

ROLLING STOCK LEASING MARKET INVESTIGATION

Provisional findings report

Summary

1. On 26 April 2007, the Office of Rail Regulation (ORR), made a reference to the Competition Commission (CC) for an investigation into the leasing of rolling stock for franchised passenger services and the supply of related maintenance services (the reference goods and services) in Great Britain. The reference was made under section 131 of the Enterprise Act 2002 (the Act) and the CC is required to publish its final report by 25 April 2009.

Background to the industry

2. Passenger rolling stock in Great Britain is predominantly owned by three rolling stock leasing companies (the ROSCOs): Angel Trains Limited (Angel); HSBC Rail (UK) Limited (HSBC); and Porterbrook Leasing Company Limited (Porterbrook). HSBC was acquired by HSBC Group in 1997, and Porterbrook was acquired by Abbey National plc (Abbey) in 2000. Angel was acquired by Royal Bank of Scotland Group (RBS) in 1997. In June 2008, it was announced that RBS had agreed a sale of Angel to a consortium of investors, which included Babcock and Brown European Infrastructure Fund, AMP Capital Investors, Deutsche Bank and others.
3. The ROSCOs were created at privatization to own the fleets of ex-British Rail passenger vehicles (known as MOLA rolling stock),¹ which are leased to train operating companies (TOCs). In addition to the three ROSCOs, there is one other lessor of passenger rolling stock to franchised TOCs—Voyager Leasing Limited (Voyager Leasing), which was set up to lease a new fleet of ‘Voyager’ trains to Virgin

¹The leases between ROSCOs and TOCs followed a standard form, known as the Master Operating Lease Agreement (MOLA). The rolling stock, formerly owned by British Rail, covered by these leases is usually referred to as ‘MOLA rolling stock’. The Government determined how this MOLA rolling stock should be divided between the three ROSCOs.

Cross Country and has not undertaken any other leasing activities. The ROSCOs' market shares are fairly similar and have not changed substantially since privatization. Angel now has a 36 per cent share of total available rolling stock used on franchised passenger services, Porterbrook 31 per cent and HSBC 30 per cent. Voyager Leasing has a 3 per cent market share.

4. Each of the ROSCOs is subject to a Code of Practice, drawn in similar terms. These provide that all customers can expect to receive fair and equitable treatment, and that any differences in the terms offered to individual customers (eg on rental rates, and other terms such as maintenance and modifications) need to be justifiable on fair and reasonable criteria. The Codes of Practice list the factors that the ROSCO may take into account in agreeing a rental.
5. Passenger railway services in Great Britain are operated by TOCs, in most cases on the basis of franchises, which are let by the Department for Transport (DfT) through a competitive tender process. The TOCs bid competitively on the basis of the subsidy that they require (or in some cases the premium they will pay) to operate the franchise. Lease rentals constitute a significant proportion of the total franchise costs. Overall, significant sums of public money are involved in funding TOCs and other parts of the rail industry—Government support for the railways in total cost around £6 billion in 2006/07.
6. The Secretary of State for Transport (Secretary of State) has responsibility for the delivery of rail services in England and Wales. The Secretary of State and her department, the DfT, have certain objectives and obligations in relation to transport

policy which take account of many priorities, in particular assuring the delivery of a reliable and comprehensive rail service and value for money.²

7. The franchising system has evolved since privatization. Most franchises typically now run for around seven years, although a few franchises were awarded in the past for longer periods. In general there is no longer a willingness to grant longer-term franchises in return for a commitment by the TOC to secure improvements as was the case under the Office of Passenger Rail Franchising (OPRAF) and the early years of the Strategic Rail Authority (SRA). The franchise invitation to tender (ITT) sets out the DfT's expectations (its 'base case') for the services to be provided on the franchise. Service Level Commitments, ie the specification of services to be provided by the franchisee, are often very detailed and may specify explicitly, or necessitate implicitly, the use of particular types, classes or fleets of rolling stock. TOCs can also put forward variations of the base case. TOCs preparing franchise bids each approach the ROSCOs or other lessors to reach conditional agreements for leasing the rolling stock they will require; these are finalized once the preferred bidder is selected. Rolling stock leases are typically for the length of the franchise although there are shorter-term leases.

