

MARKET INVESTIGATION INTO ROLLING STOCK LEASING

Provisional decision on remedies

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The Competition Commission has excluded from this published version of the provisional findings report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive alternative wording is also indicated in square brackets.

Provisional Decision on Remedies

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Summary

1. On 26 April 2007, the Office of Rail Regulation (ORR) referred the leasing of rolling stock for franchised passenger services in Great Britain ('the rolling stock leasing market') and the supply of related maintenance services in Great Britain to the Competition Commission (CC) for investigation. The reference was made under section 131 of the Enterprise Act 2002 (the Act) and followed an ORR study which was undertaken in response to a submission from the Department for Transport (DfT). On 7 August 2008 we issued a Notice of possible remedies (the Notice) which invited comments on the actions we might take, or recommend for implementation by others, to remedy, mitigate or prevent the adverse effect on competition (AEC), or resulting detrimental effects on customers, identified in our provisional findings of the same date.
2. This document presents our provisional decision on the package of remedies required to remedy, mitigate or prevent the AEC and resulting detriment to customers provisionally identified. This is based on our consideration of responses to the Notice, further submissions from parties and further analysis.
3. We considered remedies which fell, broadly, into three categories:

- (a) remedies which were aimed at stimulating rivalry between the ROSCOs by widening the choice of alternative rolling stock, and increasing TOCs' incentives to exercise choice and their ability to negotiate effectively with the ROSCOs;
 - (b) remedies which were aimed at extending the benefits of rivalry at first lease to subsequent leases; and
 - (c) remedies which would control outcomes.

- 4. We provisionally concluded that the remedies in the following package would remedy, mitigate or prevent the AEC and/or customer detriment arising from the AEC:
 - (a) recommendations to the relevant franchising authority¹ that it considers adopting longer franchise terms (in the region of 12 to 15 years or longer);
 - (b) recommendations to the relevant franchising authority that in evaluating competing franchise bids it takes account of the benefits of rolling stock which may persist beyond the immediate franchise term or lead to benefits in other franchises;
 - (c) recommendations to the relevant franchising authority that it adopts looser specification in franchise invitations to tender (ITTs) such that the choice of rolling stock is not practically confined to that currently in use on a franchise;
 - (d) through making an Order or accepting undertakings, to remove the non-discrimination requirement from the Codes of Practice; and
 - (e) through making an Order requiring rolling stock lessors to provide TOCs with a set list of information which would enhance TOCs' ability to negotiate.

- 5. We think that the proposed remedial action which can be taken by the CC itself (ie remedies (d) and (e)) would remedy, mitigate or prevent the AEC and/or detriment,

¹The franchising authority selects the TOC that provides franchised services. Currently these authorities are the Scottish Minister for the ScotRail franchise (assisted by Transport Scotland, the national transport agency for Scotland) and the Secretary of State for Transport for all other franchises (assisted by the DfT).

although we consider that the full package of remedies would provide a more comprehensive solution to the AEC and/or detrimental effects.

6. We have provisionally concluded that remedies aimed at stimulating rivalry between ROSCOs and incentivizing TOCs to negotiate harder are preferable to remedies which would control outcomes, for example a price control. In principle, as a competition authority, we seek to promote greater competition. We consider that price controls are likely to introduce significant distortions into the market with adverse long-term consequences, particularly for investment. Moreover, we consider that there are very significant practical problems in designing appropriate price controls and in enforcing them. We note that price controls could potentially take effect more quickly than our proposed remedies if they were applied to lease agreements currently in force. However, in our view this benefit is outweighed by the remedy being ineffective in other respects and disproportionate.
7. We considered relevant customer benefits. In particular, we noted that some of our remedy proposals to the relevant franchising authority concerning the conduct of franchising could affect the way in which the market for the operation of franchises delivers value for money, quality of service and innovation. In so far as there may be a trade-off between the benefits of greater competition for the leasing of rolling stock and for the operation of franchises, the balance of advantage may vary on a case-by-case basis. We consider that the franchising authorities are best placed to assess this trade-off in each case and our recommendations to the franchising authorities allows for discretion in how these recommendations are implemented. Consequently, we have not modified our package of remedies. The CC's remit is the maintenance of strong and effective competition. Relevant franchising authorities must take into account a wide range of public policy considerations, apart from competition in the rolling stock leasing market. We recognize that competition in the market for the

leasing of rolling stock is just one aspect of many that the franchising authorities need to address in seeking to secure provision of a railway system at best value for the taxpayer.

8. We believe that our proposed package of remedies in paragraph 4 will achieve as comprehensive solution as is reasonable and practicable to the AEC and/or the customer detriment arising from the AEC.
9. The CC invites views in writing on the provisional decision and its underlying analysis by Friday 16 January 2009.

Introduction

10. On 26 April 2007, the ORR referred the rolling stock leasing market and the supply of related maintenance services in Great Britain to the CC for investigation. The reference was made under section 131 of the Act and followed an ORR study which was undertaken in response to a submission from the DfT. On 7 August 2008 we issued the Notice which invited comments on the actions we might take, or recommend for implementation by others, to remedy, mitigate or prevent the AEC, or resulting detrimental effects on customers, identified in our provisional findings of the same date.
11. Having given careful consideration to all the evidence we have gathered to date on remedies,² this document sets out our provisional decision on remedies. This provisional decision relates to the adverse effects on competition that were outlined in our provisional findings. Following consideration of a number of submissions in response to those provisional findings, and in order to clarify the nature of the AEC we have identified, we have revised some aspects of the features of the market and

²Submissions in response to the Notice and summaries of oral evidence can be found on the CC website.

identified an additional feature. We outline our revised features in paragraphs 19 to 29.

