

## Rail Delivery Group

Response to:

Department for Transport's consultation on

### **The passenger rail public service obligation levy**

**Date: April 2017**

Rail Delivery Group response to:  
**Department for Transport**  
**The passenger rail public service obligation levy**

*Organisation: Rail Delivery Group*

*Type: Business representative organisation*

The Rail Delivery Group (RDG) brings together Network Rail and passenger and freight operating companies. The purpose of the RDG is to enable Network Rail and passenger and freight operating companies to succeed by delivering better services for their customers. Ultimately this benefits taxpayers, passengers and the wider economy. We aim to meet the needs of:

- a) our members, by enabling them to deliver better outcomes for customers and the country;
- b) government and regulators, by developing strategy, informing policy and confronting difficult decisions on choices, and
- c) rail and non-rail users, by improving customer experience and building public trust.

The Rail Delivery Group (RDG) welcomes the opportunity to respond to the Department for Transport's (DfT) consultation on the introduction of a public service obligation (PSO) levy for non-franchised, domestic passenger operators.

The consultation document from the Department sets out helpful information about possible design options for the new PSO levy. However, it is important to establish clarity about the broader regulatory and contractual landscape into which the levy is likely to fit, and intersect successfully with other related initiatives that are intended to contribute to better railway outcomes for passengers.

As the DfT notes in its consultation, the current interest in the PSO levy was sparked by the report by the Competition & Markets Authority (CMA) last year which looked at on-rail competition<sup>1</sup>. The levy was one component in a broader package of proposals that the CMA made, including recommendations about future franchise design, allocation of access rights and industry charging. The PSO levy was intended to offset any financial detriment that taxpayers may suffer in a world in which there was greater on-rail competition.

At this time, it is not clear which of the CMA's recommendations the DfT is minded to implement. This makes it very difficult to comment on the proposals for a PSO levy in isolation. For example, RDG's views on the introduction of a PSO levy might be very different in a world in which franchising policy remains broadly unchanged, as compared to a world in which the DfT redesigns future franchises along the lines suggested by the CMA.

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<sup>1</sup> Competition in passenger rail services in Great Britain A policy document, March 2016

Within these constraints, RDG makes the following observations:

**PSO costs** – as the name suggests, the new levy is intended to contribute towards the costs of socially and economically important, but ultimately unprofitable services. We feel that DfT’s consultation document would have benefited from more clearly defining the obligations and identifying associated costs. RDG would request that the the public service obligations in the East Coast, Greater Western and West Coast franchises are modelled, as the three main routes on which open access operators are likely to have to pay the new PSO levy. This work would allow decision makers to fully understand the impact of the levy before it is adopted.

**Level of the levy** – such clarity on the identification of which services might also help the DfT to determine the appropriate level of the new levy. The consultation document states that the levy will not exceed the ability of the underlying market to absorb additional cost, but we suggest that the DfT should also seek to limit the levy so that it does not overcompensate the cost of public service obligations along routes on which franchised operators are competing with open access operators.

**Predictability** – related to question four, it is important for the design and amount of the new levy to be known early for business planning purposes. The introduction of a PSO levy has the potential to have a very significant impact on the finances, and business model, of open access operators and it is vital that operators know the ‘rules of the game’ so that they can plan their services with a good degree of certainty about the payments that they will be required to make to government, at least 3 years in advance.

Building on this final point, it is important that the DfT signposts the introduction of the new levy well in advance of implementation. To this end, the industry would find it helpful to understand better DfT’s thinking about an implementation timetable, including the likely timing of new legislation.

RDG also notes that it can take some time for new operators to build their businesses, and may not be profitable in the first couple of years of operation. DfT should consider ways to avoid pricing these services off the network in their first years of operation, as they may be beneficial to passengers.

RDG will be very happy to provide further input and assistance in this process as may be helpful to the DfT.

### **Responses to consultation questions**

#### **Q1: Do you agree with our objective for introducing a levy and the underlying principles?**

RDG broadly support the DfT’s stated objective and principles. RDG have developed a set of principles to assist in any further policy development for the levy (which are included for reference at annex A to this response document).

As set out above, the objective (“to ensure that, where they are able to, open access passenger operators make a contribution towards socially and economically

important, but ultimately unprofitable, services”) could usefully be grounded within a broader vision from the DfT on the role for open access operators in the railway.

In this context, RDG member strongly support principle (a) – i.e. the levy, along with other policy initiatives, should ultimately enable better outcomes for passengers.

Possible additional principles might be that:

- *the levy must be applied to providers of passenger services in a non-discriminatory manner; and*
- *the levy must fit coherently with other regulatory and contractual charging and incentive mechanisms.*

In relation to principle (g), RDG consider that it is important that the levy is dynamic, through regular reviews and updates as required which will ensure it adapts to changing circumstances. It is highly unlikely that a levy will be resilient to all possible changes within the market, hence the need for the DfT to ensure that the design and calibration evolves in a way that meets the stated policy objective and principles over time.

