



OFFICE *of*
RAIL REGULATION

**LICENCE FEES/SAFETY LEVY -
CONCLUSIONS**

NOVEMBER 2005

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1. Introduction

1.1 On 31 August 2005 we published a consultation document¹ covering proposals for a revised approach to licence fees and for a new safety levy to cover the costs of our new health and safety functions post transition. The proposals are central to the question of how we will be funded as the combined safety and economic regulator.

1.2 The policy objectives were to introduce a funding system which:

- is part of a framework that encourages effective engagement with us on safety and economic matters;
- is fair and transparent;
- is broadly cost reflective;
- is cost effective (keeping the administrative burden to a minimum);
- avoids any significant windfall gains or losses compared with the existing position;
- is consistent with our position as the independent safety and economic regulator;
- is compatible with the forthcoming Department for Transport (DfT) regulations implementing the First Rail Package²; and
- is stable over time facilitating future planning.

1.3 In summary, we proposed:

- that Network Rail meet the full costs of our economic regulation activity through its licence fee; and
- that the costs of our new health and safety functions be met through a turnover-based levy on all providers of railway services³.

¹ *Licence fees/safety levy – A consultation* – Office of Rail Regulation – 31 August 2005

² See *Implementation of the First Package of EU Rail Directives – A Consultation Paper* - Department for Transport - June 2005 – London

1.4 We sought views on:

- the overall approach proposed to recovering our costs;
- the use of turnover as the basis for the safety levy; and
- detailed implementation issues, including the definition of turnover and the level of the threshold below which the levy would not be payable.

1.5 Our consultation period ended on 17 October 2005. We received a total of 23 responses. Respondents are listed in Annex A and copies of the responses can be viewed on our website⁴.

1.6 This document sets out the approach we plan to adopt. In Chapter Two we summarise the background to issues. In Chapter Three we set down the points raised in the consultation, our review of these and our considered decision on each point. We have summarised the position in our conclusions in Chapter Four. Broadly these follow our initial proposals, but with some change on the threshold and a commitment to review the safety levy in late 2007.

³ That is a person “who provides railway services” in accordance with section 43A(1) of the Health and Safety at Work Act 1974. This section provides that a person provides railway services if he “manages or controls, or participates in managing or controlling a transport system which falls within the categories identified in paragraph 1(3) of Schedule 3 to the Railways Act 2005.

⁴ <http://www.rail-reg.gov.uk/server/show/ConWebDoc.7554>

2. Background

2.1 The Government announced its intention to give us responsibility for both safety and economic regulation of railways in Great Britain in last year's Rail Review White Paper⁵. Its reasons for doing so were that:

“bringing regulation of all aspects of the rail industry – safety, reliability, and efficiency – together under a single public regulator will streamline the regulatory system, reduce bureaucracy, and ensure that these issues are looked at as a whole and not in isolation from one another.”

2.2 The intention was enacted in the Railways Act 2005, which received Royal Assent on 7 April 2005 and the relevant sections of which are due to be implemented early in 2006. We will now need to develop new ways of working and to review and revise existing practices underpinning previous approaches in order to comply with the legislation and meet the policy objectives, with which we concur. This includes the funding of both the safety and economic regulation functions and our consultation document set out our proposals on how this could best be achieved.

2.3 The transfer of safety responsibilities to us from HMRI and HSE Rail is likely to take place in the early part of 2006 and a funding regime needs to be in place from 1 April 2006.

Context

2.4 Our consultation exercise was the first stage of a two-part process, the second being DfT's consultation on the draft regulations implementing the safety levy proposals. DfT's consultation document was published on 8 November 2005 with a closing date for responses of 16 December 2005.

2.5 We believe that those consulted by DfT may find it useful to have our conclusions on the issues raised in the ORR consultation in framing their responses to DfT's consultation on the draft regulations.

⁵ *The Future of Rail*, Department for Transport, Cm 6233, July 2004

3. Consultation responses

Introduction

3.1 This Chapter summarises responses to our consultation under the following headings:

- the overall approach;
- use of turnover as the basis of the safety levy;
- the adoption of a single levy assessment rather than separate assessments for different categories of railway service provider;
- the proposed scope of the levy;
- the proposed definition of relevant turnover; and
- the proposed threshold.

The overall approach

Financial impact on Network Rail

3.2 Whilst Network Rail strongly supported the aim of streamlining arrangements and reducing bureaucracy set out in the White Paper, it observed that its costs were projected to increase by approximately £9.8 million per annum and sought an assurance that it would be held financially neutral in respect of this increase.

