;

(b) surpluses from other commercial activities; and

(c) public funds,

with infrastructure expenditure.”

24. Schedule 3 deals with “Access Charging”. Under the sub-heading “Principles of Access Charging”, paragraph 1 relevantly provides:

“(1) The infrastructure manager must ensure that the application of the charging scheme –

(a) complies with the rules set out in the network statement produced in accordance with regulation 11; and

(b) results in equivalent and non-discriminatory charges for different railway undertakings

that perform services of an equivalent nature in a similar part of the market.

- (2) The calculation of the fee may in particular take into account the mileage, composition of the train and any specific requirements in terms of such factors as speed, axle load and the degree or period of utilisation of the infrastructure.
- (3) Except where specific arrangements are made in accordance with paragraph 3, the infrastructure manager must ensure that the charging system in use is based on the same principles over the whole of his network.
- (4) The charges for the minimum access package and track access to service facilities referred to in paragraphs 1 and 2 of Schedule 2 shall be set at the cost that is directly incurred as a result of operating the train service”.

It is unnecessary to consider the detail of paragraphs 1 and 2 of Schedule 2. The minimum access package and track access to service facilities include all the services that will enable the Interested Parties to operate their passenger services over the ECML. Regulation 7 places Network Rail under a duty to provide such services in a non-discriminatory manner.

25. Under the sub-heading “Exceptions to the charging principles”, the relevant provisions of paragraphs 2 and 4 are as follows:

- “2. (1) In order to obtain full recovery of the costs incurred the infrastructure manager, with the approval of the Office of Rail Regulation under the access charges review...may levy mark-ups on the basis of efficient, transparent and non-discriminatory principles, whilst guaranteeing optimum competitiveness, in particular in respect of international rail freight.
4. (1) An infrastructure manager’s average and marginal charges for equivalent uses of his infrastructure must be comparable and comparable services in the same market segment must be subject to the same charges”.

The Claimant’s case on discrimination

26. The Claimant contends: (a) that both it and the Interested Parties are railway undertakings that are (or in the case of Grand Central will be) performing services of an equivalent nature in a similar part of the market, and accordingly the differential charging regime, under which it, but not the Interested Parties has to pay the fixed track charge, is discriminatory and contrary to paragraph 1 (1) (b) of Schedule 3; and (b) that the variable track usage charges that will be paid by the Interested Parties will

not cover the avoidable costs of their operations to Network Rail and will therefore be in breach of regulation 1(4) of Schedule 3 to the 2005 Regulations.

I will examine these arguments in reverse order.

Costs directly incurred

27. There is no doubt that it is the Defendant's policy "that open access operators should pay charges based on the incremental costs that Network Rail incurs from accommodating their services": paragraph 2.26 of "Structure of Costs and Charges [SOCC] Review: Initial Consultation Document November 2004". As part of the review process the ORR published "Emerging views on key issues" in April 2005. Paragraph 6 of the Executive Summary at the front of that document explained:
- "6. The fundamental principle underpinning the SOCC review is that charges should reflect the long run incremental costs (LRIC) imposed on Network Rail by train operators. At the present time, however, charges that are variable with use will continue to be based on average variable cost (for practical purposes equivalent to short run incremental cost). ORR considers that the LRIC of providing additional capacity or capability represents long-term commitments and should be reflected in separate, focused charges for each TOC. As better cost and demand information becomes available at a route level ORR will give further consideration to implementation of a LRIC based approach, based on charges on a vehicle-km basis (i.e. the same way as the variable usage charge is currently defined)".
28. Paragraph 12 explained that the ORR had engaged consultants, Booz Allen Hamilton/TTCI (UK) to review, inter alia, the existing variable usage charge, and said that the consultants had produced an initial document which contained recommendations for a review of the charge.
29. The Executive Summary to the consultants' report submitted in June 2005 referred to the enhancements to the charging model that they had considered as part of their review, and said in paragraph 4:
- "4. However, we have concluded that the new information now available is not sufficiently robust to warrant a change in variable usage charges at this time. There has been a significant development in the transparency of Network Rail's cost data since PR2000, both in terms of its availability (for example, maintenance costs by asset type, previously aggregated within infrastructure maintenance contracts) and granularity (for example a breakdown of track renewal costs by activity). However, information does not yet exist to support either the better estimation of long run efficient costs, the proportion of such costs which are usage-related or cost disaggregation (or bottom up cost estimation) to route or local levels".