**Q2: Do you agree that only services where tickets are available between stations in Great Britain should be in the scope of the levy?**

RDG agree with this aspect of the DfT’s proposals.

**Q3: Do you agree that the Office of Rail and Road (ORR) should play a role in administering the setting of the levy?**

RDG note the logic in asking ORR to play a role in the calibration of the levy, given their role in the market to bear test. There is overlap in the work that the DfT will need to carry out when assessing if a PSO levy would endanger the financial viability of services, and the analysis that the regulator will need to conduct when assessing if services can contribute to Network Rail’s fixed charges. It makes sense for there to be one overarching ‘market can bear test’ which is developed and owned by the technical specialists at ORR, following endorsement by operators and infrastructure managers.

However, RDG would not be comfortable if ORR were remitted to formally collect the levy or if the levy were to be made a part of ORR’s regulatory toolkit. The proper allocation of responsibilities is that the DfT should set and administer the PSO levy as the authority responsible for collecting monies from the industry, with the ORR providing the technical advice and assistance, at the DfT’s request.

RDG also consider that it is vital for ORR to be funded for any additional work it will be doing, and that resources should not be diverted from ORR’s core job of regulating Network Rail.

**Q4: 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)?**

*Responses to questions four and five are considered together.*

**Q5: Are there other options that we should consider? If so why (with specific reference to the principles set out at paragraph 1.21)?**

In line with comments made elsewhere in this response, RDG have found it difficult to reach a definitive view on the proposed options given the lack of clarity that there is about the role that there is likely to be in future for open access services, and the track access charges that ORR concludes that open access services should be exposed to (e.g. fixed costs). The view, therefore, is that it would be premature to lock down on any one option now, and there should be further consultation once the proposals for a levy are further developed.

***Option 2a and 2b***

There is, however, little enthusiasm for options 2a (*Option 2a: a levy which recovers all profit above a fair rate of return threshold*) and 2b (*Option 2b: a levy which recovers a specific percentage of profit above a fair rate of return threshold*). A levy on profits, possibly at the rate of 100p in the pound, would severely curtail operators' incentives to innovate and would ultimately not be in the interests of passengers. It is also questionable whether the DfT or ORR would be able to judge what a 'fair' rate of return for open access operators is, or, indeed, whether this is a fixed and unvarying number over time.

***Options 1 and 3***

There is greater support for the idea that the levy should be structured into a rate card (*Option 1: a levy based on a metric such as distance or passenger numbers, or a combination of the two*). This will give operators upfront certainty about the amount of levy they would face when operating new services. Some operators are concerned that a levy of this kind would have the character of an access charge and that it might be difficult in administrative terms to differentiate levy rates across different types of service in accordance with the level or PSO costs and/or markets' ability to bear cost.

The alternative of structuring the levy as a percentage of revenue (*Option 3: a levy charged as a proportion of revenue*.) is attractive in that high-yielding services pay a high levy amount while low-yielding services pay a low levy amount. However, some RDG members are concerned that a levy on revenues has some of the undesirable incentive properties that we noted afflict a levy on profits – i.e. that there is a relatively high tax on innovations that operators may make when seeking to grow their customer and revenue bases, which might deter operators from pursuing new ideas.

Whichever form the levy eventually takes, RDG consider that it is important that operators know in advance the structure and amount of levy that new services will be required to pay over a medium-to-long time horizon. Frequent resets to levy rates, especially if such resets are designed to maximise the amounts that open access operators pay to government, could mean that options 1 and 3 collapse into option 2, and present the undesirable qualities that this option has.

### **Implementing a levy**

RDG would ask the DfT are clearer on the thresholds for considering whether existing open access services should be required to pay the PSO levy, as this would assist future business planning. The DfT should be cognisant of any unforeseen, ex post disruption to the business cases on which investments into existing services were made, which could disrupt the viability of current businesses.

As a final observation, RDG would wish both DfT and ORR to note that track access charges should be recovered from open access services first, before the PSO levy is implemented. This should ensure that Network Rail is adequately funded to run the network safely and sustainably.

For enquiries regarding this consultation response, please contact:

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## Annex A

### RDG's principles for a public service obligation levy

- **Purposeful** - ensure the purpose of levy is clear, with a demonstrable need.
- **Proportionate** - the levy is proportionate
- **Transparent** - the levy is applied in an open manner which allows operators to plan and sustain their business
- **Consistent** - the levy is applied consistently, without undue discrimination
- **Targeted** - it is only applicable to commercial services
- **Accountable** - the authority must be able to explain the rationale for a levy
- **Legal** - the levy is legally sound
- **Simple** - the levy is easy to understand (links to transparency)
- **Holistic** - considered in the round with the broader charges, access rights and incentives

### DfT's objective and principles for introducing a public service obligation levy

*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.*

*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.*