3.3 From Control Period 4 (i.e. 1 April 2009) (CP4) onwards Network Rail's licence fee and safety levy will be included in our assessment of the company's revenue requirements because it will be part of the base level of costs that is the starting point for these assessments.

3.4 We have considered two approaches to the increase in costs in Control Period 3 (i.e. the current period until 31 March 2009) (CP3):

- provide a regulatory commitment to add the additional costs to the opening CP4 Regulatory Asset Base (RAB) in April 2009, as suggested in Network Rail's consultation response; or

- commit to assessing the impact of the additional CP3 costs on Network Rail's CP4 revenue requirement.

3.5 The first of these approaches is not good practice since this would capitalise operating expenditure. Furthermore, the precise role of the RAB as a basis for assessing Network Rail's future revenue remains an issue for debate and resolution during the 2008 Periodic Review. We do accept that the increased costs incurred by Network Rail in CP3 will impact on the degree of outperformance or underperformance in relation to our 2003 expectation that it will be able to report. As Network Rail is using current surpluses to enable its debt to be less than planned, the extra £29 million or so will change the debt levels we will need to assume at the start of CP4 and hence the CP4 revenue requirements. We are therefore minded to adopt the second approach. In our reports on Network Rail's financial performance for the remaining years of CP3 we will draw attention to what this would have been without the levy changes.

Effect on track access charges

- 3.6 Two respondents sought assurances that the increase in the Network Rail licence fee will not simply be passed through to train operators in the form of higher track access charges. In addition, EWS asked for confirmation that increased costs to Network Rail would not be recovered from freight operators in the long term through any charging review.
- 3.7 We do not propose an increase in track access charges during the remainder of CP3. However we are reviewing track access charges for both passenger and freight train operators as part of the 2008 Periodic Review and will consult on proposed changes to take effect from April 2009. Inevitably the additional costs will need to be reflected in CP4 revenue requirements for Network Rail.

Recycling of safety regulation funding

- 3.8 A number of respondents sought confirmation that the recycling of the direct funding element through DfT budgets had been agreed. In particular, London Underground Limited (LUL) noted that a move to a turnover-based levy would increase its safety regulation costs by approximately £1.6 million and commented that it was seeking confirmation from DfT that grant to LUL would be increased by a corresponding amount.

- 3.9 We understand that DfT's intention is to secure the recycled funding as outlined in the consultation document. This is however a matter for DfT, and you may wish to address it in your responses to DfT's consultation on the draft regulations if it is significant to you.

Effect on incentives

- 3.10 Both LUL and Transport for London (TfL) observed that LUL's safety risk profile was expected to reduce whilst its regulatory costs under the levy proposal were expected to increase and that the proposal thus lacked an incentive element.
- 3.11 Whilst we note the comments, we consider that the principal aim of the levy proposal is to balance all the factors outlined in paragraph 1.2 above rather than to provide a financial incentive. We also consider that the existing system of invoicing for safety regulation services may in fact serve as a disincentive for duty holders to engage with the safety regulator in identifying and implementing improvements.

Funding from general taxation

- 3.12 Three respondents, (the Confederation of Passenger Transport UK (CPT), The London Transport Users Committee (LTUC) and the Tyne & Wear Passenger Transport Executive (Nexus)) raised the question of whether HMRI services should be funded by central government and financed from general taxation.
- 3.13 We understand and accept that government policy is that regulatory costs should as far as practicable, be funded by the industry being regulated.

Predictability/stability over time

- 3.14 Glasgow Subway noted that the current system of charging generated highly variable costs depending on the level of involvement in specific activities and observed that the predictability which the proposals would bring, would be welcome. We agree; this was one of the intentions of the policy.

Condition 9 of the licences held by existing operators

- 3.15 EWS sought clarification of our intentions regarding the licence fee condition in the light of the proposal to charge 100% of the costs of economic regulation to Network Rail.

- 3.16 We do not intend to recover licence fees under condition 9 other than from Network Rail. However, we do intend to review the funding structure in the light of experience in approximately two years time and so we consider that it would be premature to remove the condition from licences at this stage.

