

ROLLING STOCK LEASING MARKET INVESTIGATION

Statement of issues

1. On 26 April 2007, the Office of Rail Regulation (ORR) referred the leasing of rolling stock for franchised passenger services and the supply of related maintenance services in Great Britain (the reference goods and services) to the Competition Commission (CC) for investigation. The reference was made under section 131 of the Enterprise Act 2002 (the Act) and followed an initial ORR study, which was undertaken in response to a submission from the Department for Transport (DfT).
2. In the terms of reference set out by the ORR, ‘franchised passenger services’ has the same meaning as in section 23 of the Railways Act 1993 (RA 93) (that is, services for the carriage of passengers by railway which are provided under a franchise agreement) and ‘related maintenance services’ means ‘provision of services for the maintenance of leased rolling stock vehicles by a lessor (whether or not through a subcontractor), including, but not limited to, refurbishment and the overhaul or replacement of major components’.
3. The CC is required to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.¹ This statement of issues sets out those competition issues which we currently envisage might be of relevance to our inquiry, based on the evidence that we have received to date from a range of interested parties². Some of the areas covered in this statement simply require clarification. We have not yet taken a view on whether each of the issues we raise may affect competition, nor have we reached any conclusions.
4. We will continue to gather evidence over the next few months. We plan to hold hearings with the main parties during September. As our thinking develops, we expect to issue further documents for consultation prior to further hearings and publication of provisional findings. If we were to find provisionally that there were adverse effects on competition, we would then consider possible remedies.

Issues

5. Rolling stock for franchised passenger services in Great Britain is provided on lease by the three main rolling stock leasing companies (ROSCOs)—Angel Trains, HSBC Rail and Porterbrook³—as well as at least one other lessor (Voyager Leasing⁴). We refer to these collectively as rolling stock lessors. Following the Railways Act 2005, franchises to operate rail passenger services in Great Britain are awarded by the Secretary of State for Transport, except for franchises for Scotland-only services that are awarded by Scottish Ministers. The National Assembly for Wales is a joint signatory with the Secretary of State for franchises for services in Wales. In this statement, when we refer to a ‘relevant franchising authority’ we mean the Secretary of State for Transport, Scottish Ministers or the National Assembly for Wales, as appropriate.

¹See section 134(1) of the Act. If the CC decides that there is such a prevention, restriction or distortion of competition, there will be an ‘adverse effect on competition’ (as defined in section 134(2) of the Act) and we will be required to then consider possible remedies (see section 134(4) of the Act).

²In considering the issues that appear to arise, the CC has had regard to the guidelines for market investigations in document *Market Investigation References: Competition Commission Guidelines (CC3)*. This is available on the CC website (www.competition-commission.org.uk).

³Angel Trains Limited, HSBC Rail (UK) Limited, Porterbrook Leasing Company Limited.

⁴Voyager Leasing Company Limited.

6. The issues which appear to be most relevant to the question of whether any feature (or combination of features) of the market prevents, restricts or distorts competition, fall into three broad categories, which are interrelated:
 - (a) the operation of the franchising regime or other aspects of the structure of any relevant market;
 - (b) the behaviour of rolling stock lessors; and
 - (c) conduct affecting the relevant market(s) of suppliers or customers (including train operating companies (TOCs), rolling stock manufacturers and franchising authorities⁵).

Market definition

7. The CC identifies the relevant market, or markets, in order to provide the framework within which our assessment of competition and the effects of market features can be carried out.
8. In defining the relevant market(s), we will consider, inter alia:
 - (a) whether there are distinct markets relating to specific types of rolling stock;
 - (b) whether there are distinct markets relating to the award of each franchise. If so, we will need to consider when these markets become active;
 - (c) whether leases of both new and used rolling stock fall within the same market; and
 - (d) whether, and if so, how far, related maintenance services are an aftermarket to leasing of rolling stock or are a separate market.
9. In assessing the geographic definition of the market, our working hypothesis is that it does not extend beyond Great Britain. However, we will consider any evidence which suggests that the geographic market definition may be wider than Great Britain.

Structural issues

The regulatory framework

10. Our terms of reference relate to franchised passenger rail services. We will consider whether the pricing of rolling stock leases and the rate of new build is affected by aspects of the franchising regime, including:
 - (a) processes for awarding franchises, including the timing of franchise competitions and the effect on the availability of rolling stock (for example through cascades⁶); and

⁵The Secretary of State for Transport and Scottish Ministers, as appropriate, enter into direct agreements, containing step-in rights, with rolling stock lessors and frequently also with rolling stock maintainers, in order to enable it to discharge its duty (under section 30 of RA93) to ensure continuity of rail passenger services when a franchise is terminated or otherwise comes to an end, but no further franchise agreement has been entered into in respect of the relevant services.

⁶'Cascades' occur when sets of existing rolling stock are displaced, usually by new build and a 'cascade' of rolling stock follows across other franchises.

- (b) arrangements for each franchise, including franchise specifications (particularly through invitations to tender (ITTs)) and the length of franchises.
11. We will consider whether Government policy for the railways, including changes to the rail strategy, franchising system or institutional framework, creates or mitigates risks for rolling stock lessors.