8. There has been significant investment in new rolling stock since privatization—much of this has replaced retired rolling stock and the number of passenger vehicles available for use has increased by only four per cent, whereas the number of passenger journeys increased by 58 per cent between 1994/05 and 2006/07. The Government has specified its intention to increase passenger capacity further, given the continuing growth in passenger demand for rail travel. Various initiatives are underway to secure specific new fleets, including the Intercity Express Programme

²Following the 2005 Railways Act, the National Assembly for Wales is now a co-signatory to the Welsh franchising agreement. The Scottish Ministers now have responsibility for the award of future Scotrail franchises.

(IEP), the programme of procurement of new rolling stock for Thameslink services, and proposals for increased capacity on a variety of franchises. These plans were outlined in further detail in the Rolling Stock Plan published by the DfT in January 2008. Acquisitions of new rolling stock have generally been funded by ROSCOs. The DfT can offer section 54 undertakings to reduce the lease cost by providing some assurances to ROSCOs that the rolling stock will be leased for at least a minimum period, thus reducing concerns that the rolling stock may be stranded off-lease early in its life.

Maintenance

9. Maintenance of rolling stock can be split into heavy maintenance, which involves the planned overhaul or replacement of major components (eg engines, bogies or door equipment) at a maintenance location which has lifting facilities, and light maintenance, which comprises day-to-day maintenance (including servicing, inspection, examination and repair of defects, scheduled repairs to machines, and the scheduled replacement of consumable items). Actual maintenance is usually subcontracted to third party maintenance providers, but different arrangements exist between TOCs and ROSCOs for the management of the maintenance process. Under a wet lease the ROSCO assumes responsibility for both light and heavy maintenance, whereas under a dry lease the TOC takes this responsibility. Under a soggy lease, the ROSCO is contractually responsible for the provision of heavy maintenance, whilst light maintenance is the responsibility of the TOC.

Market definition

10. The key question in market definition is the extent to which alternative products can be substituted for the product under consideration by customers, or by suppliers of these alternative products. We considered that the appropriate time to consider this substitution was when the TOC made decisions on which rolling stock to lease, and

this was nearly always at the time when franchises were let and the TOC was preparing its franchise bid. We found that several factors inhibited potential substitution of other fleets for the incumbent rolling stock on a particular franchise.

These were:

- Technical substitutability—a particular class of rolling stock may not be physically capable of running on a particular stretch of track, for example because of differences in power supply, signalling, the physical dimensions of the train etc.
- Operational substitutability—some rolling stock is not suitable for particular service requirements, for example it may not have sufficient speed or capacity to serve a particular route.
- Economic substitutability—some classes of rolling stock would not be substituted for others (even at the margin) because of significantly greater costs compared with revenue-earning capability.
- Franchise specificity—the DfT's franchise ITT may directly restrict the type of rolling stock that may be used on a particular franchise.

11. Moreover, alternative fleets that might otherwise be suitable substitutes are usually leased elsewhere. Substitute rolling stock could become available in time, however, premiums are charged on the short-term leases needed to retain the use of the incumbent rolling stock in the meantime. This could create substantial switching costs.
12. The same factors, particularly technical and operational restrictions and commitment to existing contracts, limit supply-side substitutability.
13. We found that it was impossible to generalize about the extent of a relevant product market because the degree to which these factors applied varied substantially between different lease negotiations. Therefore we concluded that the impact of

potential substitutes needed to be considered in our competitive analysis on a case-by-case basis.

14. The appropriate geographic market is no wider than Great Britain because of technical differences between Great Britain and the rest of Europe, including Northern Ireland. For example, most European trains are too wide to fit the British rail infrastructure, such as there being insufficient clearance of tunnels or platforms.
15. We concluded that provision of maintenance services is a separate relevant market from the leasing of rolling stock.

