Annex B - Gap analysis

1. This annex provides an overview of the analysis undertaken as part of the structure of charges review to assess how far the existing charging structure is from meeting our charging objectives – we refer to this as gap analysis.

2. This annex sets out the key four themes identified through the gap analysis and summarises the evidence used.

Purpose of the gap analysis

3. As part of the structure of charges review, we carried out a gap analysis to gain an understanding of the difference between the impact of the existing charging structure (more information on this can be found in Annex A of the consultation document) and our objectives (published in the December 2014 letter to the Rail Delivery Group) for the future charging structure. The purpose of the gap analysis was not to identify specific improvements to the existing charging structure but rather to establish the overall areas where the structure of charges falls short of our objectives.

4. The outcome of the gap analysis has been used to:
   ■ consider the extent to which the existing structure of charges needs to be reviewed; and
   ■ provide a helpful framework for developing our options analysis by assessing how well each option helps to reduce any of the identified gaps.

5. Our gap analysis was carried out in three steps:
   ■ Step 1: A detailed, desk based exercise to gather evidence about how our existing charges perform against our objectives.
   ■ Step 2: Building on step 1, we identified four themes that summarise the gaps between our current charges and our aims and objectives.
   ■ Step 3: Consideration of the relative importance of these different gaps under different states of the world1 – and whether they become more or less important.

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1 States of the world were developed by RDG as part of their own review of charges. A detailed overview of this work can be found on RDG’s website.
Step 1

6. The evidence gathering exercise covered each of the existing charges, reflecting that the available evidence mostly relates to individual charges rather than the current charging structure as a whole.

7. We considered evidence from various sources, specifically:
   - Documentation feeding into the design of the existing charges such as PR13 final determination and previous consultations that sought stakeholder views on individual charges and related issues.
   - RDG’s assessment of the current charges and incentives regime, which is published here.
   - Internal workshops within ORR.

Step 2

8. We identified that much of the evidence gathered under step 1 could be grouped into four high-level themes.

Figure 1: Summary of identified themes with relevant objectives

- **Cost-reflectivity**: The existing charging structure has limited ability to drive down costs, encourage efficient decision making and to achieve value for money.

- **Capacity**: The existing charging structure falls short of providing specific and strong incentives for the efficient provision and use of network capacity.

- **Competition**: The existing charging structure may not support effective competition between different types of passenger operators.

- **Complexity**: Charges have changed at control periods in a way that has created uncertainty for users of the network.
9. We recognise that these themes might not necessarily represent discrete problems with distinct solutions. However, we have found them to be a useful approach in summarising the main gaps between our current structure of charges and our objectives, and for identifying broad sets of options.

10. We consider each of the identified gaps and the relevant evidence identified within each of these below.

**Cost-reflectivity**

11. We found that individual charges and the structure of charges as a whole sometimes falls short on delivering the following sub-objectives:

- Supports lower network costs\(^2\) and efficient decision making.
- Improved costs reflectivity.
- Improved value for money for funders, taxpayers and users.
- Improved Network Rail accountability.

12. These objectives, if achieved for the overall structure of charges, would likely be closely related. For example, if our future structure of charges was more cost-reflective, this would provide the right signals to operators and Network Rail to make better decisions. This may lead to a reduction in network costs, thus improving value for money for stakeholders.

13. We found evidence that some charges are effectively supporting **lower network costs and efficient decision making** on the network:

- 2014 report by Credo for ORR, *“Evidence gathering on the effectiveness of PR08’s incentives regime”* (2014 Credo report), cites evidence of operators, ROSCOs and train manufacturers responding to the variable usage charge.

- Similarly for the electricity for traction charge, the 2014 Credo report provides evidence of operators investing in eco-driving programs, considering train temperature strategies, stopping patterns and regenerative breaking.

14. However, incentives to reduce costs are not as effective as they could be. This is because charges designed to recover a significant proportion of Network Rail’s costs, namely the fixed track access charge, provide little or no incentives for train operators to help Network Rail reduce its network costs.

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\(^2\) Lower network costs refer to the cost per unit of output.
Capacity
15. The evidence we collected suggested that there are two distinctive concepts that arise within the capacity theme:

   a) consideration of how charges support **efficient use of network capacity**; and

   b) how charges support provision of appropriate **volume and quality of network capacity**.

16. Within the current charging framework only the capacity charge and the volume incentive have a designed mechanism to influence either of these two concepts. However, they do not directly incentivise Network Rail to consider efficient volume of capacity to provide, nor to ensuring that the capacity is allocated to those who value it the most.

Complexity
17. **Predictability, stability, simplicity and transparency** of charges are principles that our charging structure should aim for. These principles enable operators to respond accurately to the signals and incentives from charges, and so can affect the likelihood that the capacity or cost-reflectivity gaps will be addressed in practice. Complexity, or even the perception of it, can reduce the overall effectiveness of the charging framework.

18. The importance of complexity of charges (actual and perceived) was also noted in the December 2014 Transport Select Committee’s ‘investing in the railway’ enquiry which concluded that: “The Office of Rail Regulation must consult on the track access charging regime with a view to reducing the current complexity”.³

19. We observe regularly, in a lot of our evidence and communications from across industry, that many stakeholders do not have a good understanding of charges. For some of the cost recovery charges, such as the electrification asset usage charge, this may not be a critical issue. For other charges, such as the variable usage charge, it impacts on stakeholders’ ability to respond correctly to the incentives set.

Competition
20. The competition theme reflects the potential for the current charging framework to be a relevant factor that limits the potential for greater on-rail competition and, in particular, competition in the provision of passenger services between franchised operators and open access operators. In particular, the differences in charges paid by franchise and open access operators mean that, for a given service,

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operation through a franchise would offset a greater proportion of the costs to taxpayers of funding the network.⁴

21. We consulted on options for amending our structure of charges for open access operators to allow increased competition in June 2013. The consultation proposed various options that would allow a partial relaxation of the ‘not primarily abstractive’ test⁵ in return for some level of mark-up paid by the open access operator. We received many responses with a lot of support for enabling more competition, although there were mixed views on the options we proposed. Most respondents thought that this should be considered as part of this structure of charges review.

**Step 3**

22. As part of our analysis we also considered the importance of identified themes under various states of the world (i.e. possible future scenarios). More information on the different states of the world can be found in Annex C of the consultation document.

23. Some of the themes, namely the **cost-reflectivity and complexity themes**, are unambiguously important under any state of the world and their importance could grow, for example, if:

- franchise protections are reduced;
- a greater proportion of costs are attributed to operators through a different funding approach; or
- there is to be more regional decision making.

24. **Capacity and competition themes** are more ambiguous in their impacts in different states of the world. On the one hand, they could become less important under an alternative state of the world where relevant parts of franchises become more highly specified. On the other hand, capacity and competition become much more important under alternative states of the world, for example, where there is:

- more on-rail competition;
- more franchise flexibility; or
- a change in the approach to the allocation of capacity.

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⁴ This ignores the potential wider and indirect effects, including any that might arise from differences in performance or efficiency between different operators.

⁵ This test is part of the overall assessment of track access decisions. It considers the extent to which new services generate new passenger revenue, relative to the levels of revenue that is ‘abstracted’ from existing services.
25. However, despite this potential ambiguity we consider that any changes in charges that focus on addressing capacity and competition could be important catalysts for longer-term change. For example, they could highlight the potential benefits of wider reforms and so contribute to changes that would move us towards future states of the world that could realise additional benefits to passengers, freight users and funders, including through greater on-rail competition.