

## **Train operating companies**

### **Introduction**

1. This appendix provides further information on the behaviour of the TOCs as customers of the ROSCOs.
2. We consider two issues:
  - (a) what incentives the TOCs have to negotiate with the ROSCOs to achieve the best possible lease rental; and
  - (b) whether the TOCs, due to their size and repeated negotiations with the ROSCOs, hold some form of countervailing buyer power.

### **TOCs' incentives to negotiate**

3. In this section, we first explain the franchise tendering process and the ROSCOs' Codes of Practice, placing the interactions between TOCs and ROSCOs in context. We then examine the incentives which we would expect to be in place for the TOCs to negotiate with the ROSCOs, the parties' views on these incentives, and the evidence as to what features TOCs have actually negotiated over.

### ***Negotiations between TOCs and ROSCOs***

4. Table 1 shows that lease rentals constitute a significant proportion of the total franchise costs and an even higher proportion of the TOCs' negotiable costs. We would therefore expect the TOCs to negotiate over lease rentals in order to differentiate their franchise bids from those of competitors and to improve their profitability. We examine in this section how far this is the case.

TABLE 1 Breakdown of franchise costs

Type of costs	Minimum	Maximum	per cent	
			Average	Costs negotiable
Leasing charges	8	25	15	Yes
Maintenance costs (on dry leases)	0	16	5	Yes
Staff costs	15	31	23	No*
Track access charges	25	38	34	No
Other costs	20	33	24	Unknown

Source: CC analysis of TOC responses.

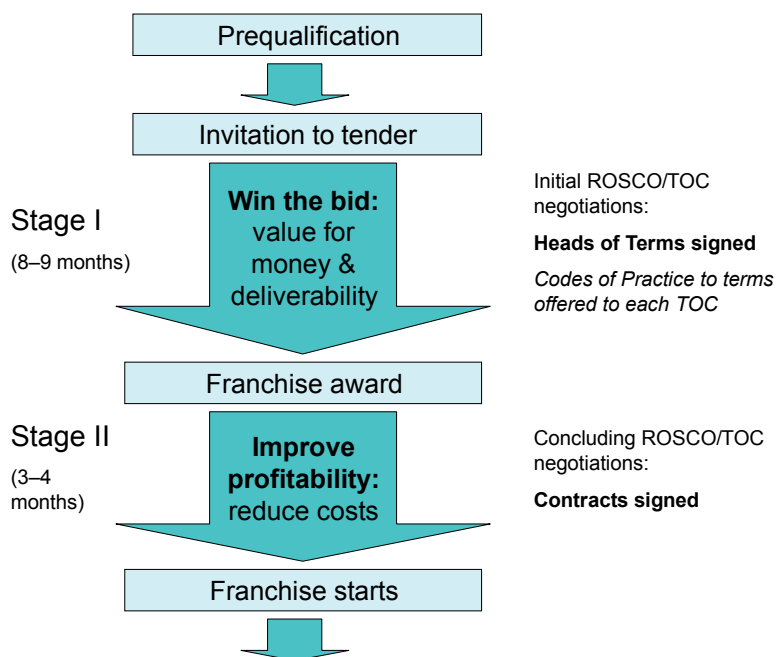
\*Staff costs have been categorized as non-negotiable because TUPE arrangements mean that the incoming TOC must take on the current staff under the same terms of employment. However, we note that these may be variable once the franchise has started.

5. The TOCs' main commercial negotiations with ROSCOs take place at two stages of the franchising process: (a) after the franchise ITT has been issued and before franchise bids are submitted; and (b) between the franchise award and the franchise start date.<sup>1</sup> Figure 1 sets out these two stages. The franchising process is set out in greater detail from paragraph 10 in Appendix 2.1.

<sup>1</sup>Angel noted that this depiction of the franchise process failed to take account of further negotiations during the franchise term (for example, the cascade of Class [X] rolling stock in the [X] franchise). However, we consider that these negotiations usually concern relatively small amounts of rolling stock and that the vast majority of negotiations take place at franchise re-let.

FIGURE 1

### TOCs' incentives at the different stages of franchise negotiations with the ROSCOs



Source: CC.

6. We would expect the nature of the TOCs' incentives at these two stages to be different.
7. At the first stage, covering around eight to nine months, the TOC endeavours to win the franchise bid with the DfT. This means that it has to comply exactly with the franchise ITT specification if it wants to avoid having its bid rejected as non-compliant. It also has to construct a bid which will weigh value for money against deliverability,<sup>2</sup> as these are the criteria on which the bid will be judged by the DfT.
8. In negotiating lease rentals with TOCs during this stage, ROSCOs are not directly regulated by the Government, but are each required to operate under a Code of Practice covering their dealings with TOCs. All three ROSCOs' Codes of Practice

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<sup>2</sup>We define these terms in Appendix 2.1.

have essentially the same wording. The Codes of Practice are self-governing, in that the ROSCOs commit to adhere to their provisions. Under the Codes of Practice all customers are required to be given fair and equitable treatment from the ROSCO with any differences in the terms offered to individual customers being justifiable on the basis of 'fair and reasonable' criteria outlined in the respective codes. The Codes of Practice specify that ROSCOs will not discriminate between customers in relation to:

- the price at which rolling stock is leased or offered;
- other terms including maintenance and modifications; or
- a sublease, sale or disposal by other means of rolling stock.

9. The Codes of Practice also state that ROSCOs will negotiate prices in good faith and in a non-discriminatory manner and list the factors that the ROSCO may take into account in agreeing a price.<sup>3</sup>

10. TOCs are, however, permitted to construct variants to the DfT's base case service specification in order to make their offers unique; a ROSCO is only required by its Code of Practice to offer the same terms to TOCs if one TOC asks for exactly the same rolling stock requirements as another TOC.

11. At the second stage, if the TOC is successful in its franchise bid, the key parameters of its bid are fixed by the DfT's acceptance of the bid. The TOC has to ensure that it is capable of converting the rolling stock offers into binding contracts with the relevant ROSCOs in a short period of around three to four months. Given that the

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<sup>3</sup>The requirement for non-discrimination is not absolute, but is qualified by reference to certain legitimate criteria for discrimination as set out in the Code (including, among other things, the credit-worthiness of the customer, or its operational record). It is only unjust or capricious discrimination which the Code seeks to prohibit.

