



Department  
for Transport

# Putting passengers at the heart of the Railway: supporting sustainable competition

## The passenger rail public service obligation levy

February 2017

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# Executive summary

The Government is committed to putting passengers at the heart of the railway. This means delivering services that passengers want, supporting innovation, and investing in improvements to the railway.

Competition, through the franchising process, has driven significant improvements for passengers, whilst delivering value for money for taxpayers.

To complement this the Competition and Markets Authority has recommended that more 'open access' (non-franchised) competition could potentially bring further benefits for passengers, provided important reforms are put in place to protect taxpayers, Government investment in the railway and the stability of the franchising market.

These reforms include reform of the track access charging framework by the Office for Rail and Road, so that open access operators contribute towards fixed network costs where they are able to; and the introduction of a public service obligation levy so that open access operators make a contribution, where they are able to, towards socially and economically important but ultimately unprofitable services.

This consultation focuses on such a levy and is seeking your views on the principle of the levy, the proposed scope and design, and high level options for implementation.

We do not expect franchised services, international services, nor freight to pay the levy.

A full list of questions to consultees can be found on page 17.

# How to respond

The consultation period began on 21 February 2017 and will run until 21 April 2017. Please ensure that your response reaches us before the closing date. If you would like further copies of this consultation document, it can be found at:

<https://www.gov.uk/government/consultations/the-passenger-rail-public-service-obligation-levy>

You can contact [webmaster@dft.gsi.gov.uk](mailto:webmaster@dft.gsi.gov.uk) if you would like alternative formats (Braille, audio CD, etc).

Please send consultation responses to:

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When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.

## Freedom of Information

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the Freedom of Information Act 2000 (FOIA) or the Environmental Information Regulations 2004.

If you want information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of

Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department will process your personal data in accordance with the Data Protection Act (DPA) and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

# The proposals

## Introduction and context – sustainable competition

- 1.1 The competitive rail franchising process has delivered significant benefits for passengers, whilst providing value for the taxpayer over 20 years. This success was recognised by the Competition and Markets Authority (CMA) in their March 2016: ‘Passenger rail services: competition policy project’<sup>1</sup>.
- 1.2 The CMA’s report also examined four options for further increasing competition in the passenger rail market. They recommended that there could potentially be further benefits for passengers by taking steps to encourage more ‘open access’ (non-franchised) competition into the market, with the intercity routes having the most scope for open access. However, they also noted that open access may not be suitable for other types of market such as commuter routes.
- 1.3 Crucially, the CMA’s lead option highlighted the need for important reforms, before increasing open access, to create a level playing field between operators in terms of the costs they pay towards the network and socially valuable services, whilst also protecting the ability of Government to support socially and economically important services and invest in the railway network.
- 1.4 We also consider it is important to maintain the stability of the franchise market so that it can continue to deliver for passengers and provide value for money to taxpayers.
- 1.5 The proposed reforms include reform of the charges open access operators pay to access the rail network, and the introduction of a public service obligation (PSO) levy.
- 1.6 Reform of track access charges is for the ORR, however the Government has been clear that we want to see reforms in this area. We are therefore pleased to see that the ORR’s consultation

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[https://assets.publishing.service.gov.uk/media/56ddc41aed915d03760000d/Competition\\_in\\_passenger\\_rail\\_services\\_in\\_Great\\_Britain.pdf](https://assets.publishing.service.gov.uk/media/56ddc41aed915d03760000d/Competition_in_passenger_rail_services_in_Great_Britain.pdf)

on the charging framework for Control Period 6 (2019-2024) proposes making changes in this area. We believe this is an important step in creating a more level playing field between different types of passenger operator.<sup>2</sup>