12. Our findings identified that there was a lack of competition in the leasing of rolling stock such that customers faced a lack of choice and ROSCOs have the ability to increase rentals above those levels that would apply if there were active competition. We have therefore sought to identify remedies that would encourage greater levels of competition in the passenger rolling stock leasing market.
13. In the Notice, we noted that the passenger rolling stock leasing market is unusual. In a well-functioning market, buyers and sellers interact with each other and supply and demand respond flexibly to price. In the rolling stock leasing market, supply and demand do not respond flexibly to price and the DfT plays an important role in decisions regarding the allocation of rolling stock and whether new or used rolling stock is to be used. This was particularly the case in the most recent franchise rounds and is likely to characterize the forthcoming Thameslink and IEP procurements.
14. The DfT and Transport Scotland, in performing their respective statutory functions under the Railways Act 1993 (which includes awarding franchises), take account of a wide range of public policy considerations and not just competition in the rolling stock leasing market. They formulate policies in response to various objectives, pressures and constraints. We recognize that in taking these wider considerations into account, competition in the market for the leasing of rolling stock is just one factor of many that they need to consider. In seeking to secure the provision of an effective railway system at best value for the taxpayer and customer, we consider that the DfT has adopted policies which are not consistent with the effective operation of a free market for the leasing of franchised passenger rolling stock. As a competition authority, our

statutory functions under the Act are to determine whether the rolling stock leasing market is competitive and if necessary adopt remedies to address any adverse effects on competition and/or detrimental effects. Some of our remedy proposals are therefore recommendations to the franchising authorities to consider changes to policies and practices which would allow greater freedom for market-based outcomes in the leasing of rolling stock.

15. In doing this, we are seeking to promote the benefits that competition in the leasing of rolling stock could bring in the form of efficiency, innovation and lower rentals. In our conclusions, we have not formed any opinion on the wider policy objectives the DfT has adopted. Our recommendations acknowledge that the franchising authorities will need to consider any consequences of our proposed remedies on these wider objectives.
16. We note that the DfT continues to have considerable power to intervene in the market including through changes to procurement processes, directing the allocation of rolling stock through franchise ITTs and other means, changes to franchises and franchising processes, use of rolling stock usage guarantees etc. It also has the ability to introduce other regulations, including the potential to legislate to influence or control rental levels. Our recommendations are designed to address competition issues in the leasing of rolling stock, but this does not preclude the DfT's ability to take appropriate actions to pursue its other objectives.
17. We also stated in the Notice that the rolling stock leasing market has not developed in the way foreseen at its inception. In particular, the sustained growth in demand for passenger rail services post-privatization was unexpected. This has increased demand for rolling stock but procurement of new rolling stock has not kept pace with the growth in passenger numbers after the retiring of rolling stock on safety grounds,

most notably the retirement of the Mark I 'slam-door' vehicles. As a consequence, there has been a limited risk of vehicles coming off-lease and thus reduced incentives for the ROSCOs to compete on price in order to keep their vehicles on lease.

18. Nonetheless, the rolling stock leasing market may be subject to change or uncertainty in the future. For example, the DfT is taking the lead in two significant procurement programmes for new rolling stock, IEP and Thameslink. The Rolling Stock Plan also sets out the level of procurement of additional vehicles proposed to increase overall capacity and in many cases it stipulates where displaced stock may be expected to be used. However, the exact way in which new vehicles and subsequent cascades will be allocated has not yet been determined. On the one hand, government involvement in procurement and rolling stock allocation may reduce choice and rivalry in the market; on the other hand, if these processes create temporary surpluses of certain types of rolling stock this could increase competitive pressures. We also note that since privatization, the rapid growth in passenger numbers has coincided with continued economic growth; it remains to be seen whether or to what extent passenger numbers will be affected by a downturn in the economic environment.

Our provisional findings

19. In our provisional findings we identified the following features of the rolling stock leasing market which prevent, restrict or distort competition. These were described under four headings:
 - (a) shortage of alternative rolling stock;
 - (b) the franchising system and the leasing of rolling stock;
 - (c) weakened incentives to compete; and
 - (d) high barriers to entry.

20. Following consideration of the responses to provisional findings, the Group has made some minor clarifications to the feature on the ROSCOs' weakened incentive to compete. The new wording makes it clear how the Group considers that this feature interacts with the other features identified.
21. In addition, we have since our provisional findings identified a further feature of the rolling stock leasing market which prevents, restricts or distorts competition. This additional feature, relating to the incentives on TOCs, is described in paragraphs 26 to 28 and is set out in paragraph 29. The other features are set out in paragraphs 22 to 25.

Shortage of alternative rolling stock

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

The franchising system and the leasing of rolling stock

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

- (a) The timing of franchise re-letting determines when transactions in the rolling stock leasing market normally occur. This, in turn, affects which rolling stock is available to a TOC when it is seeking to put forward a winning franchise bid. The effect is to reduce the potential for rivalry in the leasing of rolling stock.
- (b) In some cases, detailed specific service requirements for the franchise are laid down by the DfT in the franchise ITT which limit, in practice, available rolling stock options.
- (c) In some cases, a requirement is placed in the franchise ITT to use identified rolling stock because the DfT has given section 54 undertakings, or for some other reason.
- (d) The non-coterminous nature of the franchises limits the availability of alternatives at the required time such that a TOC would have first to lease incumbent rolling stock for a short term resulting in an additional cost (lease premium) when trying to switch to such alternatives.
- (e) The expressed unwillingness of the DfT in some instances to meet the higher lease rental of new rolling stock rules out the possibility of using new rolling stock as an alternative to used rolling stock.

Weakened incentives to compete

24. ROSCOs in many cases have weakened incentives to compete on lease rentals of used rolling stock. These cases occur where there are no potential alternative fleets, or new rolling stock, available for TOCs to choose. This has arisen as a result of the other identified features of the market. Consequently, ROSCOs face little risk of any rolling stock of that type coming off-lease for a sustained period of time, and so incentives to undercut rivals are reduced.

Barriers to entry

25. Barriers to entry into the market(s) for the leasing of rolling stock to franchised passenger services—whether entering using new, or particularly used, rolling stock—are high.

Incentives on TOCs

26. We have identified an additional feature which we have provisionally concluded has acted to prevent, restrict or distort competition, in combination with the other features.
27. In our provisional findings, we said that there were weakened incentives for TOCs to negotiate on the terms of the lease. We said that ‘if there is a limited choice of rolling stock to meet the base case service specification for a particular service, TOCs can only realize a limited competitive advantage over rivals for the franchise’ (paragraph 6.107).
28. This arises for two reasons. The limited choice of rolling stock, arising from our first feature, means that there is little ability for the TOC to negotiate the rental of rolling stock that will provide it with a relative cost advantage compared to rival bidders which would make it more likely to be able to win the franchise bid. Second, the non-discrimination clause in the ROSCO Codes of Practice limits a TOC’s incentive to negotiate with a ROSCO over the lease price. This is because it cannot achieve an advantage relative to rival TOCs, other than by identifying different rolling stock packages.
29. We have therefore provisionally identified a further feature that contributes to our AEC finding: ‘A TOC’s incentive to negotiate with a ROSCO over the price of a lease is limited, in particular due to the non-discrimination clause in the Codes of Practice’.