Further analysis of options

- 3.17 Network Rail commented that further analysis of the options would be useful and noted that we should exercise our regulatory discretion in a way that means the benefits of regulation outweigh the costs. We agree with this principle. We do not have any evidence that further analysis would lead to a different conclusion, and on that basis we do not believe that further expenditure on analysis of the options is warranted.
- 3.18 Network Rail also suggested that we should set out more clearly why we were proposing a departure from the funding principles established in 2003. In fact, we believe that the proposed move is entirely consistent with the conclusions reached by our advisers at the time, who noted in their report⁶ that there was a case for the national infrastructure provider meeting 100% of our costs. At the time, we concluded that 50% was more appropriate. However the policy context has changed with the decision to merge safety and economic regulation and we believe that Network Rail meeting the full cost of economic regulation is consistent with the objectives of our funding policy and with our statutory duties.

Efficiency and magnitude of regulatory costs

- 3.19 Network Rail stated the expectation that combining safety and economic regulation would lead to efficiency savings.
- 3.20 We have the same expectations. We believe it is very important that we should demonstrate to stakeholders that we have tight control of costs and resourcing. At the same time we need to ensure that we have the appropriate level of resources available for the effective exercise of our new functions from the date of transition. Our overall approach to resourcing the office will therefore be:

⁶ Review of Licence Fees Methodology – A report for the Office of the Rail Regulator – NERA – March 2002, London

- to develop better measurements of the outputs and value for money of regulatory activity;
- to improve our efficiency over time;
- to identify activities where we are not adding significant public interest value and reduce the resources devoted to them; and
- to be prepared to put in extra resources where this will add value.

Consistent approach to the treatment of RSSB costs

- 3.21 Network Rail commented that it would be inappropriate for changes in RSSB funding arrangements to result in the company appearing to be less efficient through being unable to recover its share of RSSB's costs through the safety levy.
- 3.22 This consultation is about the funding of ORR not RSSB. Network Rail's obligations in respect of funding RSSB are set out in its Network Licence and the RSSB Constitution Agreement.

Use of turnover as the basis of the safety levy

- 3.23 A number of respondents were concerned about the proposed move away from invoicing for services and the resultant effect on cost reflectivity. In addition, Eurostar (U.K.) Limited, considered that a simple turnover approach would not reflect the service level underpinning its business, which involves a low volume of trains with a higher than average income.
- 3.24 We remain of the view that the current "transaction-based" charging⁷ arrangements are inappropriate in the future, because they generate significant transaction costs, and risk creating an undue focus by HMRI on "chargeable" activities and a reluctance by the industry to approach the inspectorate for advice. These concerns will be reinforced if, as currently planned, the Railways and Other Transport Systems Regulations (ROTS) are repealed, and HMRI's role in specific approvals of plant and equipment is abolished.

⁷ It is important to note that direct charging only accounts for approximately 40% of HMRI's costs. The remainder is met through direct funding from Treasury via the Department for Work & Pensions and we consider that continuation of that is inconsistent with our independent status.

3.25 We consider however that:

- charges should be broadly reflective of the amount of our safety-related activity devoted to a particular railway sector/company; and
- our safety-related activity should be broadly related to an assessment of the risk likely to be generated by the sector/company in question.

3.26 We cannot fully reflect these principles in our charging arrangements at present because:

- we will need to review the balance of our safety-related activity under the new arrangements, particularly reflecting the abolition of ROTS;
- currently risk models in the different sectors of the railway industry are not comparable; and
- appropriate performance and risk metrics have yet to be developed.

3.27 A number of respondents including Great North Eastern Railway Limited (GNER), and FirstGroup plc, expressed support of the use of turnover as the basis of the levy.

3.28 Therefore, for the present, we believe that company activity, measured by turnover, is the best available proxy for risk. We propose to adopt this approach for the first two years following the transfer. During that period we will review the position in the light of experience to establish whether there is a measure which better reflects differential performance, and the amount of risk and of our safety-related activity.

The adoption of a single levy assessment, rather than separate assessments for different categories of railway service provider

3.29 Most respondents supported the single approach proposed. Merseytravel, Merseyrail and Merseyrail InfraCo Limited, addressed the issue in their joint response and concluded that a categorised approach would offer little benefit over and above a single turnover-based approach. FirstGroup and BAA put forward a similar point. GrantRail supported the single levy approach, provided the assessment was clear and fair.

