

ROLLING STOCK LEASING MARKET INVESTIGATION

Emerging Thinking

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1. Introduction

- 1.1 This document sets out our emerging thinking on competition for the leasing of rolling stock for franchised passenger services and the supply of related maintenance services in Great Britain on the basis of evidence we have analysed to date. It identifies where we are seeking additional evidence and the issues on which we intend to concentrate in the period prior to the planned publication of our provisional findings in May 2008.
- 1.2 We have not yet reached any conclusions on the statutory questions we have to answer during this inquiry.
- 1.3 However, our thinking is further advanced in some areas than in others. The areas in which we have significant further work to do, such as the assessment of profitability, are identified in this document. The purpose of this document is to expose the direction of our thinking and to elicit further evidence in relation to these matters.
- 1.4 We are publishing at the same time as this document eight working papers which address a number of the issues discussed in this document in greater detail. Together with this document, these working papers represent our views based on the evidence we have seen to date, and we also invite comments and further evidence from parties in relation to the matters covered in these working papers.

2. Industry background

- 2.1 This section provides some of the general context to our investigation. A more detailed description is provided in the Industry background working paper.

2.2 We describe first the structure of the industry and go on to discuss the role of franchising, the rolling stock lessors, regulation, rolling stock and its procurement and maintenance. We then discuss the growth of passenger rail traffic and conclude by summarizing the steps leading up to this investigation.

Privatization

2.3 British Rail, the state-owned railway business, was privatized in the 1990s. British Rail's operations were reorganized into a number of different businesses which were subsequently sold into the private sector. The new structure separated the passenger railway business into three main areas:

- provision of passenger train services;
- provision, by leasing, of rolling stock; and
- management of the rail network infrastructure: track, signalling, stations and depots (also used for the rail freight business).

2.4 A number of alternative models were considered for privatization, including the setting up of integrated regional railway companies. The approach chosen involved the 'vertical separation' of the railways whereby passenger operations, rail infrastructure ownership and rolling stock ownership would be carried out by different organizations.¹

2.5 The new structure allowed for the creation of systems of competition for the provision of passenger train services and for the provision of rolling stock; it was considered inappropriate to introduce competition for the management of the rail network

¹In 1991, the EEC legislated to separate the accounts of railway operation and infrastructure from the provision of railway transport services (referred to in the UK Regulations implementing the EEC Directive as the separation of accounts between transport operations and infrastructure management). 2001 EC legislation put additional measures in place to ensure this separation was effective. The objective of the legislation was to increase the integration and efficiency of the European Union's railways by, amongst other things, implementing measures to allow competition among the providers of rail services, including open access for international freight.

infrastructure. The new structure also involved the creation of new regulatory bodies and an appropriate legal framework.

Current industry structure

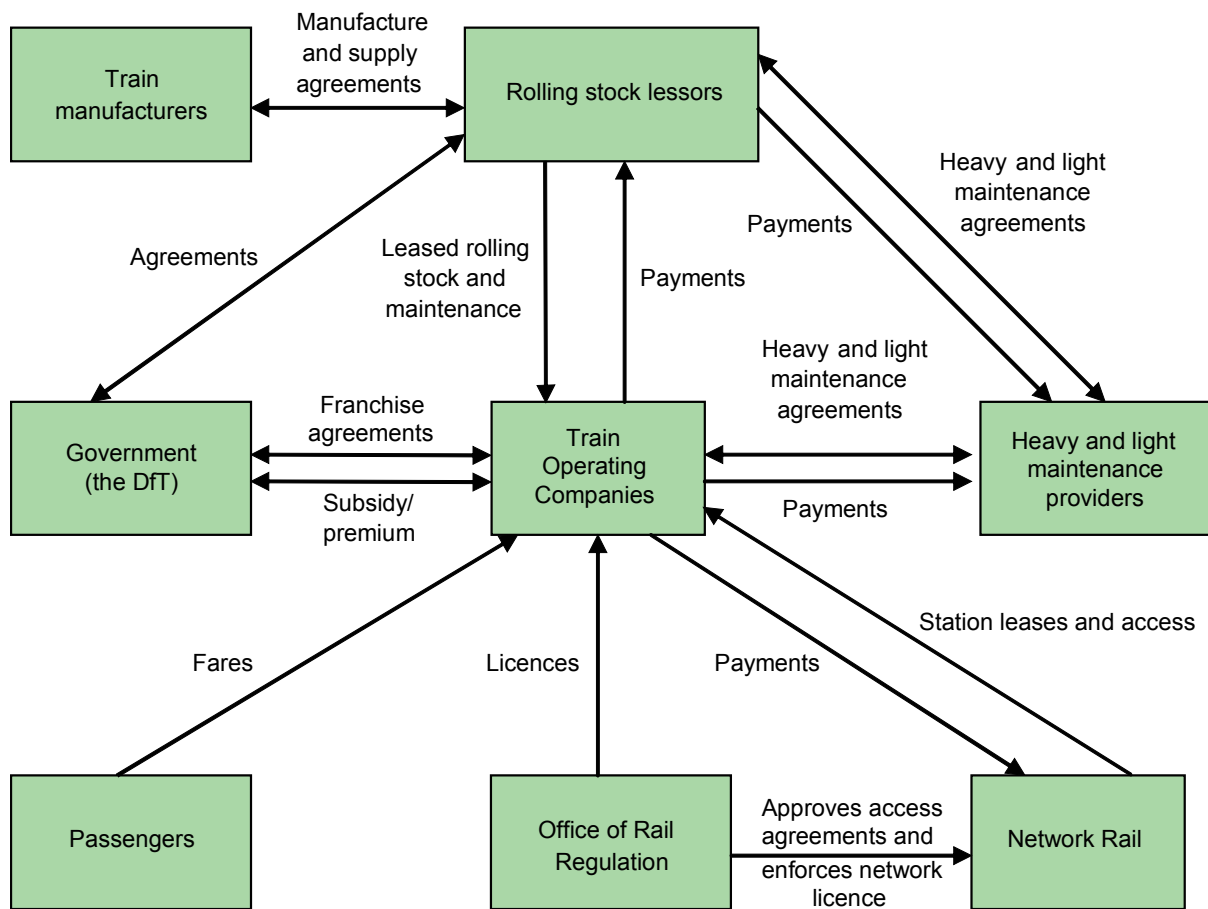
2.6 The overall structure today is similar to that following privatization, despite the substantial changes that have occurred within the intervening period. In summary:

- passenger train services are provided by train operating companies (TOCs) which compete with each other for franchises to run rail services; TOCs are typically owned by transport operators such as Arriva, NEG, Stagecoach and First;
- the network infrastructure is managed by Network Rail, a 'not for dividend' private company limited by guarantee;
- the Department for Transport (DfT) is the government department responsible for rail policy; in addition to its strategic role it manages the distribution of Government rail subsidy through the allocation of passenger rail franchises and issuing revenue grants to Network Rail;
- rolling stock is generally leased to the TOCs by rolling stock leasing companies (ROSCOs); there are three ROSCOs, each of which is currently owned by a bank; and
- the industry is regulated by the Office of Rail Regulation (ORR).

2.7 Figure 2.1 indicates the relationships between the key participants in the railway industry.

FIGURE 2.1

The current structure of the passenger railway industry



Source: CC.

Franchising

2.8 The franchising process is designed to bring benefits from competition in the provision of passenger train services. Under most circumstances it would not be effective for competing firms to offer competing services for the same journey;² instead the firms compete for exclusive contracts to provide such services for a period of time.