- 1.7 The introduction of a PSO levy is for Government and is the subject of this consultation. To help consultees understand how the levy might be implemented in practice we have included some high level options in this consultation. However, we intend to undertake a further, more detailed consultation on a focussed set of options, before the levy is able to be charged.
- 1.8 Franchised passenger operators deliver a mixture of profitable services, and social and economically important, but ultimately unprofitable services<sup>3</sup>. They also contribute towards the long-run fixed costs of the rail network through their charges (in addition to short-run costs).
- 1.9 In contrast, at present open access operators only pay access charges relating to the short-run costs they impose on the network, but they also have limited access to the network as a result of the ORR's access policy and 'not primarily abstractive' (NPA) test.<sup>4</sup> There is therefore a financial impact on Government revenues, and ultimately Government's ability to fund vital social services and investment in the network from the lower contribution that open access currently pays.
- 1.10 Whilst decisions regarding granting of access to the network are a matter for the independent regulator, the Office of Rail and Road (ORR), these financial impacts have led Government to oppose some previous open access applications to safeguard rail investment and support passenger service delivery by franchised operators. A PSO levy, alongside charging reform, would go some way to addressing this concern.
- 1.11 However, in relation to particular applications, it will still be important to ensure that there are clear benefits for passengers,

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<sup>2</sup> The ORR's consultation document is available at [www.orr.gov.uk/pr18](http://www.orr.gov.uk/pr18)

<sup>3</sup> We do not consider that it is possible to clearly distinguish between PSO and non-PSO services within our franchises

<sup>4</sup> The ORR does this in order to promote competition on the network, while having regard to the funds available to the Secretary of State (including to run socially desirable services which might not be profitable - i.e. public service obligations or PSO services).



and impacts on capacity, performance and the franchise market can be effectively mitigated.

- 1.12 In particular, they could create a greater ability for open access operators to provide services not currently provided by franchised operators. However, it should not be the case that open access is simply replicating services already provided by franchises tendered through a competitive process.
- 1.13 For the avoidance of doubt, the levy relates to passenger services and would not be applied to rail freight, where different market dynamics apply. However, it is also our intention that the levy will not be applicable to the current international passenger services. This is discussed below.

## **Background to the public service obligation levy**

### Context and applicability

- 1.14 On 23 June, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation. The outcome of these negotiations will determine what arrangements apply in relation to EU legislation in the future once the UK has left the EU.
- 1.15 The main EU Directive covering governance of railway markets (e.g. charging, access, the role of the independent regulator etc.) is the Recast of the First Railway Package (“the Recast”).
- 1.16 Article 12 of the Recast allows Member States to impose a PSO levy on railway undertakings operating passenger services to recover the costs of running public service obligations. Details on the Article can be found here: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:343:0032:0077:en:PDF>
- 1.17 The proposed levy would apply to Great Britain’s rail network. Transport is a devolved matter in Northern Ireland.

## Our approach

1.18 In light of the potential benefits to passengers described above, and as part of the Government's commitment to creating a more sustainable approach to on-rail competition, we are seeking your views on introducing such a levy. This consultation document sets out the principles we have for the levy and a high level set of options for implementing the levy.

1.19 In preparing this, we have been grateful for the contributions made by the ORR and CMA to develop our thinking. We have also been grateful for the constructive contributions made in discussions with the industry, helpfully facilitated by the Rail Delivery Group.

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

1.20 Our objective for introducing the levy is to ensure that, where they are able to, open access passenger operators make a contribution towards socially and economically important, but ultimately unprofitable, services.

1.21 To underpin our objective we have developed a number of principles for the levy:

- a) it should enable better outcomes for passengers through innovation and improved services,
- b) it must sufficiently protect taxpayers;
- c) it must not significantly distort behaviour or create perverse incentives;
- d) it must not act as an unjustifiable barrier to entry where passengers interests are advanced;
- e) it must be transparent, predictable and able to be effectively administered;
- f) it must be sufficiently flexible to different business models;  
and
- g) it must be resilient to future changes in the market and capacity.

***Question to consultees: Do you agree with our objective for introducing a levy and the underlying principles?***

## **Scope and design**

### Services covered by the levy

1.22 Consistent with the legal position, all services between two domestic stations would be in scope of the levy. However, our intention is that where a service would no longer be economically viable if required to pay the levy then it would generally be excluded from having to pay. We consider this is likely to include:

- Franchised services which are competitively tendered, benchmarked, and / or subject to a profit sharing agreement (i.e. franchise agreements)<sup>5</sup>; and
- open access operators running marginal services.