Remedies considerations

30. If the CC has decided, following a market investigation reference, that a market feature, or any combination of market features, has an adverse effect on competition, it then has to decide whether any action should be taken, or whether it should recommend action be taken by others, in order to remedy, mitigate or prevent the AEC and, if so, what action should be taken.
31. The Act requires the CC to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effects on customers so far as resulting from the AEC. However, our guidance notes that, in the case of recommendations to others to take action, there will be, inevitably, uncertainty over whether the recommendation will be accepted and, if so, over the time period before which it will be implemented.³
32. Our guidance also notes that the CC should consider the timescale within which the effects of any remedial action will occur and that the CC will tend to favour a remedy that can be expected to show results in a relatively short period—so long as it is satisfied that the remedy is both reasonable and practicable and has no long-term consequences.⁴
33. Our guidance states that in deciding what remedy or remedies would be appropriate, the CC will first look for a remedy that would be effective in dealing with the AECs of the market features rather than seeking to deal with any detrimental effects on customers. The CC is not required to remedy or remove every feature identified, indeed some features might be so fundamental to the market that they cannot in practice be directly remedied. Remedial action may also be required to address the

³Market Investigation References: Competition Commission Guidelines, CC3, paragraph 4.21.

⁴CC3, paragraph 4.16.

adverse effects directly, for example where remedies aimed at correcting the features which have caused those effects will not bear fruit for some time. Our guidance states that price restraints are the most obvious example of such remedial action, though they are not likely, by their nature, to provide a solution to the underlying problem and on that account are less preferable.⁵

Relevant customer benefits

34. In deciding the question of remedies, the CC may 'in particular have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned'.⁶ Relevant customer benefits are limited to benefits to relevant customers in the form of:
- '(i) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (whether or not the market to which the feature or features concerned relate); or
 - (ii) greater innovation in relation to such goods or services'.⁷
35. A benefit is only a relevant customer benefit if the CC believes that:
- '(i) the benefit has accrued as a result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period as a result (whether wholly or partly) of that feature or those features; and
 - (ii) the benefit was, or is, unlikely to accrue without the feature or features concerned'.⁸
36. If the CC is satisfied that there are relevant customer benefits deriving from a market feature, the CC will consider whether to modify the remedy that it might otherwise have imposed or recommended. When deciding whether to modify a remedy, the CC

⁵CC3, paragraph 4.25.

⁶Enterprise Act 2002, section 134(7).

⁷Enterprise Act 2002, section 134(8).

⁸Enterprise Act 2002, section 134(8).

will consider a number of factors including the size and nature of the expected benefit and how long the benefit is to be sustained.⁹

37. We set out our consideration of relevant customer benefits in paragraphs 286 to 292.

Detrimental effects

38. In our provisional findings we concluded that detrimental effects would arise for those leases where either there are no or very few alternative fleets available, or where the competitive pressure from alternative used rolling stock and/or new rolling stock is limited. We have identified two aspects to the detrimental effects: first, that in a substantial number of cases TOCs do not have the potential to choose from a range of fleets that best suit their needs; and second, ROSCOs have the opportunity to increase rentals above the competitive level that we would expect to find in a well-functioning market.
39. The Act requires the CC to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to remedy the AEC and/or any detrimental effects on customers resulting from the AEC. An understanding of the scale of the detriment arising is helpful in judging whether remedies are likely to achieve as comprehensive a solution as is reasonable and practicable, and also in judging whether the costs of remedies may make them disproportionate to the scale of the detriment identified.
40. In a paper which will be published separately, we review and assess the issue of detriment. We also discuss the appropriate comparator against which we have assessed the AEC. However, we were unable to identify the scale of the detriment arising from the AEC for reasons explained in this paper.

⁹CC3, paragraph 4.39.

Remedy options

41. We considered a variety of possible remedies in line with the CC's requirement under the Act to decide whether any action should be taken to 'remedy, mitigate or prevent' the AEC and/or any detrimental effect on customers. We identified three general approaches to remedies in this inquiry.
42. First, we considered remedies that would stimulate greater competition between the ROSCOs by increasing the choice of alternative rolling stock available to TOCs, including the procurement of new rolling stock, and giving TOCs greater incentives to exercise this choice and a stronger ability to negotiate with the ROSCOs. These measures would address the AEC and/or the detrimental effect on customers.
43. Second, we considered remedies which would extend the benefits of rivalry we found at first lease of new rolling stock into subsequent leases. These remedies would address the detrimental effects of the AEC rather than the AEC itself. As we provisionally concluded that there were indications of rivalry between the ROSCOs in seeking to finance and lease new rolling stock, we reasoned that it might be possible to use remedies that extend the beneficial effects of this rivalry by carrying over the initial competitively determined rental prices through to subsequent leases.
44. Third, we considered remedies which would work by controlling outcomes. They would address the detrimental effects on customers rather than the AEC itself.
45. We now describe the possible remedies that we have considered in the three categories described above. Many of these remedies were set out in the Notice but a few are additional proposals raised since the Notice was published.
46. To assist in explaining our reasoning, for each remedy option we have provided:

- (a) the rationale for the remedy, including how it addresses the AEC and/or detriment arising, and how the remedy would work;
- (b) analysis of past experience that is relevant to the remedy, where appropriate;
- (c) key points that were raised by parties in relation to the likely effectiveness of the remedy;
- (d) an assessment of each remedy; and
- (e) the CC's provisional decision on each remedy.

47. Each remedy option is considered separately; however, we note that no one remedy in isolation is likely to remedy the AEC or detriment completely. Instead, we are looking to identify a suitable package of remedies which together provide as comprehensive a solution as is reasonable and practicable to address the AEC and any resulting detrimental effects. We note that it is not practicable to address certain features we have provisionally identified, such as barriers to entering the market through used rolling stock and the technical and operational factors which restrict the rolling stock alternatives that can be considered.