TOC bears sole responsibility for costs from this point onwards, it has an incentive to negotiate since any further reductions in costs will improve its profitability.<sup>4</sup>

12. We now consider the views of the parties on the nature of TOCs' incentives at each of these two stages.

*Stage I: franchise ITT to bid submission*

13. In this section, we consider the parties' views on TOCs' incentives between franchise ITT and bid submission within the constraints of the Codes of Practice.
14. All three ROSCOs stated that TOCs had a strong incentive to negotiate and differentiate themselves from each other at this stage in order to put together the most competitive bid to win the franchise. This is best achieved through lease rental reductions, enhancements and fleet optimization. All three ROSCOs also submitted that the Codes of Practice did not restrict a TOC's incentive to negotiate because of the ability to put together bespoke offers to meet the various requirements of different TOCs. For example, one ROSCO ([REDACTED]) gave four different offers to bidders for the [REDACTED] franchise for the Class [REDACTED] fleet with each offer including bespoke elements requested by the bidders.
15. The DfT acknowledged that, in theory, TOCs had an incentive to negotiate with ROSCOs at the bid stage. However, it considered that in practice this incentive was removed by the ROSCOs' Codes of Practice which prevented ROSCOs from discriminating between TOCs. The DfT argued that a TOC had virtually no incentive to negotiate improved price terms from a ROSCO at the bid stage, since any price reduction that it secured would automatically be offered to competing bidders. The

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<sup>4</sup>Angel told us that prior to the 2005 ICEC franchise re-let, franchise agreements were not usually signed until hours prior to the start of the franchise, and that this may have affected the motivations of the preferred bidder in the second stage.

negotiating TOC would incur search costs without corresponding benefits. The DfT stated that this was an unintended consequence of the Codes of Practice.

16. All TOCs agreed that at this stage they were motivated to produce the most competitive bid. However, there were differences as to what type of incentives they considered existed (see paragraph 23). Quasar Associates, a consultancy which advises a number of TOCs on rolling stock leasing negotiations, stated that at this stage TOCs could create uncertainty by suggesting to a ROSCO that a particular fleet was under threat and thus obtain improvements to the base case. Quasar Associates further suggested that TOCs generally did not reveal their full rolling stock strategy to the ROSCOs and that this improved their negotiating position. On the other hand, Quasar Associates also noted that bidders might not propose major changes to the existing fleets because such changes would have operational implications and might make the DfT 'mark the bidder down' on the deliverability of the bid.
  
17. We asked the TOCs about the impact of the Codes of Practice on their negotiations with ROSCOs. TOCs provided a wide range of responses:
  - (a) First said that the Codes of Practice meant that ROSCOs had to give the same answer to the same questions asked by different TOCs, but it did not prevent customized variances of the base case.
  - (b) Stagecoach said that the non-discrimination clauses encouraged bidders to find bespoke arrangements with ROSCOs in order to maximize their bidding advantage.
  - (c) Arriva was very supportive of the Codes of Practice and said that without it the ROSCOs could abuse their market power.
  - (d) Govia said that the Codes of Practice limited the scope for negotiations during the bidding process.

- (e) GNER also said that the Codes of Practice limited the scope for negotiations and added that while they only restricted the possibility of negotiations at the bid stage and not after franchise award, TOCs' negotiating power after the franchise award was small.
- (f) Quasar Associates submitted that the Codes of Practice protected bidders from being offered different bids by ROSCOs. It suggested that the Codes of Practice might make it harder for Quasar Associates to find bespoke offers for its clients, but they did not prevent it from obtaining them.

### *Stage II: Franchise award to franchise start date*

18. All three ROSCOs stated that TOCs still had incentives to negotiate at this stage:
- (a) Angel said that even after the DfT had selected its preferred bidder, Angel remained under competitive pressure to engage in further negotiations on lease terms as the preferred bidder did not usually contract its rolling stock until just before the franchise commenced. Angel gave an example where it stated that the preferred bidder for the [REDACTED] franchise, [REDACTED], exerted considerable pressure to get the best modification package possible from Angel's agreed £[REDACTED] million investment in the rolling stock.<sup>5</sup>
  - (b) HSBC submitted that once the preferred bidder was chosen, the winning TOC would try to obtain further enhancements that reduced its costs, and minimized its exposure to risks. In order to extract maximum value from the agreed rentals. HSBC further suggested that the TOCs did not seek to negotiate over rentals at this stage as, if they did so, the DfT would expect to pay a lower subsidy or receive a higher premium. Instead, TOCs preferred to negotiate on non-price features.

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<sup>5</sup>The initial offer of investment was made at the franchise ITT stage and was conditional on [REDACTED] taking Angel's [REDACTED] trains until [REDACTED].

(c) Porterbrook, in contrast, said that at this stage, the winning TOC had a strong incentive to negotiate as any improvement in the ROSCO's offer would flow directly through to the TOC's profitability.

19. The DfT submitted that, in theory, the winning TOC might have a strong incentive to negotiate down the lease rentals for rolling stock as any cost saving at this stage represented additional profit for the TOC. The DfT argued that it did not have the ability to reclaim this cost saving via reduced subsidy or increased franchise premium payment. However, the DfT stated that in practice, TOCs had little, if any, ability to negotiate rolling stock rentals after they became the preferred bidder. According to the DfT, 'the winning TOC will already have reached commercially binding heads of terms and committed itself to being supplied with rolling stock by one or more ROSCOs'. The winning TOC must also provide the rail services specified in the franchise agreement and was required to reach agreement with ROSCOs in order to do so. The DfT submitted that this would give the ROSCOs strong bargaining power.

20. All TOCs had similar views that TOCs had an incentive to reduce the costs of the franchise after the franchise award as any such reductions improved the TOC's profitability. However, most of them did not believe that there was scope for achieving such improvement:

(a) Govia said that at this stage, there was too little time available for negotiations and the TOCs' bargaining position was weak. TOCs and ROSCOs would therefore merely contractualize the heads of terms previously provided by ROSCOs.

(b) Serco Ned submitted that it had never received lower costs from the ROSCOs at this stage and that negotiations focused on the terms and conditions of the franchise with the aim of reducing the overall risks and costs of the franchise.