30. Under the heading "Conclusions", the Consultants said:

"16 We have considerable reservations about whether the quality and integrity of the information on usage-related costs which has become available since 2000 is sufficient to support a change in the level of usage charges at this time. Although there is better insight into cost drivers and more transparency of the composition of the costs themselves, there is a lack of evidence on which to support a revision to previous estimates of the extent to which costs are variable with usage."

31. The ORR published its conclusions in respect of the SOCC review in October 2005. Under the heading "Track Access Charges" the Executive Summary said:

"2. We have worked closely with Network Rail, consulted widely and commissioned a range of consultancy studies in our review of the current track access charges (including the variable usage charge, traction electricity charge, capacity charge and fixed charge).

3. Our conclusions in this document confirm our emerging conclusions, published in July 2005. We will not make changes to the structure of track access charges until April 2009, to enable us to take account of further work being done as part of periodic review 2008 (PR2008). We have reached this view because:

- There has been insufficient improvement in Network Rail's understanding of costs since the last review of the structure of track access charges (as part of the periodic review 2000 (PR2000)); and
- Our consultants Booz Allen Hamilton (BAH) (working in conjunction with TTCI UK Ltd (TTCI) have recommended that further work on understanding variable cost causation should be undertaken before changes to the variable usage charge are made, in order to ensure that track access charges are sufficiently cost-reflective and provide appropriate incentives.

4. The variable usage charge is the key variable track access charge, therefore as a consequence of not making changes to this charge, we have decided to defer making changes to any of the charges until April 2009, when we will implement the conclusions of PR2008. We will take forward and complete work on the traction

electricity, capacity and fixed charges started as part of this review”.

32. In his submissions on this topic Mr Singh relied upon another report prepared for the ORR by consultants, AEA Technology, “Recovery of Costs” dated 24th August 2005. He submitted that this report demonstrated that the fixed charge did include an element of avoidable cost. However, the Consultants acknowledged that “There is considerable room for more analysis to refine the approach..... Therefore the results should be treated as only indicative at this stage”: see the Executive Summary on page (iii) of their Report.
33. Mr Singh also referred to paragraphs 4.12 – 4.14 of the November 2004 Initial Consultation Document. In summary, these paragraphs recognised the shortcomings of an approach which based the variable usage charge on short run incremental costs (SRIC) rather than long run incremental costs (LRIC) and stated the ORR’s belief:
- “that a LRIC-based approach is, at least in theory, the most appropriate approach to adopt in charging for access to rail infrastructure”. (paragraph 4.14).
34. Mr Singh submitted that it was therefore plain from the ORR’s own documents that the variable track usage charge covered only short run incremental costs, and that the fixed charge included long run incremental costs.
35. However, the next paragraph in the Initial Consultation Document pointed out that:
- “There are some practical problems with calculating and using a measure of pure LRIC”. (4.15).
- The following paragraphs outlined these problems, and paragraph 4.21 concluded by asking the question:
- “Do consultees have any views on the use of a SRIC or LRIC approach, on charging for enhancements and on the alternative merits of the approaches discussed?”
- The two Consultants’ reports referred to above were produced as part of that consultation process.
36. Drawing these threads together, the Defendant accepts that the variable track access charge should fully reflect the cost that is directly incurred as a result of operating the relevant train service, and further accepts that in an ideal world the charge would reflect not merely short run incremental costs but also long run incremental costs.
37. However, having carried out a lengthy, and very detailed consultation exercise, and having obtained advice from independent consultants, the ORR has concluded that the information presently available does not justify making any change to the variable track access charge, and that further work should be undertaken, so that as better information becomes available, the charge can be made more cost-reflective.
38. Ascertaining the cost that is directly incurred as a result of operating any particular train service is a complex and difficult task, and the answer to the question: “what is