Market shares and concentration

12. In its *Reasons for making a reference* document,⁷ the ORR noted that the three ROSCOs collectively owned 96 per cent of all rolling stock and that ownership was more or less evenly distributed between them, as it was at privatization. In considering the evidence on market shares and market concentration, we will have regard to:
- (a) actual supply and the capability to supply (taking into account off-lease rolling stock as well as on-lease rolling stock); and
 - (b) the extent to which shares in relevant market(s) have remained stable or changed over time.

Capacity

13. We will assess the availability of rolling stock (including off-lease rolling stock) and we will consider how availability affects the relevant market(s).
14. We will consider the rate of new build and assess what has affected this rate, including:
- (a) whether the conduct of rolling stock lessors or TOCs is limiting or encouraging the investment in new build projects, and the extent to which the relevant franchising authority, through ITTs or otherwise, influences the number of new build projects undertaken; and
 - (b) other factors, for example, franchise lengths, rolling stock manufacturing capacity and existing build programmes, network capabilities, changes to safety standards and other legal requirements.

Barriers to entry, expansion and exit

15. We will consider the extent of new entry into the relevant market(s) since privatization and whether there are factors that create barriers to future entry, expansion or exit. Relevant factors may include:
- (a) whether barriers to entry arise in relation to the three ROSCOs' ownership of existing stock, and in particular MOLA stock,⁸ or whether holding portfolios of rolling stock gives greater flexibility to manage risks better;
 - (b) the extent to which either a comprehensive knowledge of the rail industry in Great Britain and its relationship with Government, or detailed technical and

⁷The leasing of rolling stock for franchised passenger services: ORR's reasons for making a market investigation reference to the Competition Commission, 26 April 2007.

⁸'MOLA' stands for 'master operating lease agreement' and we use the term 'MOLA stock' to refer to ex-BR rolling stock that was in operation at privatization.

engineering expertise, or both, are pre-requisites to successful entry to the relevant market(s). We will consider whether such knowledge or expertise is readily available to any potential new entrant;

- (c) whether the role of the DfT (or other relevant franchising authorities) and the structure and operation of the franchise regime (and particularly the length of franchises and the timetable for re-letting of franchises) create risk that restrains new entry or the ability of TOCs to acquire their own rolling stock; and
- (d) whether the arrangements for UK tax allowances might operate in a way that limits the number of potential new entrants that could compete effectively in the relevant market(s).

Countervailing buyer power

16. We will consider the extent of countervailing buyer power in the relevant market(s). Generally, leases are agreed between TOCs and rolling stock lessors for the duration of a franchise. We need to understand further both how the headline rental for each lease is agreed (ie the rental that the TOC agrees with the rolling stock lessor before submitting its bid for the franchise to the relevant franchising authority), and how enhancements and refurbishments of rolling stock are agreed. Relevant factors include:

- (a) whether the extent of repeated interaction between the rolling stock lessors and the TOCs and/or relevant franchising authorities means that the TOCs and/or relevant franchising authorities are able to leverage buyer power from expected future transactions with the rolling stock lessors;
- (b) whether the Codes of Practice⁹ or other aspects of the franchising process (for example the subsidy/premium system) restrict the ability or incentive of a TOC to exercise any countervailing buyer power before or after a franchise is awarded;
- (c) the extent to which the relevant franchising authority is able to make a credible threat to refuse to agree the terms of a lease between a TOC and a rolling stock lessor;
- (d) whether sufficient alternatives exist for franchise bidders to make a credible threat to switch away from the incumbent rolling stock lessor; and
- (e) whether the range of franchises operated by an individual TOC affects its position.

Switching costs

17. We will consider how aspects of the market affect the possibilities for switching rolling stock. We will consider a range of issues, including:

- (a) the reasons for limited standardization of rolling stock;
- (b) the physical differences on the network, such as different types of electrification, signalling systems or gauging constraints, which would require adjustments to

⁹Following a review of the rolling stock market by the ORR in 1998 each of the ROSCOs published a Code of Practice (developed through negotiation with the ORR) which broadly includes a set of requirements that the ROSCOs will not discriminate in the terms it offers bidders to a franchise.

rolling stock and/or infrastructure if transferring rolling stock from one part of the network to another;

- (c) suitability of particular rolling stock (for example its performance capability, capacity, configuration, facilities etc) for different operational requirements; and
- (d) the practical and financial constraints (when passenger services have to be maintained) that would apply to transferring/changing rolling stock.

Behaviour of rolling stock lessors

Structure of leases

18. Rolling stock is usually leased on the basis of an operating lease. In relation to operating leases, we will look at both the capital and non-capital charges,¹⁰ and consider how costs (for example, major refurbishment costs) are allocated. We will consider assumptions relating to lease pricing, including residual value and early termination costs.

