



Department
for Transport

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

The passenger rail public service obligation
levy consultation response document

April 2018

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Introduction

As set out in *Connecting People: a strategic vision for rail* and the Secretary of State's guidance to the Office of Rail and Road (ORR), we are supportive of open access in the right circumstances.

Franchising will continue to be the main way we deliver services given the success it has had in delivering growth, performance, safety and customer satisfaction. Government is a substantial funder of the railway and determines the vast majority of services which run on the network on behalf of passengers and taxpayers. In doing this we balance the different objectives, and social and economic outcomes that citizens want to see from the railway to ensure it benefits everyone. Without franchising many of the vital social and economically important, but ultimately unprofitable services that people rely on everyday would not run. It is therefore absolutely right that Government, working in partnership between the public and private sectors, retains sufficient control over services and fares, as well as operator profits, through the franchising system.

However, open access can play an important role. This is particularly true where open access complements the franchising system to develop new markets, and not on densely used commuter and short distance routes where passengers have a preference for the turn up and go services that the franchising system delivers.

Therefore in February 2017 we consulted on proposals for a public service obligation (PSO) levy. This followed the recommendation from the Competition and Markets Authority (CMA) that such a levy, coupled with reforms to track access charges, could facilitate greater open access and potential benefits for passengers. The levy was intended to ensure that competition takes place on a more level playing field between open access and franchise operators. This would enable passengers to benefit from more open access, whilst securing the delivery of the vital social services that franchises run, which are critical to passengers and communities.

We agree with the CMA that it is important to have robust measures in place to protect taxpayers, government investment in the network and support for socially and economically valuable services. We consider

that it is critical that these are in place before open access can play a significantly expanded role. This is particularly the case in the next few years given constraints on public spending. In addition, given recent trends in operational performance, which appear to be at least partly related to the degree of congestion on the network, it is vital that we take into account performance impacts before making any decisions to fill gaps in the timetable where network capacity is already heavily utilised. In the longer term, as the CMA recommended, there may be greater opportunities for open access to deliver more services once charging reform and the levy are in place.

The consultation document set out our objectives for the levy, our overarching principles, and potential options for its implementation. The original consultation document provides further details on these.

We believe that a levy has significant benefits. Of the options proposed, and after taking account of the responses, we consider that the most appropriate option for the levy is as set out under option 1 in the consultation document. That is, a levy based on a metric such as distance or passenger numbers, or a combination of the two. We also consider that the Office of Rail and Road (ORR) is best placed to administer the levy, but would not collect the revenues from the levy as this would be better achieved through existing industry mechanisms. Both of these points were supported by a number of consultation responses. In discussions with stakeholders we heard, and agree, that having legislation in this area that is sufficiently flexible to adapt to changes in the market, whilst still providing enough certainty for operators and government alike is also important. More detail on our high-level conclusions is set out in the next section.

As set out in the original consultation document introducing such a levy requires primary legislation. However, the current legislative programme is very significant and there is limited parliamentary time. Therefore introducing the primary legislation required for the PSO levy is likely to be challenging in the next few years. Nevertheless we are still taking action to deliver a more level playing field. In July we issued updated Secretary of State guidance to the Office of Rail and Road (ORR) setting out the government's policy position on open access. This was followed by our document: *A strategic vision for rail* in November. Both of these documents made clear that we consider that open access is likely to be most relevant to support innovative services for passengers and complement existing services by running to new destinations.

We have also been working closely with the industry and the ORR on proposed reforms of track access charges in the run up to Control Period 6 (2019-2024). We are supportive of the ORR's proposals and will continue to work with the ORR and industry on these, including on a suitable "market can bear" test for passenger operators and a review of their access policy, as key parts of creating a level playing field for competition which delivers benefits for passengers. Consultees were clear that the levy needs to be compatible with the ORR's conclusions on access and charging and we consider that implementing the levy, once the ORR's conclusions have become clear, is therefore important.

We remain committed to further consultation and to working closely with the industry, ORR and Competition and Markets Authority (CMA) as we take forward detailed proposals for the levy. To that end we have asked the ORR to take the conclusions set out in this document, focusing on option 1 (a levy based on a metric such as distance or passenger numbers, or a combination of the two) as our preferred approach, and, working with us and the CMA, develop detailed proposals for the levy's implementation when Parliamentary time becomes available. We are very conscious of the significant work that the ORR are undertaking as part of Periodic Review 2018 (PR18) and have asked them to consider how and when they will be able to deliver their work on the levy and report back to government. We would anticipate that this is unlikely to be before the end of 2019.

The next part of this document sets out our conclusions and next steps in more detail. This is then followed by summarises summary of the responses we had to the consultation. We received 21 responses from a variety of stakeholders, including: members of the public; owning groups; industry bodies; legal firms; local travel organisations; and the Welsh government. We would like to take this opportunity to thank all those who responded to our consultation. The responses have provided a helpful and constructive basis for future action.