Category A: Remedies aimed at stimulating rivalry in the market

48. The remedies in this category all have the same broad objective: to address the AEC and/or detriment, by stimulating rivalry between ROSCOs. They seek to achieve this in three ways:
- (a) first, by seeking to increase the number of both used and new vehicles that a TOC may propose for use in a franchise and to allow for the recovery of the costs of switching between vehicle fleets over a longer period, for example through longer franchises; increasing the choice of fleets would increase the TOCs' choice of ROSCOs which should also increase the ROSCOs' incentives to offer competitive lease rental charges;

- (b) second, by increasing TOC incentives to exercise such choice and to negotiate with the ROSCOs, for example through the removal of the non-discrimination requirement; and
- (c) third, by increasing TOCs' ability to negotiate, for example in creating greater transparency of lease rentals.

49. Of the remedies discussed in this section, we have provisionally concluded that the following remedies will mitigate the AEC and/or detriment:
- (a) longer franchises combined with consideration of benefits beyond the franchise term and looser franchise ITT specifications;
 - (b) the removal of the non-discrimination provisions in the Codes of Practice; and
 - (c) greater transparency of lease rentals.
50. We have rejected other remedies in this section (coterminous franchises, pool of surplus rolling stock, budget-based franchise bidding models, limiting short-term lease premiums and an additional call option) as being ineffective in addressing the AEC and/or detriment.
51. We explain the reasons behind our evaluation of effectiveness under each remedy.
52. In relation to the remedies in this section, the DfT said that in general, remedies which rely on the injection of new rolling stock as a spur to greater competition would not be effective in addressing the AEC we had provisionally identified. The DfT said that in the absence of an uncommitted surplus of used rolling stock, there would be no credible threat to ROSCOs that their rolling stock would go off-lease.¹⁰ Cascaded used rolling stock would be absorbed rather than displaced because demand for

¹⁰DfT response to Remedies Notice, Annex 2, paragraph 9.

passenger rail services has continued to grow.¹¹ In addition, the DfT argued that because, in absolute terms, new rolling stock is usually significantly more expensive than MOLA rolling stock, it only rarely poses the threat of displacing incumbent MOLA rolling stock.

53. Transport Scotland submitted that remedies that relate to the current rail passenger franchising process are highly unattractive as Scottish Ministers would wish to retain the freedom to set franchise lengths and specify the franchise. It added that any remedies that might fetter the Scottish Ministers' ability to respond to prevailing policy, market or wider conditions would directly affect their responsiveness to perceived needs and could potentially adversely affect the objective of delivering a fit-for-purpose, effective and efficient rail system to support the range of the Scottish Government's strategic objectives.

54. Various parties argued that measures to increase competition in the leasing of rolling stock would have the effect of increasing the risk to ROSCOs that their rolling stock may go off-lease. This raises the question as to whether these remedies might cause the ROSCOs to increase rentals because of the perception of increased risk. We recognize that an increased perception of risk could increase the rentals required to supply new rolling stock. Because these remedies are designed to increase competitive pressure, we expect that the incentive upon ROSCOs to undercut competitors in order to ensure that their existing rolling stock is leased would outweigh any incentive to increase rentals because of costs attributable to heightened risk.

¹¹DfT response to Remedies Notice, paragraph 11.

A1. Longer franchises

Rationale

55. In our provisional findings, we found that there was a lack of choice of rolling stock for TOCs. In particular, we noted that the short payback period afforded by the relatively short length of most current franchises (typically seven years¹²) limited the benefits that could accrue to the TOC from switching to alternative used or new rolling stock. As franchises are awarded on the basis of value for money over the franchise term, bidders put forward rolling stock that requires the lowest level of subsidy or provides the highest premium for the franchise period. Benefits which arise outside this period (such as future increased revenues or reduced operating costs) are not taken into account by the DfT when evaluating competing bids by TOCs to operate franchises. When switching rolling stock, it may take longer than the present seven- to ten-year franchise term for the benefits of alternative rolling stock to offset the higher rentals and/or other switching costs. This is particularly the case where the new rolling stock cannot be delivered until well into the franchise term.
56. Our suggested remedy is to introduce longer franchises in the region of 12 to 15 years¹³ or longer, although the exact length of each franchise term would be for the relevant franchising authority to decide depending on the circumstances of each franchise. This remedy would provide stronger incentives for TOCs to consider alternative used or new rolling stock. We set out the ways in which this remedy could be implemented in paragraphs 270 to 272 and also note that in implementing this remedy to achieve more effective rolling stock competition, there may be a need to reconsider some of the other mechanics of the franchising process.

¹²Current franchise lengths range from four years (Thameslink/Greater Northern) to nearly 20 years (Chiltern). The lower end of this range changes to a minimum of just over seven years when performance-related extensions are included.

Analysis of past experience

57. In this section we assess, first, the rolling stock introduced on previous longer franchises and second, the TOCs' views on the impact of shorter franchise lengths on rolling stock choices.

The rolling stock used on previous longer franchises

58. A number of longer franchises have been agreed since privatization. We examined these franchises to see if they provided evidence that franchise length affected the incentives and ability of TOCs to propose alternative used or new rolling stock.

59. Table 1 sets out those franchises which originally had longer terms from the initial franchises at privatization and comments on the rolling stock proposed.¹⁴

TABLE 1 **Rolling stock introduced on original longer franchises**

<i>Franchise</i>	<i>Franchise length (years)</i>	<i>Rolling stock proposals</i>
West Coast	15	Bidders were asked to bid for two franchise options, each requiring significant investment, and lasting 15 years. Virgin won the franchise with new Pendolino rolling stock to be introduced as part of a comprehensive package for upgrading the West Coast Main Line. The introduction of the tilting Pendolino trains was heavily dependent on infrastructure upgrades. The DfT told us that the introduction of this rolling stock was required to replace existing rolling stock, some of which was life expired.
Cross Country	15	The franchise included a commitment to introduce new Voyager rolling stock, which was financed by a non-ROSCO.
Thameside (LTS)	15	The ITT was based on a seven-year franchise. It was originally awarded on a seven-year basis to Enterprise Rail, which was offered a 15-year lease if it committed to replace the existing slam-door trains. When Enterprise Rail's bid was disqualified due to ticketing irregularities, the franchise was re-tendered. Prism Rail won the re-tender on the basis of a 15-year franchise and its commitment to acquire new Class 357 trains.
South Eastern	15	The franchise award included a commitment to introduce new rolling stock.
Gatwick Express	15	The Gatwick Express 15-year franchise term was conditional upon replacement of the entire fleet with new rolling stock by mid-1999.