(c) [REDACTED]

(d) Quasar Associates told us that negotiations at this stage were usually just a matter of ‘closing out’ what had been put forward to the DfT as a rolling stock strategy. It also stated that it would attempt, if possible, to leave open the exact composition on the fleet in its bids. It told us that this created an opportunity to play one ROSCO against the other on a small part of the fleet that had not been committed.

### ***Evidence of TOC negotiations***

21. Having examined the views of the ROSCOs, the DfT and TOCs on incentives, we now consider evidence in relation to what price and non-price factors TOCs try to negotiate with the ROSCOs.
  
22. The ROSCOs had different views on which terms the TOCs negotiated hardest over:
  - (a) HSBC mentioned three elements: (i) lease terms (better-value, longer/shorter leases, change in rolling stock during franchise, etc), (ii) delivery condition,<sup>6</sup> and (iii) additional modifications. HSBC also noted that since the DfT had taken control of the franchising process, TOCs had become more focused on non-price elements (for example, performance commitments and rolling stock enhancements) than price elements. However, HSBC also noted that to maximize profits and to put in the most attractive franchise bid, TOCs also negotiated hard on rentals.
  - (b) Angel told us that there was no rule to determine what elements were most important for TOCs in negotiations as each TOC adopted its own strategy to differentiate itself to win the bid. However, Angel noted the importance that TOCs gave to non-price outcomes such as enhancements to rolling stock.
  - (c) Porterbrook mentioned two elements: (i) lease rentals and (ii) investment in refurbishment.

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<sup>6</sup>This refers to inspections of the rolling stock after delivery with scope for a remedial programme if problems are identified.

23. We also asked TOCs what they considered was most important in their negotiations. The majority of TOCs submitted that non-price differentiation (such as fleet composition, refurbishment and maintenance arrangements) was most important and a minority noted rental reductions:
- (a) Five TOCs ([X]) suggested that, given that the Codes of Practice obliged ROSCOs to make the same base case offer to all bidders, TOCs were incentivized to differentiate themselves on the basis of non-price features such as fleet composition, refurbishment and maintenance arrangements.
  - (b) Two TOCs (National Express and Stagecoach) suggested that the success of the franchise bid was primarily determined by the price that bidders offer to the DfT, of which the rolling stock rental is a significant part.
24. In this section, we therefore consider changes in price and non-price factors during the course of negotiations between ROSCOs and TOCs.

### *Changes in capital rentals*

25. To assess the extent of rental changes negotiated by the TOCs we examined the changes between the base case offer and the contracted lease capital rental. The object of this analysis was to consider what impact TOCs have had on lease rentals *beyond* the base case offer.
26. The capital rental change we have examined covers both Stage I and II in Figure 1. We were unable to collect data that separated out the two stages across each franchise re-let. Where such information was available we have assessed this qualitatively in paragraphs 31 to 35. Although our analysis only considers changes from base case offer to contracted capital rental, we have assessed changes from previous lease capital rental to new lease capital rental (ie including competitive pressures before the base case is offered) in Appendix 4.3. We consider that

changes prior to the base case offer are representative of other factors and not TOC-specific negotiations.

27. In our analysis we have used the same dataset as in our quantitative pricing analysis (for an explanation of this dataset, see Appendix 4.3). This data contains 141 leases for MOLA and post-MOLA rolling stock<sup>7</sup> covering 17 franchise re-lets since privatization and excludes leases which were subject to section 54 undertakings and early franchise terminations.<sup>8,9</sup>
28. Table 2 shows that a large proportion (54 per cent) of lease capital rentals remained unchanged between base case offer and contracted terms. Only 18 per cent of capital rentals decreased whilst 28 per cent increased. Angel noted that this did not take into account additional capital investment but we were unable to remove the amount of change in capital rentals that was attributable to additional capital expenditure because the exact amount of capital expenditure that was included in the base case offer was not always clear. We examine additional capital expenditure in variants to the base case and after the franchise award in paragraphs 31 to 35.

TABLE 2 Changes in lease capital rental from base case to contracted lease

<i>Change in capital rental</i>	<i>Number of leases</i>	<i>% of total leases</i>	<i>Number of vehicles</i>	<i>% of total vehicles</i>
Increased	39	28	2,290	32
Decreased	26	18	801	11
Unchanged	<u>76</u>	54	<u>4,008</u>	58
Total	141		7,099	

Source: CC analysis.

29. Figure 2 shows the spread of changes in lease capital rental from base case offer to contracted lease. In the overwhelming majority of leases (103 out of 141 leases), any

<sup>7</sup>There is one less lease (covering 72 vehicles) included here than in Appendix 4.3 because we did not have details of the base case offer for this lease.

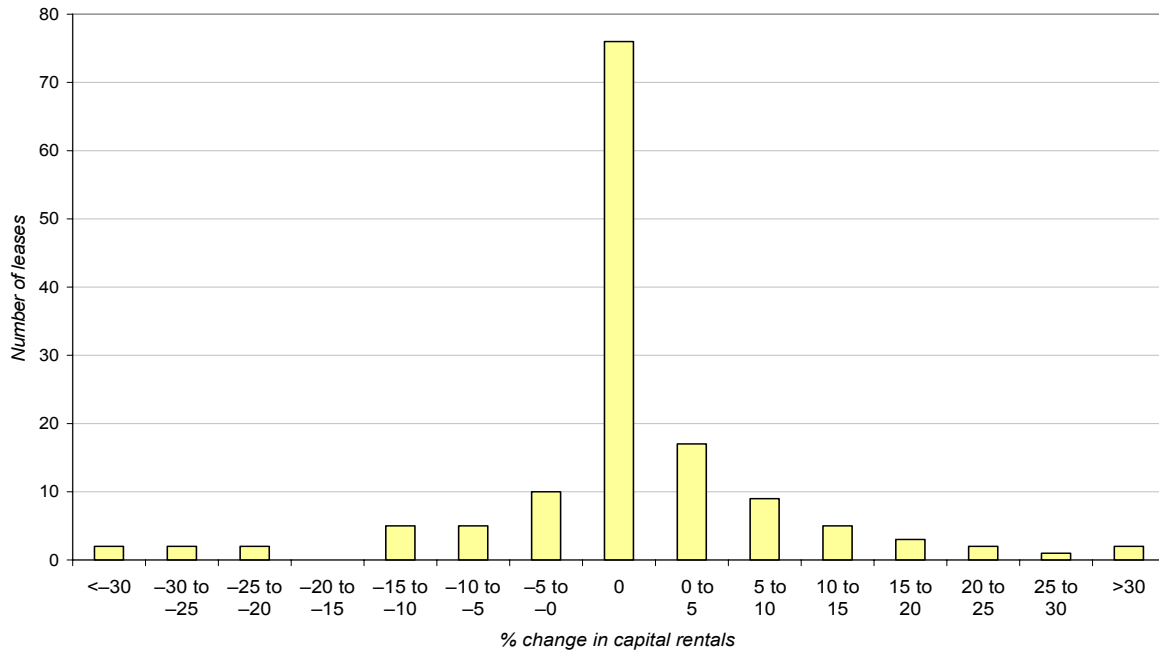
<sup>8</sup>We have used the pricing data supplied by ROSCOs for each lease negotiated and contracted for each franchise re-let. The ICEC 2007, Integrated Kent, and Great Western Link franchises have been removed from the analysis leaving 17 franchise re-lets for analysis.