1.23 We have considered the applicability of the levy to international services, consistent with the legal framework which requires the levy to cover all services between two stations within a Member State. Our interpretation of the provision is that the levy is intended only to apply where operators make tickets available between those two stations.

1.24 Should passengers be unable to purchase tickets on a service to travel between two stations on the GB rail network, even if the service calls at both stations, the levy will not apply. This means we would not expect the levy to be applicable to the current international passenger services, unless there is a change in this situation.

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<sup>5</sup> Additionally, we consider that application to franchised services would add further, undesirable complexity to the industry's financial arrangements

***Question to consultees: Do you agree that only services where tickets are available between stations in Great Britain should be in scope of the levy?***

Amount to be recovered by the levy

- 1.25 The legal position means that the maximum amount of revenue that we are able to recover through the levy is the total cost of running PSO services. This is equivalent to the sum of the (net) cost of running all the unprofitable services in premium<sup>6</sup> and ‘subsidy’<sup>7</sup> franchises.
- 1.26 Given this is very difficult to estimate, we therefore propose to ensure that the levy cannot over recover by capping the level at the aggregate cost to Government of providing subsidy franchises. It should be noted however, that with the current level of open access services, and those granted rights to run services in the future, we do not expect to reach this figure.
- 1.27 The exact amount each operator will pay will be determined based on how the levy is calculated and implemented. However, given that the levy cannot endanger the economic viability of services we are minded to consider that if a market is determined by the ORR as unable to bear full fixed track access charges (as discussed below) then it would be unlikely to face the levy.
- 1.28 We note that the ORR, as set out in their Charges and Incentives consultation, is proposing to undertake a recalibration of their ‘market can bear’ test. This could be an opportunity to take account of the CMA’s recommendations and development of the proposed PSO levy.

Relationship with ORR track access charging framework and administration of the levy

- 1.29 We are clear that any levy would need to work alongside and complement the ORR’s charging framework, and in particular the proposed reforms that the ORR are considering as part of Periodic

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<sup>6</sup> Franchises where overall revenues are higher than costs and therefore bidders offer a share of overall profits to Government as part of the franchise competition.

<sup>7</sup> Franchises where overall revenues are lower than costs and therefore bidders bid on the basis of the level of subsidy they require to operate the services.

Review 2018. We consider that the levy does not cut across the current, or potentially reformed, charging framework.

- 1.30 The ORR have noted in the charging consultation that as well as the need for the PSO levy and charging framework to complement each other, they will revisit the not primarily abstractive test that they currently apply when granting access to open access operators.
- 1.31 Given this, we believe that the ORR may be best placed to administer the calculation of the levy, particularly given its extensive economic expertise in relation to issues of this kind. Giving a clear role in the process to the ORR should also provide a significant level of independent scrutiny to the charging of the levy.
- 1.32 We recognise that a key issue in calculating the levy, and which operators are required to pay, concerns the determination of economic viability. In principle, and as reflected in our high level options, economic viability could be assessed based on the concept of a fair rate of return for a given level of risk, or could be interpreted more widely and considered through the design of a more general levy scheme.
- 1.33 In practice we expect that the ORR is likely to determine economic viability as part of their administrative process in considering access decisions.

***Question to consultees: Do you agree that the Office of Rail and Road should play a role in administering the setting of the levy?***

#### Measures to ensure the levy works as intended

- 1.34 Because the levy may lead to incentives for avoidance we intend to include anti-avoidance measures within the legislation. These will help protect taxpayers and ensure there is a level playing field between operators. Whilst the specifics of the avoidance measures will vary with how the levy is implemented, they could include clarity on what costs and revenues need to be taken into account when calculating the levy.

1.35 We are conscious that the levy will need to work for all government funders of the railway, particularly the Scottish and Welsh Governments in their capacity as franchising authorities. We intend to work closely with all affected parties to ensure that the implementation of the levy works as intended.

1.36 We will also need to establish a process for the collection of the levy and its remittance to the relevant government.

### High level options for the levy

1.37 Whilst determining the detail of how the levy will be charged is not the main purpose of this consultation we recognise that it is helpful for consultees to understand some broad options for how the levy could actually be charged.