²Competition between different operators offering services on the same route is known as 'on-rail competition'. There are a small number of routes where on-rail competition takes place under open access arrangements. There is also some on-rail competition between franchise operators on some parts of their routes. For example, ICEC and Cross Country compete on the East Coast Main Line north of Doncaster.

- 2.9 The DfT invites tenders from TOCs to operate particular franchises—sets of train services grouped by geographic areas. The invitation to tender (ITT) sets out the DfT’s expectations (its ‘base case’) as to the services to be provided on the franchise. The ITTs specify, in varying amounts of detail, the DfT’s expectations as to the rolling stock that will be used on the service and may in some cases indicate a requirement that new rolling stock will be introduced during the term of the franchise. There are presently 17 franchises that cover Great Britain.³ The TOCs put forward detailed proposals, including their target revenue from receipt of fares and the amount of any subsidy (ie payment) they would require from the DfT, or premium they would pay to the DfT, in order to operate the service. The TOCs’ proposals put forward variations of the base case as well as providing a quotation for the base case. The successful TOC will normally retain the passenger fares,⁴ but passenger rail services are generally not profitable based on fares alone, so a subsidy payment is usually required to make the business viable.⁵ The DfT assesses the TOCs’ proposals according to a number of criteria, including the size of the required subsidy or proposed premium.
- 2.10 This mechanism encourages TOCs to compete with each other to develop means of running services efficiently, thereby saving costs, and of attracting customers, thereby increasing revenues.
- 2.11 The DfT determines the length of the franchises. Franchises typically run for seven years with an option for the DfT to extend it for another two to three years depending on the franchisee (TOC) meeting performance targets.

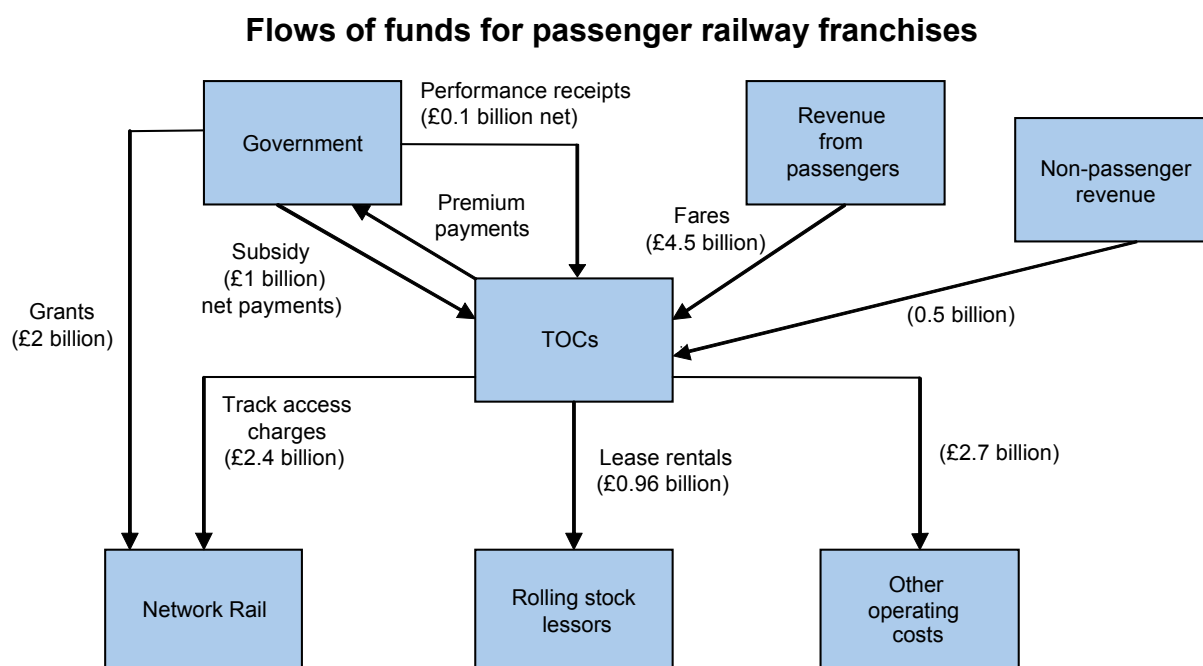
³We have classed Merseyrail and London Overground as concessions rather than franchises.

⁴Franchise agreements contain revenue sharing and support arrangements such that the DfT shares some of the revenue with the TOC above certain specified upper thresholds and provides revenue support to the TOC if revenue falls below certain specified lower thresholds.

⁵There are some profitable franchises, in which cases the operating TOC will generally make a payment to the DfT for operating the franchise.

2.12 Figure 2.2 provides an outline of the flow of funds in the passenger railway between the TOCs, rolling stock lessors and the public sector.

FIGURE 2.2



Source: CC.

Note: Funding statistics are for illustrative purposes. They are provided for the year 2005/06 and have been sourced from the *National Rail Trends Yearbook 2005–2006 Transport Statistics Great Britain 2006*, and from information provided by the ORR.

Rolling stock lessors

2.13 In preparation for privatization, the Government set up leasing companies because it decided that TOCs should lease rather than own their rolling stock, since the economic life of rolling stock normally exceeds 30 years which is much longer than the length of franchises.⁶ The Government's view was that leasing would enable prospective franchise operators to start operations without having to incur major capital expenditure on new or refurbished vehicles. In addition, without the restriction of short franchises, ROSCOs would be able to take a longer-term view of the income they would receive from rolling stock.⁷

⁶NAO Report, *Privatisation of the Rolling Stock Leasing Companies*, paragraph 1.5

⁷ORR Review of the Rolling Stock Market, May 1998, p15, paragraph 2.4

- 2.14 Three companies were created in preparation for the privatization process. Three was considered to be the minimum number of substantial companies necessary to liberalize the market and create competition. Concerns were expressed at the time that to create too many ROSCOs might render the new companies unsaleable.
- 2.15 The vast majority of passenger rolling stock is still owned by the three ROSCOs created at privatization: Angel, Porterbrook and HSBC.^{8, 9} The passenger rolling stock owned by the ROSCOs comprises rolling stock formerly owned by British Rail and transferred to the ROSCOs at privatization (approximately 60 per cent) and rolling stock purchased since the ROSCOs were created (approximately 40 per cent).
- 2.16 The first passenger rolling stock leases were agreed before the ROSCOs and TOCs were sold into the private sector. The leases 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'.
- 2.17 As well as the three ROSCOs there is another lessor of rolling stock—Voyager Leasing.^{10, 11} This company was set up to lease a new fleet of trains ('Voyager' trains) to Virgin Cross Country Trains. It has not undertaken any other leasing business. It is now owned by the Royal Bank of Scotland (RBS), which also owns Angel.

Regulation

- 2.18 The ORR is an independent statutory body with responsibility for providing overall regulation of the UK railway industry, including health and safety regulation. It is

⁸The ownership of these companies has changed since privatization. HSBC Rail was originally Eversholt Leasing Limited.

⁹The full names of these companies are Angel Trains Ltd, Porterbrook Leasing Company Limited and HSBC Rail (UK) Limited respectively.

¹⁰Voyager Leasing Limited.