Source: CC analysis.

¹⁴The DfT commented that many of these franchises had been subsequently terminated early or renegotiated. This aspect is not directly relevant to the rolling stock market although we discuss whether there are any relevant customer benefits associated with shorter franchises in paragraphs 286 to 292.

60. Table 1 shows that new rolling stock was introduced under these longer franchises initially agreed at privatization. Although new rolling stock was also introduced on shorter franchises, some of the longer franchises were awarded conditionally upon new rolling stock being introduced.
61. Between November 1999 and August 2002, the SRA adopted a policy of trying to introduce long-term franchises (of between 10 and 20 years, with termination or renegotiation possible after reviews every five to seven years). The objectives of this policy were to enable TOCs to take greater delivery risk on new investment in both rolling stock and rail infrastructure, whilst also mitigating stranding risk for the ROSCOs.
62. The SRA negotiated with a number of incumbent TOCs in the hope that they would relinquish existing franchises before the end date in return for the opportunity to bid for the longer-term franchise. However, only a small number of franchises were actually relinquished before the end dates and only the Chiltern franchise was agreed (in February 2002) as a new long-term franchise before the SRA then determined that franchise terms should generally be between five and eight years.¹⁵
63. Table 2 sets out those franchise re-lets which have had proposed or agreed longer terms and comments on the rolling stock used.

¹⁵There were two franchises (South Central and South Western) on which the TOC relinquished the franchise and bid on the basis of a long-term franchise which ultimately failed to be negotiated. The franchise length was subsequently shortened from the planned long-term franchise.

TABLE 2 Rolling stock proposals on proposed or agreed longer franchise re-lets

<i>Franchise</i>	<i>Franchise length (years)</i>	<i>Rolling stock proposed</i>
Chiltern*	20	Two bidders were shortlisted (Laing and Go-Ahead) for the franchise. Both proposed significant refurbishment to the Class 165 fleet and both proposed new vehicles to meet passenger growth. In its submissions, the DfT told us that both bidders were obliged to plan for the introduction of significant new rolling stock. It stated that new stock was required as the SRA wanted to buy additional capacity and a budget was available. The SRA intended that the franchise agreement should run for 20 years subject to the investments being agreed. Chiltern told us that it had only been able to make such investments because of its 20-year franchise term.
Wales and Borders†	15	The franchise ITT stated that 'the Authority does not expect to see new rolling stock to replace existing trains as part of the baseline proposal'. No bidders formally proposed new rolling stock although Connex was considering new rolling stock options. Over 80 per cent of the incumbent rolling stock was leased on a long-term basis.
South Central‡§	20	Following bidders' inability to deliver the proposed longer franchise, reworked proposals for a shorter franchise did not include the electrification of the Uckfield line. The winning bidder, Govia, ordered new Class 171 Turbostars to replace the Mark I Class 205/207s. No other rolling stock proposals were materially affected.
South Western‡¶	20	When the proposed franchise term was shortened (as provided for in the original agreement), the main difference to the initial bids was fewer new Class 444/450 vehicles introduced and retention of all the Class 159/170 rather than replacing part of this fleet. No other rolling stock proposals were materially affected.

Source: CC analysis.

*Although the Chiltern franchise is 20 years long, it is dependent on the DfT and Chiltern agreeing infrastructure investments. If they fail to agree, then it may be reduced to the current minimum franchise term (making it 12 years plus 8 years).

†This franchise is 15 years long but has five-yearly performance review assessments.

‡These franchises were both shortened following failure to negotiate the proposed longer franchise. The assessment in the table is made on the basis of the difference between rolling stock proposals for the proposed longer franchise and the agreed shorter franchise.

§Govia was announced as preferred bidder for the South Central franchise in October 2000 for a 20-year franchise but in August 2002 a (less than) nine-year franchise was agreed. As part of the change, the SRA was to lead the substantial programme of track and signalling improvements instead of the TOC. The TOC was to be responsible for delivering the trains, station upgrades and information systems. At the time, the SRA stated that 'taken together, these elements will deliver substantially the same benefits as those originally planned for the 20-year franchise'.

¶Stagecoach signed heads of terms for a 20-year South Western franchise in March 2001 but a short-term franchise of only four years (one-year extension plus three years to 2007) was agreed in November 2002. This franchise originally contained a provision for shortening the term from 20 to 15 years if certain capacity schemes were not implemented.

64. Table 2 shows that the long 20-year franchise, linked to infrastructure improvement, was an important factor in the introduction of new rolling stock on the Chiltern franchise. The Wales and Borders franchise shows a different outcome, in part due to the criteria laid down in the franchise ITT. In terms of the two proposed long franchises which were ultimately shortened (South Central and South Western), it is not clear that the shorter franchise lengths in each case led to significant changes in the rolling stock proposed. This is partly because both franchises contained large

quantities of Mark I rolling stock that had to be replaced with new rolling stock because of safety requirements.¹⁶

65. Our assessment shows that past experience of longer franchises provides some indication of the relationship between longer franchise terms and the incentives for introducing new rolling stock, with the relationship appearing to be clearest in the case of the West Coast and Cross Country franchises. However, we recognize that these franchises were awarded in different circumstances from the present and other factors often played a role in rolling stock decisions. Moreover, new rolling stock has also been introduced on shorter franchises. Past experience can therefore only serve as a limited guide to the future impact of this remedy.

