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OFFICE OF RAIL REGULATION

21 October 2008

Dear Stakeholder

Enforcement – some changes to our approach to financial penalties

We are seeking your views on some changes we are intending to make to our approach to financial penalties.

All licensed railway enterprises in Britain are required to comply with statutory and regulatory obligations. For Network Rail these obligations include delivering the outputs and outcomes we set down in our periodic review determinations. We expect these obligations to be met.

We inspect, investigate and follow up complaints all to assure ourselves that obligations are being complied with. Where we identify potential or actual non-compliance, we have a graduated response to enforcement. Our approach is consistent with that recommended by Professor Richard Macrory in his report 'Regulatory Justice: Making Sanctions Effective' (the Macrory Report).[1] Our aim is to restore and secure compliance as well as strengthen the incentives to comply in the future. One of the tools Parliament has given us is the power to levy financial penalties (up to 10% of the turnover of the offending enterprise). We have published our policies on enforcement and the use of financial penalties so that all licensed railway enterprises and other interested parties are able to understand our approach, as an aid to incentivise compliance and our response to non-compliance.

We published our approach to financial penalties in April 2006.[2] In October 2007 we asked for your views on changes to make our policy clearer. We did not conclude on that review as it was overtaken by our decision to impose a penalty on Network Rail for its failure to properly plan and execute engineering projects, which resulted in the possession overruns last January.

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1 http://www.berr.gov.uk/files/file44593.pdf

2 http://www.rail-reg.gov.uk/upload/pdf/287a.pdf

We have now reflected on your earlier views, our experience of imposing financial penalties, and practice from other sectors. We propose to make some changes to our policies to make our approach clearer and more useful (see the attachment).

In summary, we propose to change the penalties statement in section 4 of our current policy to:

- clarify that our main purpose is to change future behaviour and to incentivise compliance, both by the offender and other enterprises. Although the penalty principles set out in the Macrory Report do not formally apply to us, we have introduced them as a factor we will take into account when deciding if a penalty is appropriate;

- emphasise how we use the concept of seriousness, and to widen this to reflect both culpability and the actual and/or potential harm caused. This reflects our experience in arriving at penalties and practice elsewhere. It has enabled us to simplify the statement, to remove multiple references to key issues throughout our process, and to allay any concern that we might examine the same issue more than once;

- remove the reference to our starting point when calculating a penalty being any benefit gained from non-compliance. In practice we have found it difficult to assess the starting point in this way. We believe a better approach is to look first at the seriousness of the breach and to consider any benefit gained from non-compliance later in our approach;

- set out the various categories of seriousness we have found useful and the associated indicative financial ranges we have developed to help us determine a proportionate penalty for a company the size of Network Rail. We indicate how these categories might apply to a smaller company. We have added examples as a guide; and

- add to the list of mitigating factors we will consider actions that make worthwhile restoration to those harmed, where they indicate a sincere admission of guilt or remorse, are unconditional, and where any extra expenditure is verifiably additional. We have omitted one aggravating factor that appears in the current statement, because it relates to culpability and so will already be considered as an aspect of seriousness. We also make clear our approach is to apply an overall adjustment reflecting the net effect of all the relevant aggravating and mitigating factors in a case.

We have made other drafting changes to make the statement clearer and more readable.

We are consulting stakeholders on our proposed changes and would welcome your views. Please send your comments to sukhninder.mahi@orr.gsi.gov.uk by **22 January 2009**.

We would prefer you to send your comments by email. However you can also post your comments to:

Sukhninder Mahi
Licensing and Network Regulation Team
Office of Rail Regulation
One Kemble Street
London
WC2B 4AN

We would like to put your response on our website, and we may also want to quote from it. Please indicate clearly if you wish all or part of your response to remain confidential to ORR. Where you want to respond in confidence, please attach a summary that excludes the confidential information and which we can use as outlined above. We may also publish the names of respondents in future documents or on our website, unless you say you wish your name to be withheld. We will assume we may publish all responses and names unless you tell us otherwise.

If you want to discuss any of the issues raised in this document phone Rob Plaskitt, in the Licensing and Network Regulation team, on 020 7282 2072.

We look forward to hearing from you.

Yours sincerely

Bill Emery

Draft Penalties statement

1. Section 57B of the Railways Act 1993 (the Act) (introduced by section 225 of the Transport Act 2000) requires ORR to "prepare and publish a statement of policy with respect to the imposition of penalties and the determination of their amount". Related turnover regulations made by the Secretary of State under the Transport Act 2000[1] became law on 3 August 2005.

2. Under section 57B of the Act ORR must undertake appropriate consultation in preparing the statement of policy. We consulted on this policy on 17 November 2005 and took into account the responses made. We consulted on amendments to the policy in October 2007 and are doing so again now.