1.38 Even taking into account the considerations in paragraphs 1.22 to 1.36, there remains considerable discretion as to how the levy might be designed. Taking account of the design principles discussed on page 10, we have considered a number of options which are set out below. We have included commentary on how they might be implemented and some of the attractions and complexities associated with each one.

1.39 We recognise that this list is not exhaustive and we would welcome consultation responses which examine the pros and cons of further options not listed below.

- **Option 1:** a levy based on a metric such as distance or passenger numbers, or a combination of the two;
  - This could work with operators paying a certain amount of levy per passenger km
  - There could be different levy rates for different market segments, perhaps linked to the ORR's market can bear test segmentation, or route service groups
  - This option has the attraction that it could be linked to existing industry / regulatory processes and could provide operators with certainty upfront and if set in the right way encourage incentives for efficiency and competition.

Although, it may be less precise than some of the options discussed below

- **Option 2a:** a levy which recovers all profit above a fair rate of return threshold;
  - This could be based on Government or the ORR establishing a fair rate of return for a particular type of service, service group or route. Perhaps in reference to similar types of service, or operators with which the service will compete
  - Any profit above this rate of return would be paid to Government through the levy
  - This option has the attraction of recovering a significant amount of revenue from the levy, but would dampen incentives for competition. It would also require complex estimation and modelling of a fair rate of return
- **Option 2b:** a levy which recovers a specific percentage of profit above a fair rate of return threshold; and
  - As with option 2a a fair rate of return could be established for a particular type of service, service group or route. Perhaps in reference to similar types of service, or operators with which the service will compete
  - A percentage of profit above this would be paid to Government through the levy and one option is for this to be based on a sliding scale
  - This option would recover less than option 2a, but would have stronger incentives for outperformance. As with option 2 it would also require complex estimation and modelling of a fair rate of return. Defining what the right percentage to recover is may also require significant modelling
- **Option 3:** a levy charged as a proportion of revenue.
  - This could be based on setting a percentage of revenue. Potentially for a particular type of service, service group or route. Perhaps in reference to similar types of service, or operators with which the service will compete.

Alternatively, the percentage could be the same across the industry.

- This would then be paid to Government through the levy
- This option would provide certainty upfront for operators and if set correctly could provide incentives to compete and grow revenues. It would, however, require complex modelling to determine the right proportion of revenue that the levy should recover

***Question to consultees: Do you consider that any of the proposed options for charging the levy are not suitable? Do you favour any option and? If so why (with specific reference to the principles set out on at paragraph 1.21)?***

***Question to consultees: Are there other options that we should consider? If so why (with specific reference to the principles set out at paragraph 1.21)?***



# Consultation questions

We welcome consultee views on the principle of the PSO levy, our proposed scope and design, and the high level options for charging the levy. We have set out a number of specific questions below:

- a) Do you agree with our objective for introducing a levy and the underlying principles?***
- b) Do you agree that only services where tickets are available between stations in Great Britain should be in scope of the levy?***
- c) Do you agree that the Office of Rail and Road should play a role in administering the setting of the levy?***
- d) Do you consider that any of the proposed options for charging the levy are not suitable? Do you favour any option and? If so why (with specific reference to the principles set out at paragraph 1.21)?***
- e) Are there other options that we should consider? If so why (with specific reference to the principles set out at paragraph 1.21)?***

Please provide evidence to support your answers where appropriate.

The closing date for responses to this consultation is 21 April 2017.

# What will happen next

A summary of responses, including the next steps, will be published within three months of the consultation closing on [www.gov.uk/government/consultations/the-passenger-rail-public-service-obligation-levy](https://www.gov.uk/government/consultations/the-passenger-rail-public-service-obligation-levy). Paper copies will be available on request.

We will then work with the industry to further develop any proposals for the levy and refine the options for implementation.

# Annex A: Consultation principles

The consultation is being conducted in line with the Government's key consultation principles. Further information is available on the Better Regulation Executive website at

<https://www.gov.uk/government/publications/consultation-principles-guidance>

If you have any comments about the consultation process please contact:

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