¹¹Although it is a lessor of rolling stock we do not describe Voyager Leasing as a ROSCO as that is not industry practice.

responsible for regulating Network Rail, but not for managing the franchising process. Under section 67 of the Railways Act 1993, the ORR has concurrent functions with the Office of Fair Trading (OFT) under Part 4 of the Enterprise Act 2002 so far as relating to the supply of services relating to railways (including the ability to make a market investigation reference to the CC). Under this provision, the ORR also has certain concurrent functions under the Competition Act 1998 so far as relating to the supply of services relating to railways (including the enforcement of the Chapter I and Chapter II prohibitions).

2.19 The DfT is the government department responsible for transport policy. Recent strategy documents produced by the DfT include the High Level Output Specification and the White Paper *Delivering a Sustainable Railway* which set out the long-term strategic direction for the railway. The DfT is responsible for passenger and train-related matters, letting franchises and monitoring operator performance. It specifies and lets franchise contracts to TOCs to run franchised passenger services in England and intercity services to and from Scotland and Wales. It has a statutory duty to ensure the continuity of passenger services under section 30 of the Railways Act 1993.

2.20 Following the Railways Act 2005, the devolved governments in Scotland and Wales also have a role in planning, specifying, funding and managing services. The Scottish Executive has sole responsibility for securing future ScotRail franchises and the power to manage and monitor the performance of ScotRail services. The National Assembly for Wales has a responsibility for the financial and performance management of passenger services operating within Wales.

Rolling stock

- 2.21 The term 'rolling stock' describes all the different types of vehicles which move on a railway. A class refers to a particular design of rolling stock; each class has a unique number assigned to it. Groups of similar classes of trains may also have a family name.
- 2.22 There are a large number of different types of rolling stock. There are a number of technical characteristics of both the infrastructure and the rolling stock which constrain compatibility and limit the routes on which particular rolling stock can operate. For example, electric trains cannot operate on routes which have not been electrified, and trains requiring an electric third rail cannot operate on routes only having overhead electrification and vice versa, except for a small number of dual-purpose vehicles. There are also operational factors such as line speed, platform length, passenger capacity and door configuration, which can constrain the type of rolling stock which can practically be used on a particular route or service.¹²
- 2.23 There has been significant modernization of the passenger rolling stock since privatization and a number of classes of rolling stock have been withdrawn. The main legislative change that has affected the withdrawal of rolling stock since privatization has been the introduction of safety regulations requiring the replacement of the Mark 1 rolling stock.
- 2.24 The great majority of rolling stock continues to be owned by the ROSCOs, which is in turn leased to TOCs. As an alternative to leasing rolling stock TOCs may in principle purchase either used or new rolling stock (known as self-supply). However, TOC-owned rolling stock represents less than one per cent of total passenger franchised rolling stock capacity.

¹²These factors are discussed further in Annex 1 to the working paper on Substitutability.

Rolling stock procurement

- 2.25 New rolling stock may be introduced in order to provide additional capacity or to replace rolling stock that is unsuitable, because it is life-expired or as a result of changes to legislation.
- 2.26 New rolling stock can be specified in the ITT by the DfT, introduced by a TOC through a franchise bid or during a franchise, or can be purchased by rolling stock lessors speculatively, without any commitments to lease. Speculative purchase of rolling stock is rare. Currently, the introduction of new rolling stock is largely determined by the DfT's policy decisions.
- 2.27 When new rolling stock is introduced it may lead to displaced rolling stock moving to different franchises. This is known in the industry as a 'cascade'. Subsequent cascades may occur if the cascaded rolling stock displaces stock on other franchises.
- 2.28 The price for new stock has varied widely, however, in general there has been an upward trend in the real prices. The time taken to build new rolling stock varies depending on the availability of a suitable product, whether it is currently in production, the manufacturer's factory capacity, the number of vehicles ordered and the type of vehicle. Lead time can range from less than one year to nearly five years.

Maintenance

- 2.29 In preparation for privatization the rolling stock leases provided that the ROSCOs were generally responsible for the provision of heavy maintenance (such as planned overhaul of engines and other major components),¹³ while light maintenance (day-to-day maintenance, including cleaning and inspection) was to be the responsibility of

¹³In practice ROSCOs outsource maintenance work to third party maintainers.

the TOCs. Lease payments contained two elements: the capital rent, which pays the ROSCO for the use of its vehicle, and the non-capital rent, which was intended to cover the cost of heavy maintenance (and other running costs). This type of maintenance arrangement is known as a 'soggy' lease.

2.30 This structure has since been varied to some extent, with ROSCOs now offering a number of maintenance options including:

- TOCs themselves arranging for both the heavy and light maintenance (known as a 'dry' lease); and
- the responsibility for all of the maintenance lying with the ROSCO (known as a 'wet' lease); with new rolling stock the maintenance is often performed by the original manufacturer in its role as maintainer.

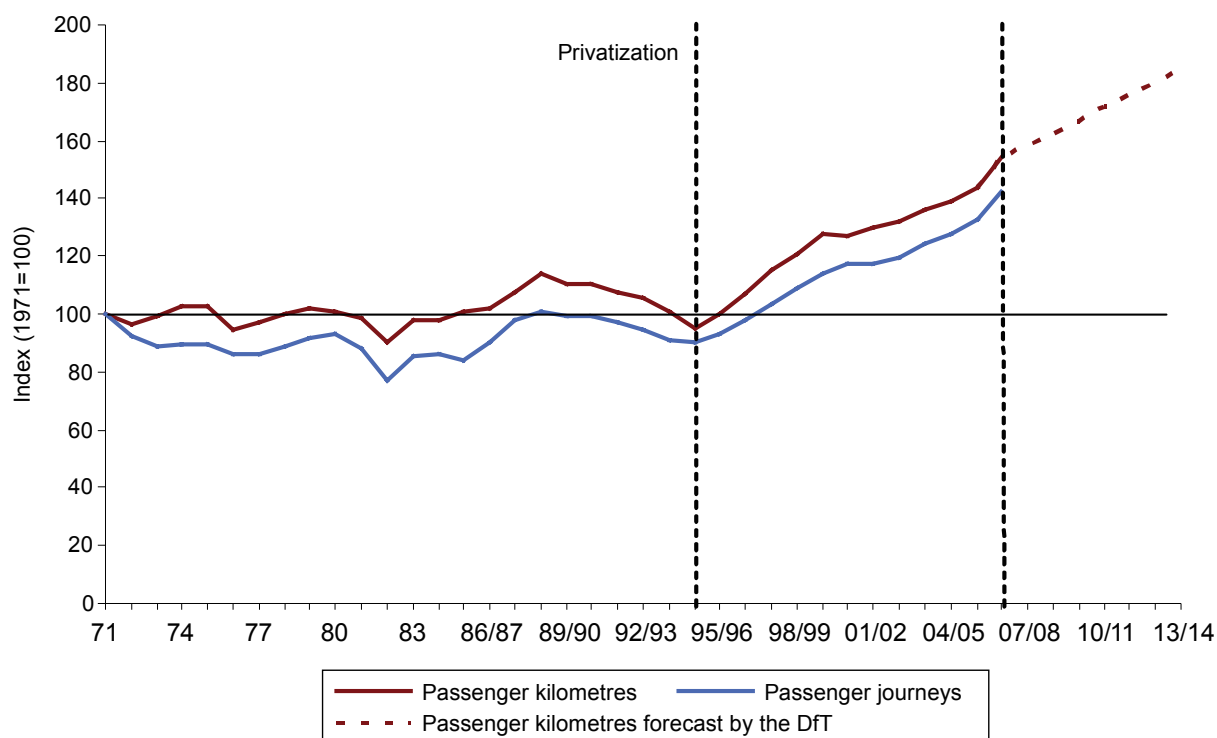
Market size and growth

2.31 The privatization of the rail industry in the early 1990s occurred against a backdrop of falling demand.¹⁴ However, from 1995 to 1996 rail usage began to rise and it has continued to grow. 1,164 million journeys were made on the national rail network in the year 2006/07, compared to 735 million in 1994/95. Demand measured in passenger kilometres has also increased. Between April 1996 and March 2007 passenger kilometres travelled grew by approximately 45 per cent, from 32.1 billion to 46.5 billion passenger kilometres (a compound annual growth rate of 3.4 per cent).