New rolling stock

16. There were indications of effective rivalry between the ROSCOs in seeking to finance and lease new rolling stock. We found that reductions in the cost of debt, which would have reduced the ROSCOs' financing costs, appeared to have been reflected in lease rentals at least to some extent and had offset the increasing nominal purchase price of new vehicles. Different ROSCOs had managed to secure differing levels of new business, and TOCs did not perceive any shortcomings in competition between ROSCOs in the leasing of new rolling stock. We found no evidence of coordination in pricing or market sharing between the ROSCOs.
17. ROSCOs which had previously supplied vehicles of a particular class appeared to have an advantage in securing any subsequent orders for that class, because of certain efficiencies. However, we considered that such benefits would be anticipated and were likely to be factored into the initial bids to supply the first order of that class of rolling stock. Overall we found that there appears to be active rivalry between ROSCOs in the provision of new rolling stock at first lease.

Rental changes

18. We found a great dispersion in capital rental changes occurring on the first post-privatization re-lease of MOLA rolling stock. There were a substantial number of capital rental reductions from one lease to the next. However, capital rentals were little changed on a vehicle-weighted average basis. Two factors largely accounted for increases in capital rentals where these have occurred. First, we found that a premium tended to be applied to short-term leases, which ROSCOs attributed to a higher residual value risk. Second, there had been many instances of substantial capital investment in vehicles at subsequent lease, which had in many cases been capitalized into rentals. Stripping out the effects of capitalized investment and short-term leases, we found that on average rentals per lease had declined by nearly 10 per cent for MOLA rolling stock (nearly 3 per cent when weighted by the number of vehicles). Slightly greater reductions were observed for post-MOLA rolling stock on the relatively limited number of occasions when this had been re-leased.

Competition in the market for the leasing of rolling stock

19. We considered the extent to which competitive pressures might have influenced rental changes. As noted in paragraph 10, various factors restrict the number of fleets that are viable alternatives to incumbent fleets at re-lease. We found that on 42 per cent of leases, the TOCs did not consider any alternative fleets as potential substitutes to the leased rolling stock in their franchise bids to the DfT, and only on 39 per cent of leases did they consider more than one alternative. On 58 per cent of leases, TOCs did not propose any alternative fleets to the leased fleets in their franchise bids to the DfT. Only in 23 per cent of cases did TOCs, collectively, put forward more than one alternative fleet. In some cases the only alternatives offered were owned by the same ROSCO; overall in 64 per cent of leases, no competitor fleets from rival ROSCOs were proposed in TOCs' franchise bids, and in 49 per cent

of leases, no TOCs told the DfT that any alternative fleets from a different ROSCO had been considered.

20. This lack of alternatives arises from the factors identified in paragraph 10. Some of these factors arise from the DfT placing restrictions on the choice of rolling stock in franchise ITTs, or because of obligations to retain particular rolling stock as a result of section 54 undertakings. We expect that the DfT's Rolling Stock Plan will result in further limitations on the TOCs' choices when negotiating with ROSCOs as the DfT seeks to influence the deployment of existing and new rolling stock to enhance capacity on the network.
21. The ROSCOs told us that the threat of displacement by rival fleets exerted a strong competitive constraint on pricing, because of the risk that rolling stock would go off-lease. In contrast, the DfT argued that because the demand for rail travel was such that practically all rolling stock was in use, the risk of vehicles going off-lease for any substantial period was very slight. The amount of rolling stock off-lease had never risen above 4 per cent of the total fleet, and had tended to be confined to certain classes of rolling stock, much of which was close to or beyond the end of its estimated economically useful life.
22. Examination of case studies and internal papers showed that ROSCOs paid close attention to rival fleets and were very aware of the risk of displacement, particularly where a suitable alternative fleet was off-lease or there was a credible threat of incumbent fleets coming off-lease.
23. We found a quantitative relationship between the number of alternative ROSCOs that held substitute fleets and rental changes at subsequent lease, although this relationship was not strong and many other case-specific factors were present. This

indicated to us that, where substitutes were available, there was some downward pressure on prices.

