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Railway Markets and Economics



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Mark Thompson  
Rail Strategy, Department for Transport  
3/18, Great Minster House  
33 Horseferry Road, London  
SW1P 4DR

Dear Mark,

### **ORR response to the Department for Transport's PSO levy consultation**

The Office of Rail and Road (ORR) welcomes the opportunity to respond to the Department for Transport's (DfT) consultation on the introduction of a public service obligation (PSO) levy for passenger rail services.

The ORR is the independent safety and economic regulator for Britain's railways, and economic regulator for railways in Northern Ireland. We regulate Network Rail and aim to promote continuous improvement in safety, performance and efficiency of the railways so that it better meets the needs of users, including passengers, and taxpayers.

We support the development and introduction of an appropriate PSO levy. As highlighted in the DfT's consultation, this was a key recommendation from the Competition and Markets Authority's (CMA) report: *'Passenger rail services: competition policy project'* (published March 2016). This levy has the potential to allow for more on-rail competition in the future (through the provision of passenger services by 'open access' or non-franchised operators), to the benefit of passengers and taxpayers. The levy would need to sit alongside ORR's proposed changes to the structure of network charges, including the potential for changes to how fixed costs are recovered.

We have two particular recommendations for government as it takes forward the PSO levy. First, that the primary legislation to implement the levy should be designed to afford a significant degree of flexibility about the detailed design of the levy, so that options are not unduly ruled out at this stage and that the design can evolve in light of experience. Second, that we see merit in ORR undertaking some of the implementation of the levy, but that this would only deliver benefits if the design of the levy aligns with that of our role in regulating Network Rail's charges. In addition, we note the importance of ensuring that any role the ORR has in implementing or administering the levy should not undermine our role to establish the charging framework and the specific charging rules for access to the network, as set out in The Railways (Access, Management and Licensing of Railway



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Undertaking) Regulations 2016 ('The Regulations'). We would, of course, need to establish a mechanism for recovering our costs.

We have set out in Annex A specific points on the questions raised in your consultation. We look forward to continue working with the DfT to ensure our charging proposals and the PSO levy proposals are joined up and we consider the impacts on operators of both policies.

Yours sincerely,

[By email]

**Chris Hemsley**



## ***Annex A – Specific points in response to those raised in the consultation***

### **1. Background**

We are currently undertaking a periodic review of Network Rail, which is due to conclude in 2018 (PR18). In this review, we will determine what Network Rail must deliver in control period 6 (CP6), the funding it requires for this, and the incentives needed to encourage effective performance and delivery. This will feed through into the service that passengers and freight customers receive and, together with taxpayers, ultimately pay for.

As part of PR18, we are undertaking a review of the structure of Network Rail's charges. Access charges are paid by train operators for use of the rail network, and they are one of Network Rail's sources of income. A key element of the PR18 structure of charges review is looking at the way fixed network costs (i.e. those costs that do not vary in the short run) are recovered from operators. Our proposal, as set out in the consultation on charges and incentives which we published in December 2016 ('our December 2016 consultation'), is to apply fixed cost charges to all operators, including open access operators (OAOs).<sup>1</sup> Our consultation closed on 9 March 2017 and we are currently reviewing responses to that consultation, in order to reach conclusions on the structure of access charges.

If, based on the responses to our consultation and our updated assessment of the options, we confirm our proposal described above, we will need to undertake a test looking at operators' ability to bear charges, in line with the requirements of The Regulations.

### **2. Objectives and principles for the levy**

The DfT consultation sets out a number of objectives for the levy. At a high level, we think these objectives are sensible ones to consider. We note that when options are more fully developed, it will be clearer how they perform against these different objectives.

As part of our PR18 review of charges, we assessed charging options against a set of objectives and criteria. These included consideration of the likely benefits to passengers resulting from our proposals, or the likelihood of an option working to increase the number of suppliers in the rail passenger market. We also assessed options in terms of their impact on the funds of Secretary of State and other funders. These criteria (and the others we have assessed our options against) are broadly consistent with the principles the DfT has set out in its consultation.

### **3. Scope and design**

On the scope of the levy, the consultation sets out that all services between two domestic stations would be in scope of the levy. It also states that the intention is that where a service would no longer be economically viable if required to pay the levy, it would generally be excluded from having to pay.