¹⁴DfT July 2004 White Paper *The future of rail*, p13, paragraph 1.2.1.

FIGURE 2.3

National rail usage (1955 to 2006/07)



Source: Transport Statistics Great Britain 2006 edition.

Note: From 1986/87 figures include an element of double counting as a journey involving more than one operator is scored against each operator.

2.32 The number of passenger kilometres travelled is forecast by the DfT to grow by 23 per cent from 2006 to 2014 (a compound annual growth rate of 2.6 per cent).

Background to this investigation

2.33 There have been a number of reviews of rolling stock leasing over the years. The most recent developments are described here and a fuller history is provided in the working paper on the Industry background.

2.34 Following the publication of the 2004 white paper, the DfT embarked on a series of negotiations with the three ROSCOs, which focused mainly on lease prices for the ex-British Rail passenger rolling stock, but also on other areas such as information provision, maintenance packages and a redistribution of risks within the market.

- 2.35 The DfT undertook further work to analyse lease prices and on the basis of this work it sought to engage with each of the ROSCOs and their parent companies. The negotiations were ultimately unsuccessful, leading the DfT to request that the ORR make a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002.
- 2.36 After conducting a short initial review of the DfT submission, the ORR decided to undertake a market study with a view to deciding whether or not to make a market reference to the CC. In November 2006, the ORR announced that it was minded to make a reference to the CC for a market investigation.
- 2.37 Taking into account the evidence gathered during the course of its market study in April 2007, the ORR referred the leasing of rolling stock for franchised passenger services and the supply of related maintenance services in Great Britain to the CC for investigation.

3. Substitutability and market definition

- 3.1 The definition of the relevant market is a useful tool for identifying the competitive constraints present in the market.¹⁵ The key to market definition is substitutability, ie whether goods or services are economically interchangeable. This subject is discussed in detail in the working paper on Substitutability.
- 3.2 We use the hypothetical monopolist framework¹⁶ to analyse the extent of markets. This framework defines substitutability by reference to the extent to which a small but significant non-transitory rise in the price of one product causes customers or suppliers to switch to another product. The process is iterative: starting with the

¹⁵The CC's approach to market definition in market investigations is set out in Part 2 of CC3, *Market Investigation References: Competition Commission Guidelines*, 2003.

¹⁶The Hypothetical Monopolist framework (or 'SSNIP test') is described in CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, paragraphs 2.4 to 2.25.

smallest conceivable economic market for that product, we ask whether this could be monopolized profitably or whether substitute products would prevent this. The relevant market is the smallest group of products that could be profitably monopolized.

- 3.3 In this investigation there are four major factors that complicate market definition:
- (a) the patterns of substitution between different classes of rolling stock vary due to the differing technical, operational, economic and franchise requirements of the different passenger rail franchises;
 - (b) the alternatives available at one point in time may be very different to those at another point in time;
 - (c) the prices we can observe may not be those that would apply if competitive processes were working effectively; and
 - (d) in certain regards the DfT¹⁷ has some of the attributes of a customer.
- 3.4 These considerations are such that we cannot form a definitive view on market definition independently from our analysis of competition. However, we set out below our working approach to market definition.
- 3.5 The suitability of rolling stock is strongly affected by the types of services that are to be provided by the franchisee. For example, a suburban frequent-stopping service will have a specified timetable, necessitating particular speed, braking and acceleration capabilities, as well as door and seating requirements. Operational requirements of this kind substantially limit the number of suitable classes of rolling stock for each franchise, sometimes to one class, sometimes to a small group of classes.

¹⁷We use the term DfT to include other relevant franchising bodies, except where the context requires otherwise.

- 3.6 The differences (notably the loading gauge and electrification system¹⁸) between the rolling stock used in Great Britain and elsewhere are such that we do not consider that any of the relevant markets extend beyond Great Britain. Rolling stock in Northern Ireland is not compatible with that in Great Britain.
- 3.7 With regard to rolling stock leasing, we consider that each franchising process creates an opportunity to lease rolling stock. It is rare for there to be potential for substitution of rolling stock between franchising processes, because new franchises are seldom awarded more than one or two at a time.¹⁹
- 3.8 We note that our view that there is limited potential for substitution is consistent with that adopted by the ORR in its reference to us but we also note that the ROSCOs did not agree with the ORR. Angel stated that the best way to assess competition is on a case-by-case basis. Porterbrook pointed to opportunities for substitution and, in particular, to opportunities for cascades and self-supply of rolling stock. HSBC argued that there was a wide market due to the DfT's position as 'the *de facto* monopoly purchaser'.
- 3.9 We note that contractually the ROSCOs' customers are the TOCs but that the franchising arrangements are such that the DfT has certain attributes of a customer:
- the rolling stock leasing rentals are likely to be directly reflected in franchise bids such that these costs are effectively passed from the TOCs to the DfT and reflected in the subsidy or premium payable for the grant of the franchise;
 - the DfT can play a pivotal role in the specification of rolling stock; and
 - leasing arrangements require approval from the DfT.

¹⁸These technical factors are described in more detail in Annex 1 to the working paper on Substitutability.

¹⁹One notable exception was 'the Midlands Three'. In this case three franchises were handled together, because of the re-mapping of the franchises in question.

3.10 Although we are investigating the leasing of passenger rolling stock, the relevant markets could include rolling stock purchased by a TOC or rolling stock provided under arrangements other than leases. However, these are of limited significance as there are few instances of self-supply and other ownership or financing arrangements. (Self-supply is discussed in paragraphs 2.24 and 5.19.)

3.11 In defining the market, we consider two possibilities when a franchise is let:

(a) the ITT specifies or proposes the use of new rolling stock; and

(b) used rolling stock is favoured, either because the ITT explicitly requires this or because the tender conditions implicitly favour used rolling stock.

Based on these starting conditions we consider firstly what rolling stock would be expected to meet the tender specification and then, in line with the hypothetical monopolist framework, whether, and under what conditions, the relevant market would be wider.

The ITT specifies or proposes the use of new rolling stock

3.12 If the DfT requires or encourages the submission of franchise proposals based on new rolling stock²⁰ then the market would include the leasing of any new rolling stock proposed by the various bidders, subject to it complying with the necessary specifications.

3.13 The market might be widened if credible proposals based on used rolling stock were submitted as part of a franchise bid to the DfT. Under these circumstances leasing of the rolling stock proposed in these bids would also form part of the market.

²⁰There are a number of reasons why the DfT does this; the major reason being the unsuitability of used rolling stock due to age or safety requirements. See also the discussion at paragraph 5.2.