3. This penalties statement relates to licence enforcement under the Act and covers both the levying of a penalty (under section 57A(1)) and the inclusion of a reasonable sum (under section 55(7A)) in an individual enforcement order. References to a penalty should be understood to apply equally to a reasonable sum, where the context permits. Penalties under the Competition Act 1998 are governed by statutory guidance on penalties, issued by the Office of Fair Trading,[2] and associated turnover regulations.[3]

4. We must have regard to the statement in deciding whether to impose penalties and in determining their amount. Any penalties in relation to licence breaches are paid to the Secretary of State for Transport.

5. ORR can impose a penalty if it is satisfied that a licence holder has contravened or is contravening a relevant condition or requirement or a final or provisional order. This means that we can impose a penalty for a past or current breach, irrespective of whether we have made an enforcement order or not. The maximum penalty we may impose is 10% of turnover, as defined in the turnover regulations.

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1 The Railways Act 1993 (Determination of Turnover) Order 2005, SI 2005/2185.

2 OFT 423, Guidance as to the appropriate amount of a penalty, 21 December 2004.

3 The Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 (SI 2000/309) (as amended by the Competition Act 1998 (Determination of Turnover for Penalties) (Amendment) Order 2004 (SI 2004/1259)).

Is a penalty appropriate?

6. In deciding whether a penalty is appropriate we shall take full account of the particular facts and circumstances of the contravention, including any representations and objections made to us, and shall act in a manner best calculated to fulfil the duties placed upon us by section 4 of the Act. We shall take account of the six penalty principles set out in the Macrory report[4] 'Regulatory Justice: Making Sanctions Effective' and the related five principles of good regulation: proportionality, targeting, consistency, transparency, and accountability.

7. Our primary objective in setting a penalty is to change the future behaviour of an offender so as to deter non-compliance with its obligations (both specifically and in general). We also aim to incentivise others subject to similar obligations to comply with them.

8. The legal status of the licence holder (for example, whether it is a publicly listed company, an unlisted company or a company limited by guarantee) and any dependency on public funds of itself will not influence a decision whether to impose a financial penalty.

Calculating the amount of a penalty

9. When assessing the amount of a penalty ORR is likely to consider a number of factors falling into three categories:

   (a) proportionality;

   (b) adjustments for mitigating and aggravating factors; and

   (c) financing duty.

Proportionality

10. A penalty should be proportionate to the seriousness of the breach. In some cases, this may lead to no penalty being required. In other cases the potential penalty may be substantial.

[4] Available at http://www.berr.gov.uk/files/file44593.pdf.

11. We will take into account that levying a financial penalty has both a financial effect and a reputational effect, and that both of these are capable of being powerful.

12. In setting a penalty, our starting point will normally be the seriousness of the offence. In considering seriousness, we will look at:

- The actual and potential harm caused to third parties and to the public interest purpose of the obligation (including to the effectiveness of the regulatory regime); and
- The culpability of the offender, including whether the licence holder has acted negligently, recklessly, knowingly or intentionally.

13. We distinguish five levels of seriousness of breaches of licence. These are: technical or de minimis, less serious, moderately serious, serious and very serious. We have developed a corresponding financial range for each level of seriousness in respect of breaches by Network Rail. The aim of this is to help us determine, in the case of a breach by Network Rail, the starting amount for a penalty to which the other factors in this statement might then lead us to make adjustments.

14. The likely levels and corresponding financial ranges for a breach by Network Rail are given below. As we consider the particular facts and circumstances of each individual case we may consider it appropriate to deviate from this. The numbers in brackets in column two show the range as a percentage of Network Rail's annual turnover. Column three gives examples of the sorts of breaches that might fall into each level.

Seriousness of breach	**£m (% of turnover)**	**Example**
Technical or de minimis (formerly called "Trivial")	Usually no penalty	A breach falling into this category would probably involve no, or very little, culpability on Network Rail's part, or cause no harm or potential harm to third parties. An example of a case that would have been likely to fit under this category, if it had existed at the time, is Network Rail's unauthorised disposal of land at East Grinstead, which occurred in 2006. This breach did not cause any significant harm and involved very limited culpability on Network Rail's behalf.

Less serious (formerly called “Minor”)	up to £2m (up to 0.04%)	Network Rail’s failure to publish accurate information about network capability, for which ORR imposed a penalty on Network Rail in April 2006. This breach was less serious because it related to a relatively small number of routes and to the difference between published and actual capability, rather than a failure to maintain capability. It was not technical or de minimis because it had more serious implications for the industry, including potentially impacting on freight customers’ ability to plan their businesses.
Moderately serious	£2 – 10m (0.04% – 0.2%)	The breach arising from Network Rail’s planning and execution of the Portsmouth resignalling project in 2007. This led to real disruption for some train operators and passengers for several months and, if repeated, the breach could have had a greater impact on third parties and Network Rail’s wider signalling programme. We did not consider it ‘serious’ because the problem was localised and a service (albeit reduced) was running.
Serious	£10 – 25m (0.2% – 0.5%)	Network Rail’s continuing failure to properly plan and execute engineering projects that require possessions, for which ORR imposed a penalty on Network Rail in May 2008. This breach was serious because the problem was a systemic one and Network Rail had prior warning of the implications of not addressing it. The breach had manifested itself by causing a large impact on third parties over New Year 2008 and there was potential for further similar harm to be repeated if the problems were not addressed.
Very serious	£25m + (0.5% +)	A breach falling into this category might involve significant harm, or the risk of significant harm, being caused to a wide range of third parties and/or greater culpability on the part of the Network Rail, for example, where it was deliberately misleading.