<sup>9</sup>[§]

change in capital rental from base case offer to contracted lease was less than 5 per cent. In 76 of the 141 leases there was no change observed.

FIGURE 2

**Spread of changes in lease capital rental from base case to contracted lease**



Source: CC analysis of ROSCO data.

*Changes in non-price features*

30. Given the high proportion of lease negotiations where capital rentals remain unchanged from base case to contracted terms and the small percentage (18 per cent) of capital rental decreases, we considered whether there were non-price elements of the lease terms which were negotiated but did not necessarily result in a change in contracted lease capital rental.

31. Angel submitted eight franchise case studies<sup>10</sup> which detailed the terms offered to short-listed bidders (both base case and variants to the base case) and final terms

<sup>10</sup>These were ICEC 2005, Thameslink/Greater Northern, Greater Anglia, Northern, Greater Western, ScotRail, Integrated Kent and South Western 2007.

offered to the preferred bidder. This enabled us to examine differences in the features negotiated at stage I and stage II.

32. Angel's case studies suggested that the main features that TOCs negotiated over as variants to the base case (ie at stage I) were:

(a) Increasing the flexibility of the return of vehicles by adding features such as hand-back<sup>11</sup> and break options<sup>12</sup> [X]. In some cases, the capital rental increased to reflect the risk of the lease being potentially less than the full franchise length or less than the existing amount of rolling stock.

(b) Making additional capital investment. Further investment was offered as a variant to the base case on at least one fleet in nearly all the case studies. In four of the franchises [X] further investment was rentalized on at least one fleet, and in three franchises [X] further investment was funded and not rentalized on at least one fleet.

(c) Other features included discounts for taking a larger fleet size, fixing capital rentals for any change in corporation tax, discounts in exchange for parent company guarantees, heavy maintenance arrangements and alternative rental payment profiles.

33. The amount of negotiation following the franchise award (ie at stage II) was considerably more limited than at stage I. However, Angel's case studies showed that TOCs primarily negotiated further over similar factors to stage 1, namely:

(a) the terms of hand-back options [X]; and

(b) the extent of additional capital expenditure [X].

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<sup>11</sup>Hand-back options are the possibility of returning certain rolling stock to the ROSCO before the end of the lease.

<sup>12</sup>A break option is the possibility of reviewing fleet quantity at certain points in time with lower penalties.

34. HSBC provided examples of changes from the base case proposal to the final proposal on [REDACTED].<sup>13</sup>
35. Porterbrook considered that TOC negotiations over non-price aspects could be illustrated by [REDACTED].

### **TOCs' countervailing buyer power**

36. ROSCOs submitted that TOCs had countervailing buyer power. Angel went further and said that the TOCs had *considerable* buyer power. In general, their arguments focused on two main issues: (a) TOCs form a part of larger TOC-owning groups and are repeat transactors with good knowledge of rolling stock lease rentals across franchises, and (b) TOCs can supply their own rolling stock. We consider each in turn.<sup>14</sup>

### ***TOCs as part of a larger train operating group and repeat transactors***

#### ***Parties' views***

37. Angel stated that TOCs enjoyed a position of strength in negotiations with ROSCOs because they were often a part of a larger TOC-owning group. It argued that following the consolidation of franchises and the emergence of a number of transport groups that were multiple franchise owners, the market power of the franchisees and the resulting competitive pressure on ROSCOs had increased. Angel argued that these groups were sophisticated purchasers who were increasingly seeking to utilize synergies between franchises to exert leverage in individual franchise negotiations. Angel also noted that rolling stock consultants, such as Quasar Associates, were able to leverage buyer power on behalf of TOCs, whether they were large or small.

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<sup>13</sup>[REDACTED]

<sup>14</sup>ROSCOs also mentioned that the opportunity to use new rolling stock as a competitive threat and the threat of putting a small proportion of a fleet off-lease is sufficient to give TOCs a strong negotiating position with respect to the whole of the fleet. We discuss these issues in the main report and Appendix 6.1 respectively.

Additionally, Angel pointed out that, as it engaged in repeat transactions with the TOCs, it needed to maintain a good relationship with them.

38. HSBC argued that TOCs were repeat transactors with which it needed to do business on a long-term basis and that maintaining good relations with TOCs was important. [REDACTED]
39. Porterbrook submitted that TOCs had buyer power partly because any attempt by a ROSCO to exploit market power in relation to one franchise would damage that ROSCO's future chances of securing business with that TOC and with other TOCs within the same owning group (and indeed unrelated TOCs if the conduct were sufficiently serious). Porterbrook stated that rolling stock consultants enhanced TOCs' knowledge of lease terms, irrespective of their size. It also added that the Codes of Practice and the role played by the DfT enhanced buyer power.
40. The DfT was not convinced that a TOC was in a position to threaten to penalize a ROSCO in other franchises where the TOC may be bidding for two main reasons. First, at the point of negotiation, a ROSCO cannot be sure what future franchise a particular train operating group will win. Second, any TOC that attempted to penalize a ROSCO would risk harming its own interests where that ROSCO offered the best lease terms. In addition, the DfT considered that the lack of excess supply and the lack of substitutability of rolling stock on different franchises would make any threat from TOCs not credible.
41. TOCs provided a variety of views as to whether they hold negotiating power as a result of being part of a larger owning group:
  - (a) Three TOCs [REDACTED] opposed the view that they could have buyer power as a result of bidding on different franchises. For example, First stated that having rolling

stock across a number of franchises did not create buyer power for larger owning groups because substitute fleets with which it could negotiate were often leased to another existing franchise that was not due for re-let at the same time.