Used rolling stock is favoured

- 3.14 In circumstances where used rolling stock is favoured, the incumbent rolling stock²¹ will normally meet the franchise requirements. Thus the market will consist of at least the leasing of relevant incumbent rolling stock.
- 3.15 The market might be wider than this if there are viable alternatives. If rolling stock of the same class as the incumbent rolling stock were available elsewhere this would also be expected to form part of the relevant market. In some cases other classes of rolling stock may be substitutable; if substitution would occur, in response to a small increase in price, then this other rolling stock would form part of the relevant market. Although substitution possibilities from other parts of the rail network arise from time to time, frequently the incumbent rolling stock is the only used rolling stock that is available at the time of the franchise re-let that can meet the franchise requirements.
- 3.16 In some cases, if the rental prices offered for used rolling stock were comparable to those that would apply for new rolling stock, then the possible use of new rolling stock might constrain prices for used rolling stock. Whether this is the case, and therefore whether any such constraint applies²² is a matter we will consider in our competitive assessment.

Maintenance

- 3.17 The provision of maintenance services does not necessarily entail the physical carrying out of maintenance.²³ A significant number of dry leases, where the TOC takes responsibility for all maintenance, have been agreed, with maintenance services being obtained by the TOCs separately. We therefore consider the provision

²¹The rolling stock that was used on the franchise immediately before the franchise letting process.

²²If the constraint from new rolling stock applied only because prevailing prices were in excess of the competitive level, then this constraint would not be relevant to market definition.

²³As also mentioned in paragraph 2.29 a ROSCO will outsource this requirement to a third party maintainer.

of maintenance services as a separate relevant market from the leasing of rolling stock and we discuss its competitiveness in Section 6 of this document.

4. Leasing of new rolling stock

4.1 When new rolling stock is sought by a TOC for a franchise, all three ROSCOs and other potential providers are in principle able to purchase that rolling stock and offer the TOC a lease. This suggests that there is the potential for effective competition for the initial leasing of this new rolling stock. This section puts forward our preliminary views.

4.2 ROSCOS and other parties have indicated that they believe the competition for leasing of new rolling stock to be effective.

4.3 We have not received evidence to date to suggest that, other than in exceptional circumstances,²⁴ there is the potential for lessors of new rolling stock unilaterally to raise prices above competitive levels.

Coordinated effects

4.4 The DfT has suggested²⁵ that if the ROSCOs were making excess profits on non-MOLA²⁶ re-leasing (ie leases entered into after the ROSCOs were established) this may be explained by strategic pricing. The DfT has suggested a mechanism by which the ROSCOs could target market shares of rolling stock of one-third each and thereby reduce competition significantly.

²⁴For example, where a particular lessor is the only potential provider of the specific type of rolling stock required by the customer.

²⁵See Appendix 2 to the DfT's submission to the CC:

http://www.competition-commission.org.uk/inquiries/ref2007/rosco/pdf/third_party_submission_dft_appendix2.pdf.

²⁶See paragraph 2.16.

4.5 We have not examined the DfT's suggestion in detail but note that the DfT's suggested mechanism of coordination based on market shares (of all passenger rolling stock) is, to some extent, based on the observation of relatively little movement in the shares of rolling stock leasing between 1996 and 2006. However, we have been able to examine more information than the DfT had available and we note that shares of new rolling stock leasing have fluctuated to some extent during that time. We would not, in any event, expect frequent or substantial changes in shares of all passenger rolling stock as re-franchising does not occur frequently and about 60 per cent of the market still consists of pre-privatization rolling stock.

4.6 Nevertheless, coordinated effects may have occurred, facilitated by the scheme suggested by the DfT or by some other mechanism. We intend to examine the possibility of coordinated effects in greater detail, particularly if our profitability analysis suggests that excess profits may be being earned on rolling stock built after privatization.

5. Leasing of used rolling stock

5.1 It appeared to us that problems relating to an inadequacy of competition were most likely to occur in the markets for used rolling stock. Our concern has been that, due to a lack of competitive pressures at franchise renewal, a ROSCO providing the incumbent rolling stock might be able to charge excessive rentals or obtain some other advantage in relation to that incumbent rolling stock when it is leased again. This has been the major focus of our investigation so far.

5.2 There are a number of reasons why, for any given franchise, used rolling stock may be preferred over new rolling stock. Given that rolling stock typically has a life of at least 30 years, and franchises typically have a life of seven years, one would expect used rolling stock to be employed much more than new rolling stock. The ORR's

figures show that, with investment, the average age of rolling stock has fallen significantly since 2001/02. At present, the average age of rolling stock is under 14 years, which, at slightly less than half of the typical 30-year lifespan, is about the average age we would expect in a normal 'steady state'.

5.3 We consider below:

- the opportunities for switching and therefore for competition;
- the negotiating power of the TOCs, including any countervailing buyer power;
- the role of the DfT; and
- the setting of rental prices by the ROSCOs.

We conclude with a summary of our preliminary views on competition for used rolling stock.

Opportunities for switching

5.4 As discussed in the Market Definition section (paragraph 3.14), the incumbent rolling stock will generally meet the requirements of the new franchise (except when it is unsuitable, for example due to age or non-compliance with new safety standards).

5.5 A TOC can only switch to alternative rolling stock where other rolling stock is both suitable for the particular franchise and is available at the time required by the TOC. Generally, nearly all rolling stock is leased out at any point in time and there is only a small likelihood that there will be any 'off-lease' rolling stock available that conforms with the franchise requirements. Franchises tend not to terminate at the same time so rolling stock will not generally be made available as a result of other franchises expiring (see also paragraph 5.8). On occasions rolling stock can be made available via cascades in which a number of associated movements of rolling stock are made within the rail network as a result of the introduction of new rolling stock; cascades are relatively uncommon.

5.6 In order to encourage new rolling stock proposals at acceptable rentals, the DfT can give undertakings ('section 54 undertakings') that provide ROSCOs with assurance that their rolling stock will continue to be leased, on very similar terms, after the first lease of the rolling stock expires. In practice this usually results in the rolling stock being used by the successor franchisee and effectively removes the scope for competition at this point. We would expect that competition when the stock is first leased should take account of the DfT's commitment to lease the rolling stock for more than one franchise period but we need to assess the competitive effect of section 54 undertakings.

5.7 Data provided by the DfT indicates that, since privatization, about 74 per cent of incumbent rolling stock not covered by section 54 undertakings, or specified in an ITT, has been passed to a new franchise from its predecessor. Of the vehicles that were not re-leased most were life-expired. Replacement of one fleet of used rolling stock by another is relatively unusual, occurring for about 6 per cent of all rolling stock and 10 per cent of rolling stock not covered by section 54 undertakings.

Table 5.1 Impact of franchise re-letting on incumbent fleet

<i>Retained</i>		<i>Replaced</i>		<i>per cent</i>
<i>S54</i>	<i>Re-leased (other)</i>	<i>Life expired</i>	<i>Not life expired</i>	<i>Not required (Surplus to requirements)</i>
31	51	11	6	1

Source: The DfT.

5.8 It has been put to us that both the way that the franchising system operates and the tightness of specification currently stipulated by the DfT reduce the opportunity for TOCs to put forward in their franchise bids any rolling stock (used or new) other than the incumbent rolling stock:

- Because relatively few (generally no more than one or two, see paragraph 3.7) rail franchises are let at the same time, the quantity of used rolling stock that is potentially available to meet a requirement is very limited.
- It has also been suggested that the DfT is highly prescriptive as to what rolling stock it considers suitable to operate a given franchise and route (both by explicit directions and by applying operational criteria that effectively restrict the classes of eligible rolling stock). It has also been suggested that the DfT applies overly tight deliverability criteria. It is argued that these factors reduce competition for used rolling stock.
- New rolling stock is only a viable option where the DfT favours this as a solution.