The TOCs' views on the impact of previous shorter franchise lengths on rolling stock choices

66. We asked the TOCs whether franchise length imposed a constraint on the rolling stock they had offered in franchise re-lets.¹⁷ These responses suggest that shorter franchises have generally made it more difficult to make a competitive financial case for alternative used or new rolling stock in a franchise bid:
- (a) Arriva submitted that the South Western, East Midlands, New Cross Country and Intercity East Coast franchises were all of insufficient length for its new rolling stock options to show a positive financial case compared with incumbent or alternative used rolling stock. Arriva noted that for higher-earning services (eg Intercity or outer-London commuting), a positive financial case is more likely to arise over 15 years.
- (b) Stagecoach submitted that considering alternative used or new rolling stock on the four-year Thameslink franchise would have been 'a waste of time'. It added that, absent a section 54 undertaking, it would need a minimum of a ten-year

¹⁶For example, more than half of the vehicles on the South Western franchise were Mark I rolling stock.

¹⁷Franchise bids did not comment on whether the franchise length was too short or long to introduce alternative rolling stock.

franchise length for new rolling stock (with 15 years on larger franchises with larger fleets). For large fleets of alternative used rolling stock, it considered that a minimum franchise length of seven years was required.

(c) Govia submitted that when it was bidding for the West Midlands franchise, it did not initially think that new rolling stock was a viable alternative for the incumbent Class 321 and Class 150 units. Although it was able to put forward a new rolling stock proposal late in the bidding process, Govia stated that if the franchise length had been longer (say ten years), it would have been able to decide that new rolling stock was viable at an earlier stage in the process.

(d) First submitted that it was likely that the financing of any new rolling stock solution with a franchise term of less than perhaps 15 to 20 years would require section 54 undertakings from the DfT in order to be viable.

(e) Chiltern stated that it had chosen not to bid for franchises where the franchise length would prevent it from undertaking investment plans which it thought necessary.

What we were told

67. In this section we set out some of the views we heard in relation to this remedy.

68. The DfT stated that there was no evidence to suggest that longer franchises alone would encourage TOCs to favour new-build stock as a rolling stock option, or that if they did, there would be a consequential reduction in the lease prices of MOLA stock.¹⁸ It also noted that previous experience of longer franchises suggested that, whilst some longer franchises had been successful in procuring new stock, this was

¹⁸DfT response to Remedies Notice, paragraph 1.9.

not universally the case. In some cases the old rolling stock would have been replaced regardless of the franchise length.¹⁹

69. The DfT told us that longer franchise periods might be appropriate in some cases, but that in deciding the optimum length, the potential impact on rolling stock would be only one of a number of factors it would take into consideration. Other considerations included the potential to achieve better value for money for taxpayers and better performance for passengers under more regular franchise re-letting.²⁰ These factors are discussed further in our consideration of potential relevant customer benefits in paragraphs 286 to 292.
70. The ORR told us that TOCs, as the primary passenger-facing stakeholders within the industry, with a significant amount of operational knowledge, were well placed to play an active role in bringing this knowledge to bear on investment and operational decisions.²¹ The scope for TOCs to benefit by responding to such opportunities was significantly restricted by the current system of, predominantly, short franchises. It said that a combination of longer franchises and lower levels of franchise specificity (see section A3) might stimulate a more creative response by franchisees to the needs of their markets, including over choice of rolling stock. Longer franchises would also provide opportunities for incumbents to acquire in-depth knowledge and experience of the specific market in which it operated, enabling more informed business decisions in areas such as rolling stock specification.
71. Of the ROSCOs, Porterbrook argued that if, as a consequence of longer franchises TOCs took out longer leases with ROSCOs, this would reduce their residual value

¹⁹Ibid, paragraph 54.

²⁰Ibid, paragraph 45.

²¹ORR response to Remedies Notice, paragraph 14.

risk, which would encourage new financiers to enter the market.²² It told us that a large number of financiers expressed an interest in participating in the Mark I replacement rolling stock replacement procurement run by the SRA. In that case, the SRA initially offered 20-year franchises. When the franchise term was curtailed, the number of alternative financiers dwindled.²³ Angel said that it had an open view on lengthening franchise periods, saying that from a ROSCO's point of view it could see benefits and drawbacks in longer franchises.²⁴ On the one hand, the greater certainty provided by longer franchise periods might bring lease rentals down and encourage TOCs to put forward more innovative solutions. On the other hand, it said that the ROSCOs still owned a lot of MOLA rolling stock, most of which was approaching what was likely to be its final round of franchise re-lets. It told us that this rolling stock would face a heightened risk of early retirement if franchises were lengthened so as to extend far beyond the remaining useful economic life of the rolling stock available. HSBC stated that longer franchises were likely to have negative consequences that outweighed any positive benefits.²⁵ It suggested that there were more effective means to encourage new entrants and bring about the consideration of new or alternative rolling stock than longer franchises. For instance, longer leases or guarantees of usage would achieve similar benefits, but these would not have to be linked to longer franchises.

72. The TOCs' perspectives on this remedy varied and, for this reason, the Association of Train Operating Companies (ATOC) told us that it could take no view.²⁶ For example, Govia was not convinced that longer franchise periods would automatically result in more competition for the provision of rolling stock. It said that it might create a situation where certain classes of rolling stock were tied up in lease commitments

²²Porterbrook response to Remedies Notice, paragraph 2.5.

²³Ibid, paragraph 2.5.1.

²⁴Angel response to Remedies Notice, paragraph 75.

²⁵HSBC response to Remedies Notice, paragraph 7.6.

²⁶ATOC response to Remedies Notice, p3.

for longer periods of time and there would therefore be less fluidity in the market than with franchises of the current length. Either way, it said that it did not believe that the impact of lengthening franchises on the rolling stock market would be great.²⁷

Chiltern, on the other hand, was in favour of 20-year franchises. It said that their effect would be to lower ROSCOs' risks, and hence rentals, and incentivize new lessors to enter the market. It would also extend the payback period for costs associated with fleet changes and allow incremental increases in fleet sizes.²⁸

Our assessment

73. Taking into account all the evidence above, we think that longer franchise periods would be effective in addressing the AEC and detriment in several ways:
- (a) First, longer franchises would allow the payback for the costs of switching to alternative rolling stock to be spread over a longer period. This would give greater incentives for TOCs to include alternative used or new rolling stock in franchise bids. Further procurement of new rolling stock may lead to cascades of rolling stock from one franchise to another, offering other franchise operators greater choice of used rolling stock.
 - (b) Second, if longer franchises lead to longer leases, then this should reduce the residual value risk for ROSCOs which may in turn lead to lower lease rentals.
 - (c) Third, longer franchise periods could attract new financiers into the rolling stock market, thus providing increased competition for the ROSCOs. The best example we have seen of this was in the case of Voyager Trains and the Virgin Cross Country fleet.