Conclusions and next steps

- 1.1 Here we set out our high-level conclusions from the consultation and the approach we have asked the ORR to take forward and develop towards implementation when appropriate legislative space becomes available. A detailed summary of responses is set out in the next section.

Objectives

- 1.2 Some consultees proposed additional criteria (such as “purposeful”, “proportionate”, “targeted”, “accountable”, “simple” and “holistic”), all of which we agree are important. These are many of the principles of effective government regulation and we will take them into account as key design principles as we develop the levy further. With respect to ‘simplicity’, we also agree with the desirability of this, but note the complexity of levy arrangements of this kind, such that some degree of detailed arrangements is likely to be necessary to ensure that the policy objectives are achieved.
- 1.3 It was clear that several consultees felt that if they were to be charged a levy then this should mean greater access to the network. We believe that the levy could enable this, but it is critical that both are taken forward together.

Scope and design

- 1.4 We continue to expect that the levy will not apply to the current set of international passenger services. This is because passengers are unable to purchase tickets on these services to travel between two stations on the GB rail network and therefore these operators do not compete with franchised operators on the publicly-funded railway network. Were they to do so by operating domestic services, alongside their international services, then we would anticipate the levy would apply to these services.

Administering the levy

- 1.5 Because of the ORR’s role in setting the charging framework for the rail network and the need to ensure that the levy is compatible with

this framework we consider that the ORR is best placed to administer the levy. It would be our intention for this role to form part of the legislation.

- 1.6 The ORR's independence and extensive economic expertise will provide operators with the assurance that they will be treated fairly, and that the levy will be set at an appropriate level to ensure the economic viability of operators. As we set out in the consultation document, the ORR's development of the "market can bear" test for passenger operators could be a useful methodology on which the PSO levy could be implemented.
- 1.7 We do not foresee a role for the ORR in collecting the levy, as this would be better achieved through existing industry mechanisms. How this would work in practice will be an important further consideration as work on the levy is taken forward.

Preferred option for the levy

- 1.8 Our preferred option for the levy is option 1 from the consultation document: a levy based on a metric such as distance or passenger numbers, or a combination of the two. This is because it has significant compatibility with the existing industry / regulatory processes, in particular the ORR's proposed market can bear test which it is currently taking forward as part of PR18.
- 1.9 We consider that a levy designed in this way will provide operators with the certainty they require and provide the right incentives for efficiency and competition which should ultimately deliver for passengers.
- 1.10 Although some consultees favoured other options, this option had general support from consultees who recognised the opportunity to align it with the existing regulatory structure.
- 1.11 We also heard in discussions with stakeholders that having legislation in this area that is sufficiently flexible to adapt to changes in the market, whilst still providing enough certainty for operators and government alike, is important. We agree with this and would expect the ORR to consider all options in more detail before we put in place detailed legislation.

Next steps

- 1.12 We have asked the ORR, working with us and the CMA, to take forward detailed design of the levy in a way that fits with their approach to the Periodic Review 2018 (PR18) process. Recognising that getting the PR18 process completed effectively is their current priority.
- 1.13 Whilst legislative time is constrained over the next few years we will consider the ORR's progress and look for an appropriate Parliamentary opportunity to introduce the levy when it arises.

Summary of responses

1.14 We posed five main questions in the consultation document. These are set out below along with a summary of the responses we received. Although not every response can be set out in detail here, we have considered every response carefully and will take them into account appropriately as we develop the proposals further.

Do you agree with our objective for introducing a levy and the underlying principles?

1.15 The majority of respondents gave their support, in principle, to the introduction of a PSO levy. This included a number of responses which gave qualified support. Several of these stated that their support was conditional upon the levy applying to all operators, not just open access services. Others stated that their final opinion on any PSO levy would depend on the collective impact upon competition of all industry changes and reforms, and not just the levy itself. Several responses requested the inclusion of a principle that the levy would be applied in a non-discriminatory fashion across all franchised and non-franchised operators.

1.16 Several responses considered that the quid pro quo for paying a levy was greater access to the network. A minority of respondents opposed the levy in principle, on the grounds that they believed that it would reduce the provision of open access services.

1.17 One respondent, declining to support or oppose the levy, asked for further clarity around its expected impact upon competition, and its intended objectives. Another respondent advocated that, rather than introduce a PSO levy, that the franchise system should be abolished.

1.18 Of those respondents who were in favour of a levy, there was broad agreement with most of the DfT's suggested principles. Three respondents included additional criteria that they requested be added to or combined with the DfT's suggested principles. These included "purposeful", "proportionate", "targeted", "accountable", "simple" and "holistic".

1.19 One respondent asked for clarity on how funds raised by the levy would be spent by Government.

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

1.20 The vast majority of responses agreed that any levy should only apply to services where tickets are available between two stations in Great Britain.