We have not yet assessed whether any of these factors makes a material difference to the effectiveness of competition. We recognize that the DfT has reasons, not related to competition, for its current approach to managing franchising activity. Our concern is to examine whether and how this approach might affect competition.

5.9 The above discussion indicates that in many cases there are no alternatives to the incumbent fleet of rolling stock.

5.10 In some cases there are one or more alternatives. However, the DfT argued that even where alternative rolling stock is available, the overall demand for used rolling stock means that there are usually competing bidders for available stock with the result that the availability of that rolling stock provides a limited constraint on prices. We recognize the importance of this issue. However, having identified that competition takes place in small, temporary markets we believe that it is important first to characterize the competition at this level before forming a view as to the impact of any such general factors. We are therefore currently studying a large set of lease negotiations to assess what, if any, difference the presence of alternatives tends to make to the outcome of negotiations.

Negotiating power of the TOCs

- 5.11 Due to the limited opportunities for substitution the same rolling stock is likely to be built into the proposals of each of the bidding TOCs. For any lease proposal the ROSCOs are each required by a code of practice to offer the same price to each TOC that requests one.²⁷ If all TOCs know that they would obtain the same price they would have little or no incentive to negotiate with the ROSCO.
- 5.12 However, we have been told that TOCs can and do start individual negotiations by requesting a price on a bespoke proposal (which may be a variation of the initial proposal) that cannot be compared directly to another TOC's fleet requirements.
- 5.13 We therefore consider that the codes of practice do not remove any incentives from the TOCs to negotiate with the ROSCOs.²⁸
- 5.14 We have been told that TOCs negotiate with ROSCOs at all stages of the franchising process. Much of this negotiation relates to the refurbishment of rolling stock rather than the level of the rentals. We are in the process of analysing whether this results in any material reduction in effective rental prices or in significant improvement in the value of the ROSCO's offer.

Countervailing buyer power

- 5.15 ROSCOs submitted that TOCs had countervailing buyer power. Four possible sources were cited:²⁹
- membership of a larger train operating group;
 - being a repeat customer;

²⁷The codes of practice incorporate a number of elements; including a fairness and non-discrimination provision which requires that the ROSCO does not discriminate between customers.

²⁸The incentives for TOCs to negotiate are discussed in the working paper on Customer behaviour.

²⁹ROSCOs put forward different arguments; these arguments were not all supported by all the ROSCOs.

- ability to exploit their position as prospective lessees of new rolling stock to improve their negotiating position with regard to used rolling stock; and
- ability to supply their own rolling stock.

We consider each of these arguments in turn.

5.16 Since privatization, franchises have become larger and the number of owning groups operating TOCs has become smaller. There are now 17 franchises³⁰ operated by eight owning groups. Membership of a large owning group might allow TOCs to move rolling stock between franchises within the same group, or to threaten to do so. However, we have not received evidence of this occurring, on any significant scale, and note that the same factors (rolling stock specification and availability) that hinder competition between ROSCOs are likely to rule out this possibility.

5.17 ROSCOs have told us that the need for the ROSCO to maintain good ongoing relationships with TOCs and the owning groups gives some power to these customers. However, the TOCs' position as repeat customers of the ROSCOs does not give the TOCs additional rolling stock alternatives.

5.18 Although TOCs may benefit from competition between ROSCOs for new rolling stock³¹ we have seen no evidence that this brings any significant benefits to the TOCs in relation to used rolling stock, nor that TOCs are able to exploit competition for new rolling stock to their benefit when leasing used rolling stock.

5.19 A TOC could gain countervailing buyer power through the ability to supply its own used rolling stock. We note, however, that there have been very few examples of self-supply in practice; TOC-owned rolling stock represents less than 1 per cent of

³⁰We have classed Merseyrail and London Overground as concessions rather than franchises.

³¹See Section 4.

total passenger franchised rolling stock capacity. Self-supply is unlikely to act as an effective constraint because:

- relevant (used) rolling stock is unlikely to be available for a TOC to buy at a price that would give it any advantage over leasing from the ROSCO;
- ROSCOs are specialized businesses; they are set up and organized to be efficient owners of rolling stock; they therefore have advantages over TOCs, such that self-supply is likely to be less efficient than leasing; and
- most TOCs do not wish to have rolling stock assets on their balance sheets.

5.20 Our preliminary view is therefore that TOCs do not have significant countervailing buyer power.

Role of the DfT

5.21 The ROSCOs have suggested that in carrying out its legal functions, the DfT has entered into agreements with ROSCOs giving the DfT certain contractual rights over the ROSCOs (eg the call options in the direct agreements³²). The ROSCOs have also suggested that the DfT has market power as the architect and funder of the franchise system, (and ultimately the funder of rolling stock leases for subsidised franchises).

5.22 The DfT does not agree with the ROSCOs' views. It considers that there are significant legal limits as to how it may act in carrying out its functions. Moreover, the DfT points to its own lack of freedom to negotiate, given its legal duty to ensure the provision of rail services under section 30 of the Railways Act 1993.

³²These are described in the working paper on Industry background.

- 5.23 It does not appear to us that the DfT has the power attributed to it by the ROSCOs. The DfT's functions do not enable it to impose price reductions for rolling stock that has no alternatives or that only one ROSCO can supply.
- 5.24 HSBC put it to us that ROSCOs were fully aware that unless they offered value for money, and were perceived to do so, they would have no future. It stated that there was a large disparity between the power of the Government as the funder of the railways, and the ROSCOs, which were only brought into existence as an effective way of providing finance for rolling stock.
- 5.25 It seems likely to us that some of these considerations constrain the conduct of ROSCOs at some level. However, any such constraint is unlikely in itself to generate competitive outcomes.

Determining rental prices

- 5.26 The rental charges include an element of profit margin to cover the risks the ROSCOs face and overhead expenses.³³ It is difficult to assess the reasonableness of this component of the margin, but we will endeavour to form an overall view on margins in our analysis of profitability (see paragraphs 8.12 and 8.13). When initially determining the rental prices for the first lease of rolling stock the ROSCOs generally assume that capital rental payments will be the same (in nominal terms—ie with no inflation-based increases) for the duration of the rolling stock's life. It is necessary for the ROSCOs to form a view on the likely rental payments that will be obtained for the life of the rolling stock and to determine the level of rental payments required to ensure a long-term return on the rolling stock. In other leasing industries the lessor may assume a disposal value that it could obtain after the expiry of an initial lease. However, there is no active market for used rolling stock and so an approach that

³³Appendix B of this document describes the processes the ROSCOs use to determine lease rentals.

assumes a disposal value after the expiry of a lease would not be suitable for ROSCOs.