15. The highest range given of £25m + is limited only by the legal maximum of 10% of turnover (around £500m in the case of Network Rail).

16. In relation to a smaller licence holder, the starting penalty would normally be lower than the figures given above for Network Rail, though not necessarily reduced pro-rata to turnover. Our aim would be to reflect the particular circumstances of the licence holder, and to achieve the same impact and degree of incentivisation that would apply in Network Rail's case for breaches of a similar level of seriousness.

17. We will adjust the starting penalty to take account of the principle that the starting penalty should be not less than any benefit for the licence holder from the breach.

Adjustments for mitigating or aggravating factors

18. We will adjust the starting penalty up or down to take account of relevant mitigating and aggravating factors, according to the particular facts and circumstances of each case. The appropriate adjustment will be a matter of judgement, taking previous cases into account for consistency. We will apply an overall adjustment reflecting the net effect of all the relevant mitigating and aggravating factors.

19. ORR may consider the following factors as mitigating or aggravating factors as appropriate:

    (a) any steps which have been taken to rectify the breach, including whether these were initiated proactively by the licence holder or in response to ORR's actions;

    (b) any steps which have been taken to minimise the risk of the breach recurring or the absence of internal procedures intended to prevent infringements occurring and the extent to which organisational weakness may result in repeated infringements of the same type by the same licence holder;

    (c) any actions which have been taken to make worthwhile restoration to those who suffered the consequences of the breach, where the actions indicate a sincere admission of guilt or remorse, are taken

unconditionally and any committed expenditure is verifiably additional;

(d) the extent of involvement of directors or senior management in the action or inaction which caused the breach or their lack of involvement in action to remedy the breach;

(e) repeated or continuing infringement of this or other obligations, particularly if subsequent breaches occur after the licence holder becomes aware of, or is made aware of, the initial infringement; and

(f) co-operation with ORR's investigation or evidence that the licence holder attempted to conceal the infringement from ORR.

20. We will consider mitigating actions falling into category (c) taken after a penalty has been proposed, but we are likely to give them less weight than those taken before we propose to impose a penalty. In considering by how much a penalty could be reduced in recognition of such actions, we will be mindful of our primary objective to change the future behaviour of an offender. It is unlikely that any potential penalty would be reduced to zero on a "£ for £" basis as this would not be likely to achieve such an outcome. In addition, it should be noted that our statutory framework does not allow us to consider imposing alternatives to a financial penalty payable to the Secretary of State.

21. Other mitigating or aggravating factors may arise depending on the particular facts and circumstances of a specific case.

22. The net effect of mitigating and aggravating factors may be significant. Potentially, these adjustments could reduce a penalty to zero, or increase it several fold, in appropriate cases. A penalty on a licence holder may therefore be adjusted to be outside the range which determined our starting point.

Financing duty

23. Under section 4 of the Act, ORR is required to act in a manner that does not make it unduly difficult for a network licence holder to finance those activities relevant to ORR's functions. We also have a duty to enable others to plan their businesses with a reasonable degree of assurance. We shall take these requirements into consideration in setting a penalty.

24. However, we consider that these duties do not require us to protect a firm from its own inefficiency. In the event that ORR concludes, having regard to the particular facts and circumstances, that it would be appropriate to impose a penalty sufficient to change future behaviour or incentivise compliance, we consider it would be inappropriate not to do so just because this would make it difficult for an inefficient operator to finance its functions.

Reaching a conclusion

25. Having considered, to the extent appropriate, the factors listed above, ORR will determine an appropriate amount for a penalty. In doing so, we shall ensure that the amount determined does not exceed 10% of the turnover of the licence holder (as calculated in accordance with the turnover regulations) and that it is consistent with our statutory duties in section 4 of the Act. The imposition of a penalty is also subject to the procedural requirements set out in Annex B of this document.[5]

Revision of the statement of policy

26. ORR may, from time to time, revise this statement, in accordance with section 57B(4) and (5) of the Act. This is the first revision of the penalties statement published in April 2006.

[5] This is a reference to Annex B of our current policy statement. It is available at: http://www.rail-reg.gov.uk/upload/pdf/287a.pdf.