²⁷Govia response to Remedies Notice, p2.

²⁸Chiltern response to Remedies Notice, p2.

Provisional decision—longer franchises

74. Our provisional decision on longer franchises is that it will effectively mitigate the AEC that we have provisionally found, particularly by increasing the threat to ROSCOs that alternative used or new rolling stock may displace their rolling stock. We recognize that franchises of 12 to 15 years or longer may not be appropriate in all cases. We consider that the relevant franchising authority is best placed to assess where it would be beneficial to adopt longer franchises and to determine how best to implement them, although we have put forward some options in paragraph 270.

Other variants to this remedy

75. We also considered two other aspects related to longer franchises.
76. First, we considered whether, as a consequence of longer franchises being adopted, lease lengths could be de-coupled from the franchise length so that a TOC could be awarded a franchise on the basis that leases of some or all fleets were less than the length of the franchise. This would leave TOCs with the flexibility to switch to alternative fleets and potentially increase competitive pressure on the ROSCOs. We concluded that, as a consequence of longer franchises, the relevant franchising authority could open up the possibility of further competition on rolling stock during the course of the franchise by not requiring the franchise term to match the length of all the leases.
77. Second, we considered the suggestion made to us that TOCs should be appropriately compensated for investments in rolling stock whose value extended beyond the end of the franchise period. The purpose of this would be to increase incentives for TOCs to introduce new rolling stock. We thought, however, that this suggestion was most relevant to assets other than rolling stock, for example station car parks, which are beyond the scope of this inquiry. We found that there were a number of practical

difficulties with this remedy, such as the design of a suitable mechanism to compensate the TOC. We concluded that longer franchises would achieve the same incentives for TOCs in any event. We therefore did not consider this proposal any further.

A2. Assessing the benefits of rolling stock beyond the franchise term

Rationale

78. This remedy proposes the creation of a clear mechanism whereby the relevant franchising authority would consider the benefits of introducing alternative used or new rolling stock arising beyond the immediate franchise term and across other franchises (for simplicity we also refer to this as a 'lifetime assessment'). This would address the AEC by creating greater incentives for TOCs to consider alternative used or new rolling stock, so creating greater uncertainty as to whether the incumbent ROSCO's rolling stock will be leased.
79. In implementing this remedy the relevant franchising authority would be formally undertaking to evaluate the current *and* future effects of changes in the composition of rolling stock on the franchise. It could also consider the cascade effects to other franchises although this may be more difficult to assess. We discuss the ways in which this remedy could be implemented in paragraphs 270 to 272.

What we were told

The DfT's explanation of the current evaluation process

80. The DfT told us that in many respects it already conducted a lifetime assessment prior to putting together the specification for a franchise. The DfT submitted an explanation to us as to how it currently takes into account the lifetime benefits of alternative used or new rolling stock considered for use on a franchise. In this section

we have set out our understanding of the DfT's current approach based on what we were told.

81. The DfT told us that the assessment of alternative rolling stock took place at two levels:

(a) by the DfT itself at the franchise ITT specification stage; and

(b) by bidders at the bid proposal stage.

- *Specification stage*

82. At the franchise ITT specification stage, the DfT compiles a list of options for rail provision given its budgetary constraints. This leads to the development of a 'do minimum' scenario and alternative scenarios.²⁹ According to the DfT, budget flexibility was always constrained at this stage. The DfT told us that when it assessed the different rolling stock options that formed part of these scenarios, it took account of financial factors (ie increased revenue, operating costs) and economic factors (ie improved quality, crowding relief).

83. Following this scenario assessment, an 'internal comparator' of services, which is not published, is decided upon by the DfT using certain assumptions (including rolling stock assumptions and estimates of their costs based on previous lease rental information held by the DfT). The internal comparator influences the outputs specified in the base case in the franchise ITT.

84. The DfT told us that this internal comparator was chosen based on: (1) value for money, (2) affordability, (3) deliverability and (4) fit with policy objectives. It stated that this internal comparator did not take account of lifetime benefits or costs per se

²⁹The DfT noted that the 'do minimum' scenario was not always given lengthy consideration as a possible specification. The 'do minimum' is what the DfT calls the base case against which the business case and costs/benefits of any franchise changes are considered.

and that it was ‘simply a series of estimates about costs and revenues once the DfT has made some assumptions (about services, fleets etc) and decided what to put in the ITT’.

- *Bid proposal stage*

85. Once bids have been submitted, franchises are awarded based on an assessment of bids responding to the base case only.

86. Bids are assessed first on deliverability and then on price, so that the franchise is awarded to the bidder offering the lowest price for a robust delivery of the services and targets in the franchise contract. There is no other basis for assessment—‘the DfT is not willing to pay more subsidy or forgo premium in return for a level or quality of service above that which we have asked for’.

87. The DfT told us that there were no barriers to bidders offering alternatives where these alternatives met the DfT’s requirements and where they did not cost more over the life of the franchise. However, with reference to how it considers the benefits of alternative rolling stock, the DfT submitted that it had ‘rejected models which require the public sector to pay now for projected future benefits, as these reduce the ability of Government to prioritise within a fixed budget’. It stated that in practice, this means that any rolling stock proposals identified by bidders which do not cover costs over the life of the franchise must be specified by the DfT.

Other responses on this remedy

88. The ROSCOs had mixed views on consideration of lifetime benefits. Angel stated that it had no direct knowledge as to how the DfT evaluated the cost-benefit ratio in its franchise assessment but that for its own purposes it found whole (or remaining)

lifetime evaluation the most meaningful analysis.³⁰ HSBC recognized that this remedy might work in principle in the same way as it did for regulated utility companies, but that a problem with this system would be that TOCs could not be held accountable if their forecasts were not realized after the end of the franchise.³¹ Porterbrook stated that it was not aware of the evaluation criteria currently being used by the DfT but noted that the DfT was moving towards a lifetime assessment in the IEP.³²

Our assessment

89. This remedy would be effective in addressing the AEC by creating greater incentives for TOCs to consider alternative used or new rolling stock, so creating greater uncertainty that the incumbent ROSCO's rolling stock will be leased. This would increase the competitive pressure on ROSCOs. In the same way as longer franchises, taking account of the lifetime benefits of rolling stock would enable TOCs to spread switching costs over a longer period of time, rather than just in relation to the franchise term.
90. We noted that there might be some practical difficulties in implementing this remedy. For example, there may be a difficulty in setting out a clear evaluation mechanism for bidders and there would need to be an agreed methodology for evaluation of the benefits beyond the franchise period and on other franchises to avoid bidders over-estimating the benefits of introducing alternative rolling stock. However, we think that these practical difficulties are surmountable.