(b) National Express stated that ROSCOs needed to keep good relations with TOCs. It also stated that its size, strength and synergies as a group could enable it to strike better deals but that this potential benefit was largely nullified by the Codes of Practice.

42. Other third parties also expressed a view on the importance of repeat transactions:

(a) Bombardier told us that:

they [the TOCs] have quite a strong way of negotiating with the ROSCOs and ourselves as well, particularly the bigger ones that have quite a large share of the market. It does not make any sense if you do not support them on one transaction when there are another ten transactions they are probably going to be looking at.

(b) Quasar Associates submitted that TOC groups build up knowledge of rental pricing across a range of fleets as they gain experience through franchise bids. However, Quasar Associates also told us that 'we have accumulated knowledge of ROSCO margins and rental prices over a number of lease transactions but this has only a minor impact on our ability to improve terms offered by ROSCOs. It is competition between ROSCOs (and other funders) which increases our ability to negotiate'. Quasar Associates also stated that for 'must have' stock, little pressure could be applied for a change in terms.

*Evidence on TOCs' negotiating power as large operating groups and repeat transactors*

43. The number of franchisees and TOC-owning groups has been reduced since privatization from 13 to 8, leaving First, National Express and Govia as the TOC-owning groups with the most franchises (see Table 3). We noted that any increased

buyer power from consolidation of franchises is restricted by the fact that TOCs have very limited scope to move rolling stock easily from one franchise to another. This is because it will likely leave them short of rolling stock on the franchise from which the rolling stock has been moved and, in many cases, in default of their franchise obligations to the DfT.

TABLE 3 Changes in numbers of franchises and TOC groups since privatization

TOC groups*	At privatization	June 2008
Arriva	0	2
Serco Ned Railways	0	2
Laing Rail	1	2
Govia	1	3
First	1	4
Stagecoach	2	2
Virgin Rail	2	1
National Express	5	3
Victory Railways (Go-Ahead)	1	0
Sea Containers	1	0
GB Railways	1	0
MTL Services	2	0
Connex	2	0
Great Western Holdings	2	0
Prism Rail	<u>4</u>	<u>0</u>
Total of franchises	25	19

Source: CC analysis.

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\*Includes London Overground and Merseyrail which are concessions operated by LOROL (a 50-50 joint venture between MTR Corporation and DB Regio (formerly Laing Rail) and Serco Ned respectively.

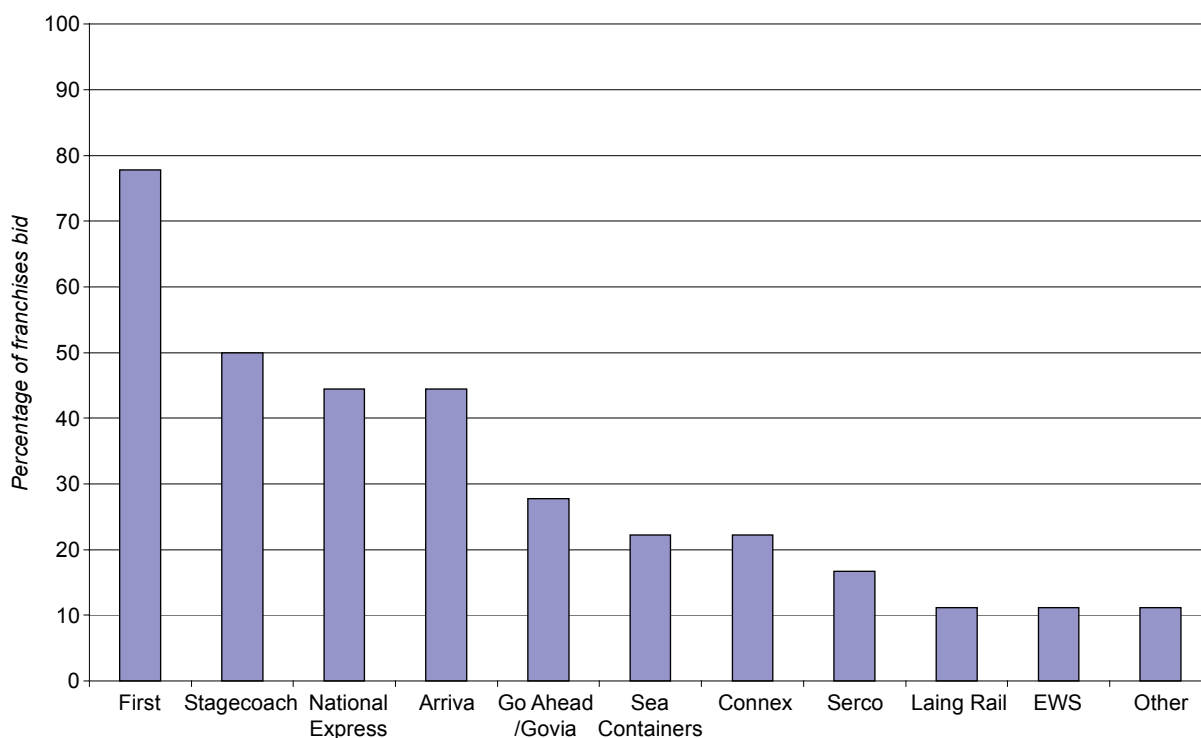
44. In terms of repeat transactors, we assessed the level of participation by TOC-owning groups in short-listed bids for the 19 franchise re-lets for which we had bid data.<sup>15</sup> Figure 3 shows that TOC-owning group participation in short-listed franchise bids varies widely across owning groups—ranging from First which has participated in 78 per cent of bids to EWS which has participated in 11 per cent of bids.

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<sup>15</sup>For the purpose of assessing which TOC bid on franchise re-lets we have included Southeastern, ICEC 2007 and Great Western Link because the reasons for removing these franchises in Appendix 4.3 do not affect the decision of a TOC-owning group to bid.

FIGURE 3

**Percentage of franchises on which TOC-owning groups have been short-listed**



Source: CC analysis of DfT franchise bid data.