24. However, we found that the overall lack of spare capacity in the leasing of passenger rolling stock means that in cases where there is little or no surplus rolling stock suitable for a particular use, the risk that rolling stock will fail to be used somewhere on the rail network is low. Consequently, we consider that even where alternative fleets are available to a TOC, there is a weak incentive for a ROSCO to compete on price because the overall lack of spare capacity means that it is likely to be able to keep its fleets on-lease somewhere on the network.
25. At re-lease, ROSCOs appeared to regulate their own pricing behaviour and did not in general seek to increase rentals. Even in the absence of competitive constraints, the ROSCOs took account of their obligations under their Codes of Practice only to increase rentals where there was an objective justification for doing so (in practice this seemed to correspond to short-term leases and capital investment). The ROSCOs may also perceive margins as satisfactory (especially where funding costs have fallen). The ROSCOs also referred to an expectation that the DfT might seek to investigate or impose some form of regulatory constraint if it believed that rental increases were unjustified.
26. We accept that the DfT does have a number of statutory powers, although none of these allow it to impose direct control on lease rentals. Given the constraints that the DfT faces arising from its obligations to ensure that rail services continue to operate and its wider objectives to ensure that rail services are delivered effectively, at present it does not directly attempt to control individual lease rentals and does not perceive that it has the power to do so. The DfT would also face considerable difficulties in identifying appropriate prices and reasonable margins if it were to try

and control individual lease rentals directly. The Government does, however, have legislative and practical ability to determine the overall shape of the market and influence rolling stock allocation and use.

27. We found that ROSCOs considered the relative price of new rolling stock when that was perceived as a potential threat; in such cases this appeared to set a ceiling price for used rolling stock when adjusted for differences in utility (quality, operating costs, revenue raising capability etc) between new and used rolling stock. However, we also found that new rolling stock was often not a realistic substitute for incumbent rolling stock. TOCs would be likely to be dependent on the DfT agreeing to the investment in new rolling stock because of the generally higher capital rentals of new rolling stock compared with used, even where the new vehicles provided a better service and had greater revenue-earning potential. TOCs perceived that the DfT often did not generally consider proposals for new rolling stock to constitute the best value for money, and in a few cases the DfT had explicitly ruled out new rolling stock.
28. The DfT told us that the benefits of introducing new rolling stock in a franchise bid were usually assessed over the life of that franchise, rather than taking account of any longer-lasting benefits. The TOC also faces substantial switching costs, including short-term lease premiums for incumbent rolling stock pending the manufacture of new rolling stock, staff training costs and route acceptance costs. There are also risks of delays and possible initial faults associated with new types of rolling stock which might affect the deliverability of the franchised services. While the TOC faces all these costs and risks, in the context of franchises of around seven years in length it will only realize a small proportion of the benefits of new rolling stock before the franchise expires.

29. TOCs will therefore often be deterred from factoring new rolling stock into their franchise bids. For these reasons we conclude that new rolling stock will not always be fully effective in limiting rentals to competitive levels, and in some cases may provide only a very weak constraint.
30. The switching costs and risks applying to new rolling stock will also apply to some extent to switching to alternative used rolling stock, particularly where non-coterminous franchises necessitate the negotiation of short-term leases before alternative rolling stock becomes available. Other potential switching costs include staff training and route acceptance. Switching costs reduce the effectiveness of potential competitive pressures from rival used fleets.
31. Our finding was that in a large number of cases there was a shortage of choice available to TOCs at the point of franchise re-letting due to limited suitable substitutes being available, restrictions in the franchise ITTs ruling out substitute rolling stock, switching costs deterring switching, and because TOCs perceive that the DfT is in many cases unlikely to be willing to fund new rolling stock.
32. A number of other potential constraints on pricing were put to us. We considered whether TOC owning groups had significant countervailing power arising from their size and their repeated interaction with ROSCOs on different franchises. We found that the TOCs had limited ability to threaten credibly to refuse to do business with any ROSCO and we found that there was no correlation between the TOCs' size and experience and their ability to negotiate better terms. Therefore we were not persuaded that TOCs had effective countervailing buyer power.