- 5.27 For the period of each lease, capital rental payments almost always follow a flat profile, as specified in the lease contract, and, are not generally adjusted for subsequent changes in interest rates or tax rates.³⁴
- 5.28 The TOCs and the DfT indicated to us that when rolling stock is leased on the second and subsequent occasions ROSCOs generally seek to maintain the same capital lease rental payments as under the previous lease, with possible increases for any upgrading of the rolling stock. We asked the ROSCOs to what extent the previous lease rental payments formed a starting point for their price setting. We received differing responses from the ROSCOs. In some cases the previous lease price would be a starting point for the process of deciding the price to be offered in negotiations with the TOCs bidding for the franchise. However other factors such as availability of alternative rolling stock, indifference pricing and commercial issues could also influence the starting point for negotiations. The ROSCOs cited various commercial issues that would influence the lease rental that was ultimately negotiated.
- 5.29 Only one ROSCO said that it explicitly considered an ‘indifference pricing’ methodology when determining rental rates at a re-lease. This ROSCO stated that it considered the rental price of new rolling stock and adjusted this rental downwards to reflect the reduced utility of the older used rolling stock to a point where the TOC is

³⁴We note, however, that there are some tax-based leases.

indifferent to leasing the used rolling stock or new rolling stock having similar operating characteristics.³⁵

5.30 The DfT noted that indifference pricing and constant (nominal) rental prices were not likely to be compatible as there would be variation in new rolling stock prices over time.

Effects of interest rate changes

5.31 There are a number of cost factors that affect the ROSCOs. We have at this stage paid particular attention to interest rates as these are a major cost, and the DfT has drawn attention to the fact that rental prices do not appear to have declined despite falls in interest rates.

5.32 We asked the ROSCOs to comment on the effect of a fall in interest rates on the rental prices that would be charged when agreeing a new lease for used rolling stock. Our interpretation of the ROSCOs' responses, taken as a whole, was that there would be no automatic effect on rental prices and that there were a number of other relevant factors.

5.33 Our examination of the negotiation of rental prices suggests that changes in interest rates have had little bearing on the rentals charged for second and subsequent leases. This examination is not yet complete, and is complicated by the particular factors (such as rolling stock upgrades) of each case.

5.34 The DfT has argued that the absence of rental reductions in response to declines in interest rates indicates that rental charges are above the competitive level.

³⁵The processes the ROSCOs use to determine lease rentals are described in more detail in Appendix B.

- 5.35 We do not think that the DfT proposition is necessarily correct. In a well-functioning market we would expect prices to be determined by the interaction of supply and demand. Interest rates need not have a direct effect on the rental prices that would be charged in a well-functioning market, although interest rates may affect supply and demand,³⁶ thereby having an indirect effect on prices.
- 5.36 Whilst we would expect prices in a well-functioning market to respond to costs, the relevant costs, in the short-to-medium term, would be the marginal costs. The ROSCOs incur interest costs as a result of their decisions to purchase rolling stock. For used rolling stock these are not marginal costs;³⁷ these costs are incurred whether or not the rolling stock is leased out. In this respect, as discussed below, they should have no effect on prices.
- 5.37 In a well-functioning market, if there were adequate supply of used rolling stock, such that demands could be met without the need for new rolling stock, then the rental price of used rolling stock would not be directly affected by interest rates. In circumstances where demand exceeds supply for used rolling stock then we would expect used rolling stock rental prices to rise until new rolling stock became an effective substitute. In this situation the relevant market definition would include both used and new rolling stock. The rental price of *new* rolling stock would be directly affected by interest rates and interest rates would thereby have an effect on the price of both new and used rolling stock.
- 5.38 The DfT contends that rental prices for used rolling stock should be significantly lower than for new rolling stock. However, if there is a shortage of supply of used rolling stock, it does not appear to us that in a well-functioning market this would

³⁶Interest rates are likely to have myriad of indirect effects. For example, they are likely to affect the number of passenger journeys.

³⁷There are few short-term marginal costs once the stock is built. If the ROSCO believed that off-lease stock was very unlikely to be re-let, it could scrap the stock and save maintenance and storage costs.

necessarily be the case. (Though we would expect some differences in rental price, reflecting the difference in the perceived value to the TOC of different types of rolling stock.)

5.39 The assessment of prices for used rolling stock is complex and we have not yet formed a view on this matter. Our view will be informed by our detailed work on competition and profitability. Although we do not agree with all of the DfT's arguments relating to rental prices, we do have a concern that rental prices in excess of those that we would expect in a well-functioning market may be charged since TOCs, in many cases, have very few or no alternatives.

Summary of our preliminary views on the leasing of used rolling stock

5.40 Our analysis so far suggests that:

- When bidding for a franchise, TOCs generally have very few or no alternatives to the leasing of incumbent rolling stock.
- The underlying reason for the lack of alternatives is the need for rolling stock to meet the specific requirements of a franchise, both in terms of suitability and by being available at the required time.
- TOCs can and do negotiate with the ROSCOs. We are in the process of analysing whether this process of negotiation results in any material reduction in rental prices or in significant improvement in the value of the ROSCOs' offers to the TOCs.
- TOCs do not generally have countervailing power that would enable them to resist the exercise of market power by a ROSCO owning the incumbent fleet of rolling stock.
- Although the DfT has power over the franchising system, this is not likely to be sufficient to prevent ROSCOs setting rental prices that are higher than they would be under conditions of effective competition.

- We would not necessarily expect rental prices for used rolling stock to respond to interest rates, except when these rental prices were constrained by the possibility of leasing new rolling stock.

5.41 Further analysis is required to characterize competition in more detail and to establish whether there is an identifiable difference between the rental prices agreed when there is some competition and those agreed when there is none.

6. Competition and maintenance issues

6.1 We consider the provision of maintenance services³⁸ as a separate relevant market from the leasing of rolling stock (see paragraph 3.17).

6.2 Concern has been expressed that ROSCOs might be engaging in practices that exploit their positions in rolling stock leasing to gain advantage in the market for maintenance services. This could be done by bundling maintenance services with leasing of rolling stock or by refusing to offer dry leases (leases where the TOC takes responsibility for all maintenance) to TOCs.

6.3 We have received no evidence to suggest that HSBC or Porterbrook are engaging in bundling of maintenance with rolling stock or refusing to offer dry leases to TOCs. We have received some evidence that Angel has refused a number of TOCs dry leases and some TOCs have expressed strong concerns about this.

6.4 Refusal to offer a dry lease to a TOC prevents that TOC from arranging maintenance services itself. This could result in detrimental effects to end-customers if existing or potential competitors in the market for the provision of maintenance services are excluded or have to face higher costs. This may weaken competition in the market

³⁸These issues are considered in more detail in the working paper on Maintenance.

for the provision of maintenance services, potentially leading to higher prices or worse service than would otherwise be the case.

6.5 However, there may be efficiency arguments for bundling maintenance together with the provision of rolling stock in this way, so that end-customers ultimately benefit from the practice. For example, ROSCOs might have a stronger incentive to keep rolling stock in good condition because they are interested in the condition and performance of rolling stock across its whole life, whereas TOCs are in principle only concerned for the duration of the current lease. Even though ROSCOs might be able to obtain compensation from TOCs if rolling stock has been inadequately maintained, the costs of resolving any disputes may render this mechanism ineffective.

6.6 We have also received submissions to the effect that it is beneficial for TOCs to attend both to routine and longer-term maintenance events.

6.7 The TOCs have also complained about a lack of transparency (for example a lack of clarity in the treatment of the ‘maintenance reserves’—sums of money which the TOCs are required to deposit with the ROSCOs to meet potential maintenance liabilities) in the prices of all three ROSCOs. These issues make it more difficult for TOCs to make informed decisions as to the best maintenance strategy to follow.

6.8 We need to carry out further investigation with regard to maintenance issues and have, so far, formed no preliminary views.

7. Entry

7.1 This section discusses past entry to the rolling stock leasing market and the possibilities for further entry. A more detailed discussion may be found in the Entry working paper.