The proposed scope of the levy

Light rail, tramways and unlicensed operations

- 3.30 The Confederation of Passenger Transport (UK) (CPT) noted that any reduction in licence fees offsetting the increased cost of the safety levy would not apply to those operators, including light rail, tramways and heritage operators, who are currently exempt from or fall outside the scope of the Railways Act 1993 licensing regime.
- 3.31 We confirm that this is the case. Our responsibilities as the health and safety regulator will be wider than our economic regulation responsibilities and whilst the offsetting reductions will be important to licensed train operators in managing the financial effects of the new funding regime, the purpose of the policy is to balance all the factors set out in paragraph 1.2 above, not to avoid any additional costs to particular sectors.
- 3.32 We believe that the de-minimis threshold of £1 million rail-related turnover per annum will address a number of concerns raised as will the proposal (see paragraph 3.49 below) for a flat rate charge where turnover is between £1 million and £5 million. We recognise that for larger operators, a turnover-based levy will lead to a marginal increase in payments compared with the current position.
- 3.33 We will discuss the implications of this with representatives of the light rail/tramways sector before we make our final decision on the levy for 2006-07.

Heritage Railways

- 3.34 The Heritage Railway Association stated that Government policy was that the proposed levy should not apply to heritage railways and provided a copy of a statement from the Government Whips Office written in response to questions asked during a Grand Committee session on the Railways and Transport Safety Bill in 2003. In addition CPT referred in its response to the difficulty of identifying an appropriate turnover figure for heritage operations, primarily on the grounds that these operations do not on the whole tend to distinguish between turnover on railway services and on other related activities (shops, museums etc.)

- 3.35 We recognise that the heritage sector has concerns. The statement was however given in the context of the debate on the Railways and Transport Safety Bill and well before the proposal for the merger of ORR's economic and HMRI's health and safety functions. The policy context has changed and the Railways Act 2005 of course provides for the merger. We can find no continuing commitment to the Government policy during the passage of the Railways Act 2005. We believe it is appropriate for the position to be reconsidered – especially in the context of a wider review of the costs of regulation. We recognise the special contribution of the heritage sector, both in terms of cultural and economic impact, as well as the characteristics of the sector – principally the extent of unpaid and voluntary support - and we do not intend as a matter of policy to bring heritage operations specifically into the scope of the levy. We nevertheless consider that where there is a significant resource requirement on our safety-related activity this should be reflected in part in the levy charged.
- 3.36 We recognise that for some operators the amount would be very small, and the cost of collection/obtaining an audit certificate may be disproportionate. We are therefore proposing that the levy should not apply where the relevant turnover is less than £1 million and additionally in the light of the consultation, that a flat rate of £1000 should apply where relevant turnover is between £1 million and £5 million. We want to discuss the practicalities of this with representatives of heritage railways before making our decision on the 2006-07 levy.

Track transit systems - airports

- 3.37 BAA noted that these systems (in use at Heathrow, Gatwick and Stansted airports) are free to passengers and hence have no identifiable turnover. BAA asked for clarification as to whether they would be included.
- 3.38 These systems are currently covered under ROTS and do have a call on HMRI resources. It is also noted that the hazard profile for these systems is significant in that they are automated and partly elevated. On that basis, we are minded to include these systems in the scope of the levy. As there will be no satisfactory turnover figure we will need to develop an equivalent number based on BAA's estimated costs plus a reasonable return on the provision of these services. It is likely that this will be an issue to be examined in the proposed review in two years time.

ROSCOs

- 3.39 Two respondents (Angel Trains Limited and HSBC Rail (UK) Limited) sought confirmation that the rolling stock leasing companies (ROSCOs) would not be included within the scope of the levy arrangements. We confirm that this is the case as ROSCOs do not fall within the definition of railway service providers in section 43A(1) of the Health and Safety at Work etc Act 1974 (HSWA).

The proposed definition of relevant turnover

Treatment of grant and subsidy

- 3.40 Strathclyde PTE for the Glasgow Subway commented that the treatment of subsidy and grants (i.e. whether or not grants and subsidies should be included) required further clarification. FirstGroup stated that turnover should include all income related to the provision of railway services and hence that grants should be included.
- 3.41 We note the responses and confirm that all subsidy or grant payments should be included in the calculation of relevant turnover as required under appropriate accounting standards.

International turnover

- 3.42 EWS sought clarification that the relevant measure would be turnover within Great Britain and would not include revenue raised in respect of international operations.
- 3.43 We consider that where operators provide services which run wholly outside Great Britain, turnover on these activities should be excluded. However turnover derived from the provision of railway services within Great Britain, whether or not these form part of an international service, would be included.

Audit of turnover

- 3.44 EWS supported the proposal for an auditors' certificate. On the other hand Merseytravel, Merseyrail and Merseyrail InfraCo Limited noted the relative costs especially for smaller operations and suggested a graduated approach to the certificate requirement. GNER suggested that we should provide the audit rather than the undertaking submitting the figures.