33. We found that new entry and expansion are largely infeasible for used rolling stock as there is no second-hand market³ and ROSCOs are unlikely to sell their rolling stock to a potential rival. Entry with new rolling stock was also found to be difficult, as prospective entrants were likely to lack the knowledge and experience of securing contracts in the context of the franchising process and had disadvantages in terms of scale and scope, and thus greater exposure to re-leasing risks. The one example of entry, Voyager Leasing, related to a specific fleet in the unusual circumstances of a long-term lease. The DfT noted that in theory alternative funding models for future acquisitions could be adopted, which might enable other financiers to take the place of ROSCOs. However, we found that new rolling stock was an area where the market already appears to work well.
34. We found that TOCs were unlikely to choose to purchase and supply their own vehicles in competition with the ROSCOs, because of the mismatch between asset life and franchise length, and the difficulties in exiting the industry in the absence of a second-hand market. In addition, TOCs are generally thinly capitalized and will not want expensive assets on their books. TOCs may also be at a financial disadvantage compared with the ROSCOs because of lesser tax capacity.
35. We considered whether profitability could provide any indications of the extent of competition in the market. However, we faced some significant conceptual and practical problems in undertaking this assessment. The industry has only been privatized for 12 years compared with an asset life of 30 years or more, and most MOLA rolling stock has only been re-leased once. It is unclear what value to assign to MOLA rolling stock in the absence of a second-hand market. Overall, we think that the specific problems of measuring profitability of MOLA rolling stock are so

³Because existing ROSCOs do not tend to sell any of their vehicles and rolling stock from abroad is generally incompatible with the infrastructure on British railways.

significant that it is not possible to determine a precise level of profitability with a high degree of confidence, and so we do not rely on levels of profitability as an aspect of our competitive analysis in reaching our provisional findings. Returns also have to be assessed in the context of risk. We accept that the nature of the industry, with its dependence on Government support and susceptibility to policy changes means that ROSCOs face some uncertainty about the long-term prospects for each of their assets, albeit that circumstances to date have been largely very favourable to them.

36. We were, however, able to examine whether there were any differences in margins or returns for individual fleets based on a range of possible asset values. We found that in general, margins on MOLA rolling stock were higher than those on post-MOLA rolling stock, which was consistent with there being a difference in the nature of competition for the leasing of new rolling stock and existing rolling stock. There was, however, a high degree of variability in margins on individual fleets.

Assessment of competition for maintenance

37. We looked at competition in the market for maintenance services. In principle, the option for a TOC to undertake maintenance services itself under a dry lease would be expected to act as a constraint in the market.
38. We considered whether ROSCOs have the power to tie maintenance services to the leasing of rolling stock (ie to sell the two services together rather than separately). Such tying of maintenance to leasing would only be effective in excluding rivals, such as the TOCs taking on their own maintenance, if it created a price incentive to favour the ROSCO. HSBC and Porterbrook told us that their capital rentals remained unchanged whether on a wet, soggy or dry lease and we received no conflicting evidence on this point. Although we were told of several situations where capital rentals have increased on Angel's fleets when transferring from soggy to dry leases,

we found that Angel is not using pricing strategically to attempt to deter TOCs from providing their own maintenance, nor to deter any other potential entrants.

39. Some TOCs commented that Angel had on occasions refused to agree to dry leases. Where refusals had occurred in the past, these actions appeared to be justified on grounds of efficiency, rather than representing a strategic attempt to reduce competition. Generally, we expect that TOCs are able to provide their own maintenance services in competition with the ROSCOs and this should act to constrain the ROSCOs' pricing of maintenance services.
40. In our view the ROSCOs have provided the TOCs with sufficient pricing information necessary to allow TOCs to evaluate the relative costs of different maintenance arrangements, notwithstanding that differences in pricing practices between ROSCOs may have created the perception that there was insufficient information to make this comparison.
41. Overall we did not find evidence of a shortage of rivalry in the market for the provision of maintenance.

Features

42. With regard to our duties under the Act, we need to decide whether any feature or combination of features of the market within the meaning of section 131(2) of the Act prevent, restrict or distort competition in connection with the supply or acquisition of any goods or services in the UK.
43. From our findings in this report, we have identified the following features which either individually or in combination prevent, restrict or distort competition in connection with the leasing of rolling stock for franchised passenger services in Great Britain. There

is significant overlap between these features and their effects but we have found it useful to group them into four key findings.