Capital charges

19. We will consider:
- (a) how rolling stock lessors determine capital charges. For example, we will consider whether the ‘indifference pricing’ model¹¹ or an alternative pricing model is used, how pricing relates to the rolling stock lessors’ costs of capital, the role of residual value risk in lease prices, whether pricing models are based on full use of the stock for its whole life, and how these features differ (if at all) between new and existing stock;
 - (b) the costs of holding rolling stock off-lease and how this affects residual value risk and capital charges;
 - (c) whether rolling stock lessors are able to bundle different types of rolling stock together;
 - (d) the extent to which rolling stock lessors compete against one another when quoting capital charges; and
 - (e) the extent to which lease lengths lead to different lease prices and how this differs for existing and new rolling stock.

¹⁰Capital charges are those which cover the use of the rolling stock and non-capital charges relate to expenditure on heavy maintenance and other running costs.

¹¹At the time of the creation of the ROSCOs, a market did not exist for the leasing of second-hand rolling stock. Rental prices for MOLA stock were therefore set on the basis of prices which it was intended would make operators indifferent between leasing existing or new rolling stock.

Non-capital charges

20. In the ORR's *Reasons for making a reference* document, attention was drawn to concerns relating to the non-capital elements of ROSCOs' lease arrangements, including a lack of transparency and performance regimes.¹² We are considering:
- (a) possible lack of price transparency, such as the operation of maintenance reserves and how balances are transferred when a TOC switches to a 'dry' lease (where the TOC is responsible for heavy and light maintenance);
 - (b) whether aspects of the behaviour of the rolling stock lessors indicate, result from, or give rise to bundling, of maintenance provision with leasing of the rolling stock (so called 'wet' leases); and
 - (c) whether rolling stock lessors are reluctant to negotiate performance regimes in relation to their responsibilities under the lease.

Coordinated effects

21. We will consider whether there is a likelihood of coordinated effects and, in particular, whether there is evidence of coordinated bids or market sharing by rolling stock lessors.

Conduct of lessees and others

TOCs

22. We will consider the ability and incentives of TOCs to obtain competitive supply of rolling stock, for example the extent to which TOCs:
- (a) explore all suitable alternative rolling stock at franchise renewal; and
 - (b) use sub-leasing and/or acquire limited rolling stock of their own
23. We will assess how TOCs may influence prices and choices of rolling stock leases in the future, for example by:
- (a) their procurement practices for new build projects, including the degree to which new rolling stock is highly bespoke; and/or
 - (b) their role in maintaining rolling stock during a lease term.

DfT and other franchising authorities

24. We will consider how the actions of the DfT and other franchising authorities affect competition. In particular, we will consider:
- (a) their role in promoting or preventing changes in rolling stock between the different franchises and in facilitating cascades;

¹²In its 'Reasons for making a reference' document, the ORR referred to concerns over the apparent unwillingness of ROSCOs to negotiate back-to-back performance regimes and service level agreements to share the risk of poor maintenance on TOCs' operating performance.

- (b) the degree to which criteria relating to specificity and deliverability set for each franchise restrict or create opportunities for substituting rolling stock across the network in Great Britain;
- (c) the effect of the exercise of the duty under section 30 of RA 93 to ensure continuity of passenger rail services; and
- (d) their role in procuring or supporting the procurement of new rolling stock, including setting a rolling stock strategy, adopting alternative approaches to procurement (such as the Intercity Express Programme¹³), setting franchise specifications and providing section 54 undertakings.¹⁴

Other market participants

25. We will consider whether any action of third parties, including Network Rail, manufacturers, open-access operators and other stakeholders in the relevant market(s) affects competition in leasing of rolling stock.

Indicators of the extent of competition

26. We will consider the effectiveness of competition by examining the outcome of the competitive process in the relevant market(s) by looking at other indicators of the extent of competition. These may include prices, profitability, and comparators such as the operation of other leasing markets.

- (a) *Prices.* We will consider whether prices for leases and maintenance services are set at competitive levels. Issues which are likely to be relevant include:

- (i) any variation in the level of prices over time, and whether these reflect changes in costs and/or demand. Cost factors include the level of risk;
- (ii) any variation in prices for different types of stock, for example prices at release of both pre- and post-privatization stock and the relationship with the number of rolling stock lessors and the amount of alternative rolling stock;
- (iii) the relationship between the amount of spare rolling stock and lease prices; and
- (iv) the extent to which prices are negotiated between the ROSCOs and the TOCs.

- (b) *Profitability.* We will consider whether there is evidence of pressure on profit levels. Issues which are likely to be relevant include:

- (i) the appropriate method(s) for measuring the profitability of rolling stock lessors; and
- (ii) the effect of cyclical factors on profitability.

- (c) *Comparators.*

¹³The Intercity Express Programme (IEP), currently led by DfT, to specify the next generation of high-speed rolling stock for intercity services.

¹⁴RA93 s54 undertakings are given when the relevant franchising authority guarantees the re-leasing of rolling stock on the same terms for a set period to reduce residual value risk.

- (i) We may consider comparisons with other markets with similar characteristics, such as other leasing markets and the provision of rolling stock for open access or freight services.
 - (ii) We will consider international comparisons where relevant.
- (d) *Innovation.* We will consider the extent to which there has been innovation in relation to rolling stock leasing and procurement, and the provision of associated maintenance services, and the effects of this on the quality of rolling stock and the choice for franchise train operators; and whether the scope for innovation has changed over time.