45. To test the hypothesis that the largest and most frequently-bidding TOC-owning groups might have greater buyer power than other TOCs, we considered:
- (a) capital rental changes between base case offer and contracted capital rental; and
  - (b) the extent of variation in offers made to each TOC.

*Analysis of capital rental changes*

46. Our analysis is a simple comparative analysis of the importance of TOC-owning group size and experience. We assume for the purposes of this analysis that all other variations of lease terms from the base case which may affect pricing outcomes are

equal. We used the data for 141 MOLA and post-MOLA leases as described in paragraph 27.<sup>16</sup>

47. Table 4 shows the number of franchise re-lets and the number of leases in our data that have been negotiated by each TOC-owning group. It also shows the average capital rental change between base case offer and contracted rental, expressed as a percentage of the base case offer and weighted by number of vehicles.

48. The weighted average percentage change in capital rental varies across the TOC-owning groups—larger TOC-owning groups such as [X] and [X] have a weighted average percentage change of [X] per cent and [X] per cent respectively, and smaller TOC-owning groups such as [X] and [X] have a weighted average percentage change of [X] per cent and [X] per cent respectively.

TABLE 4 Number of franchise re-lets by TOC owning group and change in capital rental between base case offer and contracted lease

Company	No of franchise re-lets used in analysis	No of leases negotiated*	Franchise re-lets won since privatization	Average change in capital rental between base case offer and contracted lease, weighted by number of vehicles %
Arriva	2	11	Arriva Trains Wales, New Cross Country	( X )
First	4	41	First Capital Connect, Great Western, ScotRail, TransPennine Express	
Govia	2	8	Southern, West Midlands	
Laing	2	17	Chiltern, London Rail Concession	
National Express	1	21	Greater Anglia	
Serco Ned	2	16	Merseyrail, Northern	
Stagecoach	3	17	East Midland, South West Trains 2003, South West Trains 2007	
Sea Containers	1	10	ICEC	
Total	17	141		

Source: CC analysis.

\*This excludes all section 54 leases and all other price committed leases as a result of franchisee default (ie [X]).

49. Figure 4 shows the distribution of capital rental changes for each TOC-owning company.

<sup>16</sup>We considered that it was acceptable to examine MOLA and post-MOLA leases together for the purposes of this analysis because we were examining only the changes from the base case offer to the contracted lease. There were no comparison issues created by previous lease rentals.

FIGURE 4

**Relationship between TOC-owning group and capital rental change from base case offer to contracted lease**

[REDACTED]

Source: CC analysis.

50. Figure 4 shows that both [REDACTED] and [REDACTED] have the widest ranges of capital rental change. Smaller and less-experienced TOC-owning groups such as [REDACTED] and [REDACTED] negotiated reductions on more leases in comparison with [REDACTED] which has only negotiated a rental reduction on one lease.
51. Figure 4, although dealing with small sample sizes for each TOC-owning group, suggests that TOC-owning group size and experience (which tends to decrease as one moves from left to right on the x-axis) bears no obvious direct relationship to changes in capital rentals from base case offer to contracted rental. When we considered the reasons for the most extreme changes in capital rentals, the majority were caused by changes in capital investment requirements from the base case offer. Our analysis suggested that other factors are more important than TOC size and experience in explaining the variation in changes in capital rentals.

*Analysis of the extent of variation in offers made to each TOC*

52. When ROSCOs are negotiating with each franchise bidder, they may offer each TOC different variants to the base case. This variation between bidders is not captured in the simple comparative analysis above, which focuses on differences in movements between base case offer and contracted lease capital rentals on different franchises and not on differences in the same franchise.
53. Angel noted that the mere fact that variations in offers are made shows that competitive pressures are felt. We used Angel's case studies to assess the extent to

which different offers were made to different TOCs in the franchising bidding process and the extent to which those TOCs with more experience and size were able to achieve better terms.

54. Angel submitted that there had been considerable variation between bidders in many franchises (notably in the [REDACTED] and [REDACTED] franchise re-lets). We noted that in some of Angel's case studies ([REDACTED]) there was variation in the detailed terms offered to different bidders. Such variation typically concerned differences in the detail of hand-back options, fleet size and composition, and in the nature of additional capital expenditure.
55. However, we noted that in many franchise re-lets the most significant terms in the variants to the base case were offered to nearly all bidding TOCs, consistent with the requirements of the Codes of Practice. Where terms differed between bidders, it was not clear that the largest and most experienced TOCs were consistently achieving better terms. For example, on the [REDACTED] franchise where there was considerable variation between bidders, [REDACTED] and [REDACTED] seemed to negotiate as many different terms as [REDACTED], and [REDACTED] went on to win the franchise.
56. One exception to this is where [REDACTED] was able to negotiate a [REDACTED] per cent discount on the [REDACTED] and the [REDACTED] franchises in return for a parent company guarantee for its lease obligations. No other bidding TOCs negotiated such a guarantee on these franchises. However, on the [REDACTED] franchise, [REDACTED] and [REDACTED] both negotiated an escalating rent profile subject to a parent company guarantee, whereas [REDACTED] did not.

### ***Self-supply***

57. Angel and Porterbrook both submitted that the possibility of self-supply was an important competitive constraint on the ROSCOs. In this section we therefore assess

the extent to which TOCs have circumvented the ROSCOs by self-supplying rolling stock either by (a) purchasing used rolling stock or (b) purchasing new rolling stock.<sup>17</sup>

We consider the reasons for the current levels of self-supply and then assess the impact that self-supply has had as a negotiating threat.

### *Extent of self-supply*

58. Table 5 sets out the rolling stock which franchised passenger TOCs currently own and self-supply. Table 5 does not include a small number of one or two vehicles bought for a nominal sum by TOCs and used for stock balancing movements, driver training or on heritage lines, as these have no effect on that TOC's negotiating strength.<sup>18</sup>

59. Table 5 shows a total of 96 vehicles currently being self-supplied by passenger franchised TOCs. This amounts to less than 1 per cent of the vehicles owned by the rolling stock lessors.<sup>19</sup> Table 5 also shows that only three franchisees (Arriva Trains Wales, First Great Western and Stagecoach's South West Trains) own more than a few vehicles. Only First's purchase of 54 HST vehicles could be considered a significant purchase that placed competitive pressure on the ROSCOs' fleets.