1.21 A minority of responses believed that any levy should apply equally to domestic and international services. Some of these responses queried DfT's interpretation of the law in this area.

1.22 Further clarity was requested on whether the term "domestic stations" will include stations that are within Great Britain but are on independently-run railways.

Do you agree that the Office of Rail and Road should play a role in administering the setting of the levy?

1.23 There was near-unanimous support among consultees for the view that the ORR should play some role in administering the setting of any levy. It was felt that this would ensure a joined-up approach for charges and incentives during ORR's Periodic Review 2018.

1.24 However, the exact nature of the ORR's role, and whether this should include setting the levy, was disputed. Some respondents were content for ORR to have a strong role in administration of the levy.

1.25 Other respondents felt that the levy should not form part of the ORR's regulatory tools and the ORR should not collect payments. They also felt that the DfT, not the ORR, should set payment rates. Some suggested that the DfT or the devolved transport bodies should administer the levy, supported by the technical guidance of the ORR. Some also believed that it would only be appropriate for the ORR to administer the levy if it is based on the 'market can bear' test they are developing.

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 page 10)?

- 1.26 Responses to this question generally assessed the advantages and disadvantages of each individual option before coming to any final conclusions.
- 1.27 The general consensus of those who commented upon Option 1 (a levy based on a metric) was that it was suitable, although potential drawbacks were noted by some supporters. A minority deemed Option 1 to be not suitable.
- 1.28 This option was seen as simple and able to be linked to existing regulatory processes. It would also give upfront certainty to operators and could be applied to franchises. Some respondents felt it would increase fares and not incentivise efficient use of the network.
- 1.29 With one exception, the strong consensus of those who commented upon Options 2a and 2b (a levy based upon recovering profit or a percentage of profit) was that they were unsuitable.
- 1.30 For some these options were seen as positive in that they would minimise additional start-up costs for open access operators and limit barriers to entry into the market. However, others felt that the options would create a barrier to entry, be complex to administer and not incentivise operators in the right way. They also felt it would be difficult for government to judge what a fair rate of return is.
- 1.31 The general consensus of those who commented upon Option 3 (a levy based on a proportion of revenue) was that it was suitable, although potential drawbacks were noted by some. A significant minority deemed Option 3 not to be suitable, either in its current form, or in any form at all.
- 1.32 Option 3 was seen as a fair one providing operators with certainty upfront. The fact that applications already require this type of analysis was also seen as an advantage. On the other side some respondents felt it would be difficult to model and would not account for the significant start-up costs of open access operators. Others felt it would deter innovation and the exemption of marginal services would create perverse incentives.

1.33 Some respondents noted that whichever option is chosen, they would like to see that the primary legislation is flexible enough to allow the design to evolve in light of future experience.

Are there other options that we should consider? If so why (with specific reference to the principles set out on page 10)?

1.34 The majority of respondents did not offer further options. However, two new options were proposed. The first of these was a levy connected to station access.

1.35 This respondent stated that the purpose of the levy, in their opinion, was for open access to drive infrastructure investment rather than constrain infrastructure. They therefore suggested that the levy reflect a charge on the 'network benefit' gained from operators having station access.

1.36 They proposed that such a levy might be in direct proportion to several measures (such as passenger numbers, station access charges and distance travelled) which they argued were reflective of both the benefit gained and the capacity used by the services.

1.37 The second additional option suggested was a levy using Moira modelling to calculate revenue abstraction. This respondent's opinion was that a key objective of the levy is to recover revenue lost by public sector rail operations as a consequence of open access rail operations. Therefore the levy should be equal to the amount of revenue abstracted from public sector operations, subject to earning a reasonable rate of return.

1.38 This approach, in the respondent's opinion, would encourage open access applicants to focus on the development of new markets in order to minimise potential loss of revenue that they would face under the levy.

1.39 Some respondents also suggested modifications to our original list of options. These included:

- Modifying Option 1 so that, like Option 3, there were variants around different service groups;
- Rather than basing Option 3 on a service group, using passenger flows. The levy would only apply to passenger

flows beyond a certain distance and where there is clear evidence that the services are commercial;

- Exempting regular interval services from all options, provided that they were fully integrated in terms of timetabling and fares; and
- Offsetting the levy via a social benefit value ascribed to different services.

List of respondents

Addleshaw Goddard LLP
Arriva
The Competition and Markets Authority
FirstGroup
Go-Ahead Group
Go-Op Co-operative
Ken Skates AM, Welsh Government Cabinet Secretary for Economy and Infrastructure
Network Rail
The Office of Rail and Road
The Rail Delivery Group
Transport for London
Torbay Line Rail Users Group
TravelWatch Northwest
Stagecoach Group and Virgin Rail Group
Which?
5 members of the public