We agree with these general principles; noting that our approach is typically to focus on market segments (rather than individual services), which avoids some complexity and tends to maintain incentives on operators to improve efficiency. Analysing at an operator or service-level would be more complicated and may undermine the rewards available to operators from being more efficient than their rivals.

The consultation sets out one approach to implementing these principles; namely that franchised passenger services which are competitively tendered, benchmarked, and / or

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<sup>1</sup> Our December 2016 consultation is available [here](#).

subject to profit sharing agreement (i.e. franchise agreements) would be excluded from having to pay.

We note that this is one possible approach but there are others. As part of our thinking around how mark-ups might be levied in CP6, we will need to look at how the market can bear assessment applies to franchised services, and in particular core franchised services (i.e. those services specified by the franchising authority as part of the franchise agreement) and additional services that franchised operators might choose to run. After further detailed design, it could prove simpler to apply the levy to all or part of a franchise operation, with the levy income offsetting net franchise payments. Indeed, this approach might support more effective competition and administration of the levy; avoiding complex debates about whether certain services fall within or outside of the core franchise requirement.

Reflecting this, we recommend that any primary legislation drafted to introduce the levy should remain flexible on the scope and design of the levy. This would enable the most sensible approach overall to be taken (i.e. when considering both the way that mark-ups might be levied in the future and the PSO levy). It would also ensure that specific design features are not 'locked in' as part of the legislation.

On the issue of the administration of the levy, we agree there are potential benefits from the ORR having a role. Based on the consultation, our working assumption is that the ORR's role in administering the levy would be around determining which services are in scope for the levy, and calculating the levy. For the sake of clarity, we understand that the ORR's role would not include collection of the levy, decisions around the structure of the levy or the legal status of the payments. There will be important links between the ORR's work on access charges (and implementation of fixed cost mark-ups) and the calculation and administration of the levy. This includes for example considering how to apply a market can bear test and an economic viability test (which are inevitably going to look at similar features of rail services).

The benefits of ORR administering the levy are likely to materialise if the design of the levy is based on the same structure as the market can bear test (i.e. based on market segments or types of services rather than operators) and the application of the economic viability test implies a similar threshold for the payment of mark-ups and/or the levy. However, if the two schemes apply different principles there could be significant disadvantages in the ORR administering the levy; as it could result in ORR needing to take different decisions on seemingly similar sets of circumstances. This could make it harder to discharge our current functions in respect of the structure of charges.

We also note that if the ORR has a role in administering the levy, this should not undermine our role to establish the charging framework and the specific charging rules as per The Regulations. There are a range of practical issues regarding the ORR's potential administration of the PSO levy which would need to be considered, and which may, or may not, require legislation or additional regulations. We would be happy to work through these issues with the DfT to ensure an approach which fits with our current responsibilities and duties is put in place.

Finally, if ORR were to take on the function of calculating and administering a PSO levy, this function would need to be appropriately resourced and funded. We would need a mechanism for appropriately recovering these costs. The level of resource required to administer the levy would depend on the design of the levy, with some options implying significant, detailed analysis of profitability.

#### **4. High level options for the levy**

We welcome the fact that the DfT has set out a number of options in its consultation to enable stakeholders to understand what some of the broad approaches for implementing a levy might be. We note that all of the options have advantages and disadvantages, both in terms of the incentives / behavioural effects, but also in terms of the level of complexity involved in calculating the levy.

At this stage, we recommend that any legislation to introduce the levy should remain flexible in terms of options for how the levy might be implemented. This will enable a full consideration of costs and benefits to be undertaken before one particular approach is chosen.

As stated above, we also note that the case for ORR administering the levy might be particularly strengthened if the option implemented for the design of the levy was based on the same structure as the market can bear test which the ORR is proposing to develop in order to levy fixed cost mark-ups. If the levy was designed such that the assessment of whether a particular service should pay it or not was also based on the service type or market segments, the ORR's existing knowledge and analysis in this area could be usefully deployed to understand whether any market segments can pay a levy above the fixed cost mark-ups they are already subject to. However, these issues will need to be considered in more detail as part of the next stage of this.

#### **5. Conclusions**

We welcome the DfT consultation on the introduction of a PSO levy and look forward to working with DfT going forward to ensure the approach to fixed cost charges and the PSO levy are joined up and create an environment which will facilitate more on-rail competition going forward.