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<sup>17</sup>By self-supply, we include situations within a group of companies where one company within the group owns the rolling stock and leases to another company within the group. For example, Sovereign Trains owns and leases rolling stock to Grand Central.

<sup>18</sup>[redacted]

<sup>19</sup>The 11,602 vehicles of which this is a percentage does not include the self-supplied rolling stock or vehicles leased to Hull Trains, but this does not make a material difference.

TABLE 5 Rolling stock owned by passenger franchised TOCs

TOC	Rolling stock owned	Number of vehicles	Age of vehicles at date of purchase (years)	Purchased from (date)	Cost of fleet £	Reason for purchase
Arriva Trains Wales	Mk II coaches	22 coaches	c30	HSBC (2006)		Purchased for special events at the Cardiff Millennium Stadium.
Arriva Trains Wales	Class 121	1 vehicle	46	HSBC (2006)		Purchased for a low-mileage route (Cardiff Queen Street to Cardiff Bay) in restructured timetable.
First Group	HSTs	54 vehicles (5 sets—12 power cars and 42 trailer cars)	28	Porterbrook (2004)		Used initially in unsuccessful bid for ICEC then for successful bid on Greater Western franchise. These additional sets were needed to allow the partial withdrawal of the Class 180 fleet on the Greater Western franchise. The acquisition and refurbishment was funded by First at a group level and the vehicles are leased to the TOC in a manner similar to that used by the ROSCOs. See paragraphs 68 to 71 for further details.
First Group	Class 143	6 vehicles (3 x 2-car sets)	21	Wessex Trains (2006)		Acquired from Wessex Trains at the start of the Greater Western franchise. The purchase was a requirement of the handover of the old franchise from Wessex Trains which had purchased the rolling stock from a local authority.
Laing	Class 121	1 vehicle	39	Network Rail (1999)		Purchased to replace a Class 165 unit and to run on a single track branch line between Prince Risborough and Aylesbury on the Chiltern franchise.
Stagecoach	Class 483	12 vehicles (6 x 2-car units)	69	HSBC (2007)		Purchased to run on the Island Line, which operates a ten-year franchise on the Isle of Wight.

Source: Responses to the CC's questionnaires.

\*Range quoted due to different figures provided by Porterbrook (£[redacted] million) and First Group (£[redacted] million).

60. In addition to Table 5, we are aware of three previous cases of self-supply for passenger franchised services:<sup>20</sup>
- (a) Connex Leasing Limited purchased rolling stock for the Connex franchises. These vehicles were subsequently purchased and leased by HSBC.
  - (b) Wiltshire Leasing was a subsidiary of Great Western Holdings,<sup>21</sup> set up to finance the new Class 175s for the Northern franchise and the new Class 180s for Greater Western. Angel told us that these vehicles were procured in preference to other MOLA rolling stock that could have been available at the time (eg the incumbent locomotive hauled stock and/or excess HSTs). These vehicles were subsequently purchased and leased by Angel.<sup>22</sup>
  - (c) GNER previously owned one Class 89 locomotive and ten unserviceable Mark III sleeper coaches. These have all now been sold after alternative rolling stock became available.
61. In contrast to passenger franchised services, Table 6 shows that self-supply by open access operators<sup>23</sup> (BAA, Grand Central and WSMR) is higher (132 vehicles) than for passenger franchised TOCs.<sup>24</sup> This is particularly striking given the small proportion of overall Great Britain rolling stock operated by open access operators.<sup>25</sup>

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<sup>20</sup>Angel told us that Connex Leasing Limited and Wiltshire Leasing were set up by the respective franchisees in order to create funding competitions between the ROSCOs for new rolling stock.

<sup>21</sup>At the time Wiltshire was set up, only 25 per cent of Great Western Holdings was owned by First Group. First Group acquired the remaining 75 per cent at a later date.

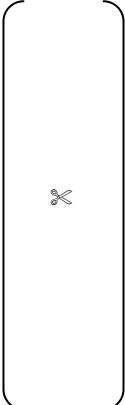
<sup>22</sup>Effectively, Angel purchased these fleets from Alstom pursuant to production contracts novated from Wiltshire Leasing.

<sup>23</sup>The open access operators are outside our terms of reference so we consider them for comparison purposes only.

<sup>24</sup>Table 6 does not include the 38 Eurostar train sets, which are owned by Eurostar (UK) Limited. Twenty-seven of these trains run on the Eurostar routes under the English Channel. Nine sets are used by SNCF in France. However, up to three of these sets were leased by Eurostar (UK) Limited to GNER for use on its London–Leeds service until December 2005.

<sup>25</sup>Hull Trains is the fourth open access operator but does not own any rolling stock.

TABLE 6 Rolling stock owned by open access operators

<i>Operator</i>	<i>Rolling stock owned</i>	<i>Number of vehicles</i>	<i>Age of vehicles at date of purchase (years)</i>	<i>Purchased from (date)</i>	<i>Cost of fleet</i>	<i>Reason for purchase</i>
BAA	Class 332	61 vehicles (14 sets)	Built in 1998	New rolling stock (1998)		To operate the Heathrow Express, for which BAA has a 25-year track access agreement from 1998 to 2023.
BAA	Class 360/2	25 vehicles (5 sets)	Built in 2005	New rolling stock (2005)		To operate a stopping service on the Heathrow line in conjunction with First Great Western (Heathrow Connect), with a term coincident with the Greater Western franchise.
Sovereign Trains/ Grand Central*	HSTs and Mk 3 vehicles	30 vehicles (6 x Class 43 power cars and 24 Mk 3 trailers)	25 to 30	Porterbrook (2007)		Used on open access routes for which Grand Central has five-year track access agreement. Grand Central was unable to reach agreement on leasing suitable vehicles.
Wrexham, Shropshire & Marylebone Railway Company (WSMR)‡	Class 67 locos and Mk 3 coaches	16 vehicles (4 driving trailers and 12 coaches)	23 to 32	Porterbrook, (2007)		Used on open access route for which WSMR has seven-year track access agreement. WSMR uses these vehicles with diesel locomotives (Class 67) hired from EWS.

Source: Responses to the CC's questionnaires.

\*The vehicles were sold to Lynfield Leasing, which was a short-term intermediary in the purchase of rolling stock for Sovereign Trains. Sovereign Trains leases the rolling stock to Grand Central.