(a) There is a shortage of alternative rolling stock solutions available to the TOCs when bidding for franchises as a result of one or more of the following factors:

- (i) technical and operational factors restrict the available rolling stock solutions, such that in many instances there is no alternative to the incumbent fleet; and/or
- (ii) the costs and risks involved in switching to leasing alternative used or new rolling stock in many cases discourages TOCs switching to these alternatives when bidding on franchises; and/or
- (iii) the current criteria applied by the DfT for the award of franchises, and the short payback period afforded by the relatively short length of most current franchises (typically seven years) limit the benefits that could arise to the TOC from switching to new rolling stock.

(b) The interaction between the franchising system and the leasing of rolling stock for franchised services determines many aspects of the structure of the market:

- (i) the timing of franchise re-letting determines when transactions in the rolling stock leasing market occur. This, in turn, affects which rolling stock is available to a TOC when it is seeking to put forward a winning franchise bid. The effect is to reduce the potential for rivalry in the leasing of rolling stock; and/or
- (ii) in some cases detailed specific service requirements for the franchise are laid down by the DfT in the franchise ITT which practically limit available rolling stock options; and/or
- (iii) in some cases a requirement is placed in the franchise ITT to use identified rolling stock because the DfT has given section 54 undertakings, or for some other reason; and/or

- (iv) the non-coterminous nature of the franchises limits the availability of alternatives at the required time such that a TOC would have first to lease incumbent rolling stock for a short term resulting in an additional cost (lease premium) when trying to switch to such alternatives; and/or
 - (v) the expressed unwillingness of the DfT in some instances to meet the higher lease rental of new rolling stock rules out the possibility of using new rolling stock as an alternative to used rolling stock.
- (c) ROSCOs in many cases have weakened incentives to compete on lease rentals of used rolling stock. This arises where there are no potential alternative fleets, or where the demand for a particular type of rolling stock across the whole network requires all or virtually all of that rolling stock to be used, such that there is little risk of any rolling stock of that type coming off-lease for a sustained period. This situation has resulted from the increasing demand for rail travel coupled with the DfT's objective to ensure that as much of the existing rolling stock as possible is in use.
- (d) Barriers to entry into the market(s) for the leasing of rolling stock to franchised passenger services, whether entering using new or particularly used rolling stock, are high for the reasons set out in paragraph 6.118.
44. We considered the nature and extent of the detrimental effects of these features on customers (TOCs and the DfT) and on both end consumers (passengers) and the wider public (who support rail services through substantial subsidy). Detrimental effects on customers are defined in the Act as: 'higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or less innovation in relation to such goods or services' (section 134(5)).

45. Detrimental effects arise for those leases where either there are no or very few alternative fleets available, or where the competitive pressure arising from alternative used rolling stock and/or new rolling stock is limited. Specifically, the features we have identified have the detrimental effect that in a substantial number of cases TOCs do not have the potential to choose from a range of fleets and so cannot make a choice of fleets that best suit their needs. Moreover, in the case of many leases, rentals are likely to be higher than we would expect to find in a well-functioning market. We find that the reduction in choice arising from the features is substantial. However, we find that the level of customer detriment in the form of higher rentals is not as high as what we would expect from those features alone because ROSCOs have tended not to increase capital rentals as far as they profitably could where rolling stock has been re-leased even in the absence of credible alternatives. We consider that this behaviour is due to the ROSCOs taking account of the Codes of Practice and the fear of the potential for economic regulation.
46. Accordingly, we provisionally find, on the statutory questions we have to decide pursuant to section 134(1) of the Act, that there are features of the market which, either alone or in combination with each other, prevent, restrict or distort competition in connection with the leasing of rolling stock for franchised passenger services and hence that there is an adverse effect on competition (AEC) within the meaning of section 134(2) of the Act.
47. We did not identify any features which prevent, restrict or distort competition in the market(s) for the supply of maintenance services for rolling stock for franchised passenger services in Great Britain.