- 3.45 On balance we are prepared to adopt a flexible approach to the audit certificate requirement for the smaller enterprises. We therefore propose to give enterprises with turnovers (or equivalent turnovers) of less than £10 million a choice as to whether to provide an auditors' certificate or to self-certify, recognising that in time we would receive the audited accounts which would confirm or otherwise the self-certificated numbers. We would expect to make adjustments to recover undercharging where the self-certified numbers materially understated the turnover.

Infrastructure contractors

- 3.46 EWS noted the proposal to exclude infrastructure contractors from the safety levy on the grounds that the costs would probably be passed on to the relevant infrastructure manager. EWS did not oppose the idea provided it was applied fairly to all contractors of the infrastructure manager. In this respect, EWS argued that freight operators supplying infrastructure trains and related services were acting as infrastructure contractors and hence any turnover generated from these activities should be excluded.
- 3.47 We do not agree. We consider that in supplying infrastructure haulage services, freight train operators fall within the definition of railway service providers in section 43(A)(1) of the HSWA, whereas infrastructure contractors providing other infrastructure services do not.

The proposed threshold

- 3.48 We received a range of responses on the proposed threshold. A number of respondents (e.g. Network Rail, Island Line, South West Trains Limited) considered that the proposed threshold of £1 million was sensible. EWS did not disagree with the level of the threshold but considered that those providers of railway services with a relevant turnover below the threshold should pay a flat rate fee of £500 per annum. Nexus expressed the view that there ought to be a number of thresholds below which fixed levies would be payable – a similar approach to that adopted in respect of charging for RSSB. The level of the threshold is also a key concern for heritage operators.
- 3.49 We remain of the view that a threshold of £1 million is appropriate. Our initial calculations suggest that this would yield a levy payment in the region of £1000, which seems to be above the level where the costs of collection are disproportionate. However, we note the concerns raised in the consultation

responses and in the light of these we consider that railway service providers with a relevant turnover of between £1 million and £5 million should pay a flat rate of £1000. We do not consider that a lower flat rate fee for turnover below £1 million would be appropriate in view of the associated costs of collection.

4. Conclusions

4.1 In the light of the consultation responses we conclude that:

- the overall approach set out in the consultation document (that is, Network Rail meeting the whole cost of economic regulation with the cost of safety regulation recovered through a levy to be paid by providers of railway services) has widespread if not universal support across the industry;
- turnover is an appropriate measure on which to base the safety levy and there should be a single levy assessment, rather than separate assessments for different categories of railway service provider;
- the levy should cover train operating companies (franchised and non-franchised), freight operating companies, infrastructure managers, London Underground Limited, international operators and light rail and tramways. It would however be appropriate for us to review the scope in the light of experience in approximately two years time. In addition, we expect to engage with representatives of the light rail/tramways and heritage sectors to review the practicalities of the proposals prior to finalisation of the determination for 2006-07;
- the definition of relevant turnover should be “turnover on railway services” as set out in section 43(A) of the HSWA. However relevant turnover means turnover on operations within Great Britain. Grants and subsidy payments should be included in the calculation of relevant turnover. Revenue derived by freight operators from running infrastructure trains and related services should also be included;
- turnover returns should be supported by an auditors’ certificate, although where reported turnover is £10 million or less we would generally expect to accept some form of self-certification; and
- the initial threshold should be £1 million of relevant turnover as proposed in the consultation, although where relevant turnover is between £1 million and £5 million we will charge a flat rate of £1000. ORR will review these figures as part of the post implementation review referred to above.

Annex A – Respondents to the consultation document

Angel Trains Limited

Balfour Beatty Rail Limited

Confederation of Passenger Transport UK

English Welsh & Scottish Railway Limited

Eurostar (U.K.) Limited

First Group plc

Glasgow Subway – Strathclyde Passenger Transport Executive

Go-Ahead Group

GrantRail Group Limited

Great North Eastern Railway Limited

Heathrow Express and BAA

Heritage Railway Association

HSBC Rail (UK) Limited

Island Line Limited

London Transport Users Committee

London Underground Limited

Merseyside Passenger Transport Executive and Merseyside Passenger Transport Authority/Merseyrail Electrics 2002 Limited/Merseyrail Infracore Limited

Merseytravel

Network Rail Infrastructure Limited

Nexus (Tyne & Wear Passenger Transport Executive)

Northern Rail Limited

South West Trains Limited

Transport *for* London