†Range quoted due to different figures provided by Porterbrook (£[redacted] million) and Sovereign Trains (£[redacted] million).

‡WSMR is a joint venture (50/50) between Renaissance Trains and DB Regio (formerly Laing Rail).

*Purchasing and self-supplying used rolling stock*

62. Table 5 shows that all purchases of rolling stock by passenger franchised TOCs have been from used rolling stock. In addition, two of the ROSCOs submitted that some TOCs had expressed an interest in buying further rolling stock. However, none of these expressions of interest led to actual purchases of rolling stock:

(a) [REDACTED] and [REDACTED] were both interested in Angel's HST fleet;

(b) [REDACTED] was offered a sale price by Angel for the [REDACTED] fleet as part of its bespoke offer for the [REDACTED] franchise bid, but did not pursue the offer; and

(c) [REDACTED] However, HSBC noted that it did not receive a firm offer.

63. In relation to First's acquisition of HSTs (the largest acquisition of used rolling stock by a franchised operator), Porterbrook stated that it sold these vehicles because [REDACTED].<sup>26</sup> [REDACTED]

64. First submitted that the HSTs were bought in a poor condition and required considerable refurbishment work. It further added that the 'purchase was only possible because the vehicles were not immediately needed for service and were in a condition reflected in the purchase price. Normally, ROSCOs will not sell their used rolling stock[s], preferring to continue leasing them at current levels'.

*Purchasing and self-supplying new rolling stock*

65. An alternative way for TOCs to self-supply is to purchase new rolling stock. Tables 5 and 6 show that the only example since privatization of self-supply of new rolling stock is BAA's purchase of new trains on the Heathrow Express and its sister stopping service, Heathrow Connect. However, BAA's situation is unique:

(a) BAA is an open access operator—the Heathrow Express operation has a 25-year agreement and the Heathrow Connect service (which is coincident with the First

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<sup>26</sup>[REDACTED]

Greater Western franchise) has an overarching agreement to operate until the introduction of Cross Rail services to Heathrow.<sup>27</sup>

(b) BAA submitted that it considered leasing rolling stock when it commenced the Heathrow Connect service but found that this was not commercially favourable given the cost of capital available to BAA.

66. We were told of one other example of self-supply of new rolling stock that has been considered since privatization. GNER submitted that its parent company, Sea Containers, had proposed acting as the ROSCO for the leasing of rolling stock for its bid for the proposed 20-year ICEC franchise in 2005. The plan was to procure a small fleet of new Class 380 Advanced Tilting Trains, but this was aborted when the 20-year franchise option was removed.

*Reasons for the lack of self-supply*

67. We asked the TOCs for their views on self-supply. Only three TOCs ([REDACTED]) had considered self-supply as a possible option, with all three stating that further purchases are not presently economically attractive. There appear to be a number of key reasons for self-supply being commercially unattractive:

(a) A franchisee is unlikely to want to assume the residual value risk at the end of a franchise period, which is usually limited to seven years with a high probability of the franchise being awarded to another TOC when it is re-let. Two TOCs ([REDACTED]) specifically cited residual value risk and six TOCs ([REDACTED]) noted that franchise terms were too short to consider self-supply. The importance of the length of the franchise term can be seen by the extent to which some open access operators

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<sup>27</sup>Both HSBC and Porterbrook stated that BAA's rolling stock currently ran on dedicated airport lines and so at this stage did not act as a competitive constraint. Angel, on the other hand, considered that if BAA decided that it required a new fleet because of capacity constraints, these units would become available and provide a competitive constraint.

with longer terms (BAA 25 years, WSMR ten years) engage in self-supply more than passenger franchised TOCs.<sup>28</sup>

- (b) TOCs are primarily involved in running train services and are thinly capitalized. TUPE<sup>29</sup> arrangements at the end of a franchise make exit costs relatively low when franchises are lost. Owning and managing rolling stock would entail a completely different business model requiring extensive capital investment and with higher potential exit costs due to the lack of a second-hand market for rolling stock.
- (c) A TOC looking to self-supply new rolling stock would face barriers to entry similar to those facing a new entrant to the rolling stock leasing business, as discussed in Appendix 4.4.

### *The impact of First's self-supply*

68. Angel and Porterbrook both stated that First's ability to self-supply HSTs affected negotiations on certain franchises. First told us that it used this rolling stock initially in an unsuccessful bid for Inter City East Coast in 2005, then for its successful bid on the Greater Western franchise in 2006.<sup>30</sup> In this section we therefore consider the impact of First's self-supply in relation to these two franchises. In each case, the precise impact of First's small HST fleet is hard to isolate, but we found that other factors had a significant role in shaping negotiations over capital rentals.

#### *First's unsuccessful ICEC 2005 franchise bid*

69. In its ICEC 2005 franchise bid, First proposed to replace the incumbent fleet of Angel's HSTs with a combination of its own HSTs, a reduced number of Angel's HSTs and some of Porterbrook's HSTs.

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<sup>28</sup>Hull Trains, an open access operator, noted that it was unlikely to consider purchasing rolling stock because the asset life was 25 to 30 years, far greater than the access rights that it was likely to be able to acquire. It considered the residual value risk to be too great.

<sup>29</sup>The Transfer of Undertakings (Protection of Employment) Regulations.

<sup>30</sup>[X] First's HSTs are presently 28 years old and the Greater Western franchise runs until 2013 (plus a three-year extension). First's HSTs are therefore unlikely to act as a competitive constraint unless First is able to release them from the Greater Western franchise.

70. [REDACTED]<sup>31</sup> [REDACTED]

*First's successful Greater Western franchise bid*

71. In its Greater Western franchise bid, First proposed to use its own HSTs and Porterbrook's off-lease HSTs to allow the partial withdrawal of Angel's Class 180 fleet.<sup>32</sup> First's HSTs were considered to be a threat to Angel's and Porterbrook's incumbent HSTs on the Greater Western franchise and [REDACTED]. We examined the effect on capital rentals across these four fleets: [REDACTED].<sup>33,34,35,36</sup>

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<sup>31</sup>[REDACTED]

<sup>32</sup>First considered that the Class 180 fleet was 'very costly to operate, subject to reliability issues and flawed in its design'.

<sup>33</sup>[REDACTED]

<sup>34</sup>[REDACTED]

<sup>35</sup>[REDACTED]

<sup>36</sup>[REDACTED]