Experience of entry to date

- 7.2 Although a number of firms have shown interest in entering the markets for the leasing of rolling stock,³⁹ Voyager Leasing is the only example of entry since privatization. Voyager Leasing was set up as a specific arrangement relating to a particular fleet of rolling stock. Since its formation it has not broadened its scope and has no plans to do so.
- 7.3 Voyager Leasing's entry came as a consequence of a 15-year franchise granted to Virgin Trains to operate the Cross Country franchise which enabled Virgin to implement a long-term strategy by investing in new rolling stock designed for that specific franchise, using innovative financing arrangements. In the absence of long-term franchises, under current policy, there appears to be little opportunity for such initiatives.

Possible entry strategies

- 7.4 Entry into the markets for the leasing of used rolling stock seems highly unlikely. A new entrant would have to acquire used rolling stock, and the only significant sources are the existing ROSCOs. The likelihood of a ROSCO selling used rolling stock to a potential (or existing) competitor appears very low.
- 7.5 Entrants into the markets for new rolling stock could follow a number of potential strategies:
- broad entry into leasing of new stock, with the aim of building a business similar to the existing ROSCOs over time;
 - specialized entry, similar to that of Voyager Leasing; and
 - entry based on alternative funding or financing structures.

³⁹Although leasing firms have been sold by their owners, we do not regard these examples of the acquisition of an existing leasing firm as market entry because the firms still exist and the structure of the market remains the same.

- 7.6 Taken together, the effects of perceived residual value and political risks, portfolio benefits and economies of scale, access to finance, tax capacity, and industry and technical expertise appear likely to deter entry. Whilst large financial institutions will be well placed to deal with some of these issues, a significant number remain. Entry adopting the traditional leasing model of the existing ROSCOs appears highly unlikely.
- 7.7 Specialized entry, following a similar strategy to Voyager Leasing is possible. However, we note that there has only been one such occurrence and it appears likely that this type of strategy is practical only in limited circumstances and where train operators have the opportunity to procure new rolling stock to their own specification, usually on the basis of a long-term franchise.
- 7.8 A number of current and future programmes for the procurement of new rolling stock may be designed in such a way as to be attractive to firms outside of the current set of ROSCOs. These include Transport for London's (TfL) plans for the North London and East London lines and the DfT's Intercity Express Programme (IEP). At present an assessment of the likely outcomes of these initiatives would be speculative; however, we consider that it is unlikely that any new entrant would constrain the existing ROSCOs in the short-to-medium term.

8. Risk and profitability issues

- 8.1 We examine profitability as one possible indicator of the conditions of competition. Our guidance states that 'a situation where, persistently, profits are substantially in

excess of the cost of capital for firms that represent a substantial part of the market could be an indication of limitations in the competitive process'.⁴⁰

8.2 The DfT carried out an analysis of the profitability of capital rentals for the ROSCOs. It concluded that the ROSCOs were making excess profits on capital rentals of MOLA stock. It estimated the customer detriment arising from these excess profits at between £34 and £177 million a year. The wide range is due to different valuation bases being applied to rolling stock assets in the calculations.

8.3 The ORR reviewed profitability submissions from the DfT and the ROSCOs, as well as carrying out its own limited analysis. It found that, notwithstanding some valid criticisms by the ROSCOs, 'plausible approaches [to profitability] that we have considered are consistent with excess profits being earned'.⁴¹

8.4 We are in the process of a detailed analysis of the profitability of the three ROSCOs.⁴² This analysis is intended to help us to form a view as to the profitability of the various parts of the businesses (eg used rolling stock, new rolling stock and maintenance).

Significance of risk

8.5 In forming a view as to whether a given level of profit represents a reasonable return we will have regard to the risks the ROSCOs have faced and will face in the future. We have received many submissions on these issues and we note that there is a large difference between the views of the ROSCOs and those of the DfT. A more detailed discussion of the various risks ROSCOs face may be found in the working paper on Risk.

⁴⁰CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, paragraph 3.82.

⁴¹*The leasing of rolling stock for franchised passenger services: ORR's reasons for making a market investigation reference to the competition commission*, 26 April 2007, Executive Summary, paragraph 24.

⁴²We will also consider the profitability of Voyager, but not in depth.

- 8.6 Risk may affect our assessment of profitability by:
- weakening the relevance of past profits as an indicator of underlying profitability because such profits may not be representative;
 - requiring us to make an allowance for various risks in our assessment of projected returns; and
 - affecting the cost of capital that we use to decide what a reasonable return for each of the ROSCOs has been and will be.
- 8.7 Historical profits are one guide to the future. However, if the ROSCOs have been 'lucky' in the past, then this might cause us to overestimate their future prospects; we note that growth in demand for passenger rail services has been far greater than had been expected at privatization with the result that rolling stock utilization has remained high. The favourable economic environment over this period has been one of the main factors driving growth.
- 8.8 We note that certain risks may change or develop over time. For instance, the DfT's policy in two years time is not likely to differ dramatically to that today, but its policy in 22 years time could well be substantially different.
- 8.9 Like any business, ROSCOs are exposed to a variety of risks. It appears to us that the most significant risk to which the ROSCOS are exposed is the risk that rolling stock may not be leased or can only be leased at a rental that is much lower than that originally expected.⁴³ This risk may be influenced by the DfT's procurement policy, technological change, and by new safety and other standards. The DfT and the ROSCOs appear to have very different views on the scale of these risks, which we will need to consider carefully.

⁴³This is sometimes called 'stranding risk'.

8.10 Some risks can affect the appropriate cost of capital to use for assessing a businesses performance. However, not all risks fall into this category and we consider that much of the risk to which a ROSCO is exposed should not affect its cost of capital.⁴⁴

Interest rate and tax changes

8.11 Ownership of long-life assets exposes ROSCOs to the risk of significant gains or losses as a result of interest rate and tax changes. We will need to consider how these exposures are managed by the ROSCOs, and how they should be taken into account in our assessment of profitability.

Our approach to the profitability analysis

8.12 We consider that the assessment of profitability on lease rentals for rolling stock should include an examination of returns based on whole life cash flows, assessed with reference to the relevant cost of capital.

8.13 For maintenance services there are issues determining a separable capital base. We will therefore consider maintenance returns in aggregate with lease rental returns. In addition we will also assess maintenance margins by reference to maintenance income.

9. Next steps

9.1 Following publication of this Emerging Thinking and the associated working papers we will consider responses we receive and conduct further hearings.

9.2 Our analysis will focus on the following areas:

(a) assessment of profitability and risk;

⁴⁴This is a technical subject and will be discussed in more detail in a future working paper related to the cost of capital.

- (b) the competitive effects of section 54 undertakings;
- (c) the possibility of coordinated effects in the competition for new rolling stock;
- (d) the effects, if any, of the availability of suitable alternative used rolling stock on the outcomes of negotiations;
- (e) assessing in further detail how rental prices have changed between leases and what factors may have impacted on the changes;
- (f) whether negotiation by TOCs with ROSCOs results in any material reduction in effective rental prices or in significant improvement in the value of the ROSCO's offer;
- (g) conduct of the franchising process;
- (h) maintenance issues; and
- (i) what insights, if any, are available from comparison to the rail freight rolling stock market and other comparable sectors.

9.3 Further working papers will be published as appropriate. Consideration of profitability involves the analysis of confidential information so any published working papers on profitability will be high-level summaries of our analysis.

9.4 We plan to publish our Provisional Findings in May 2008.