³⁰Angel response to Remedies Notice, paragraph 87.

³¹HSBC response to Remedies Notice, paragraph 7.14.

³²Porterbrook response to Remedies Notice, paragraph 2.11.

Provisional decision—assessing the benefits of rolling stock beyond the franchise term

91. Our provisional decision on assessing the benefits of rolling stock beyond the franchise term is that it will effectively mitigate the AEC that we have provisionally found. In some respects, this is a second-best alternative remedy to longer franchises because longer franchises would encourage TOCs and the relevant franchising authority to think in terms of longer time periods (closer to the life of the rolling stock) in any event. However, recognizing that not all franchises may suit longer franchises, there will be situations where we think the relevant franchising authority could make explicit use of the consideration of longer-term benefits in franchise bids to encourage alternative rolling stock proposals. As with longer franchises, it is for the relevant franchising authority to decide how best to implement this remedy, although we have put forward some options in paragraphs 270 to 272.

A3. Looser specification of franchise ITTs

Rationale

92. In our provisional findings, we found that the degree of detail contained in the franchise ITTs, in addition to other constraints upon TOCs' choice, limited the number of ROSCOs from which they could source rolling stock. We considered both direct specification of rolling stock (for example, the ruling out of new rolling stock on a franchise) and indirect specification of rolling stock through the franchise Service Level Commitment (for example, specifying the number of seats available on carriages combined with the frequency of services to be provided).
93. This remedy proposes recommending to the relevant franchising authority that it should couch its franchise ITTs in less specific terms. In particular, we considered recommending that the relevant franchising authority should not rule out new rolling stock in its franchise ITTs.

94. This remedy would directly address the AEC by increasing choice of rolling stock for TOCs. It would allow the customer-facing TOCs to be at the forefront of considering how best to meet customer requirements (rather than the relevant franchising authority). This would encourage innovation by TOCs in the choice of rolling stock and increase competitive tensions between ROSCOs.³³

Analysis of past experience

95. To assess the potential effectiveness of this remedy, we considered in which instances the DfT's previous franchise ITT specifications have limited bidders' choice of rolling stock in the past.
96. It is difficult to understand the extent of limitation of rolling stock choice from TOCs' bid submission evidence as TOCs are unlikely to declare disagreements with the DfT's franchising approach (as the bid is about meeting the DfT's requirements rather than the opposite). To account for this, we asked each of the TOCs to provide examples of cases where choices have been narrowed by franchise specificity.
97. We considered direct specification and indirect specification separately. We also considered evidence that the DfT may tacitly limit specification (through providing 'pointers' during the franchise process) even where no mandatory limitations are stated. We consider each of these in turn in this section.

Direct specification

98. In our provisional findings, we identified three broad types of direct specification in franchise ITTs.³⁴

³³This may arise through TOCs suggesting that rolling stock on other franchises could be cascaded to the franchise being let. This was a suggestion made by Quasar Associates during the course of the remedies process.

³⁴See Tables 2 and 3 in [Appendix 2.1](#) in our provisional findings.

- (a) restriction of use to incumbent vehicles (3,498 vehicles or 30 per cent of incumbent vehicles on these franchises);
- (b) specification of vehicles to be replaced or cascaded out (1,471 vehicles, 13 per cent of incumbent vehicles); and
- (c) restriction of choice in terms of alternative rolling stock that could be taken on.

99. We have set out our detailed analysis of each of these instances of specification in [Annex 1](#). In the light of this assessment, the recommendation of relaxing direct specification seems most relevant in the following situations:

- (a) where incumbent vehicles are specified even though the franchise has not terminated early and viable alternatives are available; these situations have been mostly confined to rolling stock covered by section 54 undertakings, where the DfT might have been able in some instances to be more flexible in allowing the rolling stock to be used elsewhere (this would have allowed alternatives to be considered in respect of up to 1,303 incumbent vehicles);
- (b) where incumbent vehicles are specified to be replaced by new vehicles for non-legislative reasons³⁵ (this would have allowed alternatives to be considered in respect of up to 167 incumbent vehicles); and
- (c) where new rolling stock is specified or excluded for non-legislative reasons (this would have allowed alternatives to be considered in respect of up to 436 new vehicles plus up to 1,712 incumbent vehicles).

100. By avoiding specification of these rolling stock inputs and focusing on the service outputs required, we calculate that this would have allowed alternatives to be considered in respect of up to 3,618 vehicles (31 per cent of vehicles that were let on the franchises we examined).

³⁵By non-legislative reasons, we mean, for example, for reasons other than health and safety (which includes the Mark I replacement).

Indirect specification

101. We were unable to make a detailed assessment of indirect specification in the provisional findings although, based on submissions by TOCs, we considered that indirect specifications have acted to restrict choice. In this section, we have first set out what type of detail is provided in the franchise ITTs and then we have considered how this might be varied to increase choice of rolling stock for ROSCOs.
102. The DfT's franchise ITTs have tended to set out the following detail, although the extent of detail varies from franchise to franchise:
- (a) Service details (contained in the Service Level Commitments)—for example, the number of trains per hour during certain parts of the day with required stopping patterns and journey times.
 - (b) Requirements to plan to meet crowding and manage demand—these have sometimes been expressed as a requirement for the base-case train service to provide a certain level of capacity (for instance, that passengers stand for no more than 20 minutes for any part of a journey; or standing density should not exceed the train's capacity by more than a specified average or that vehicles arrivals in the peak should increase by a specific number).
 - (c) Performance—for example, delay minute targets, cancellations targets, capacity requirements (in terms of seats).
103. We examined franchise bid submissions for comments that suggest that alternative rolling stock might have been put forward in the event of there being materially less specification in the Service Level Commitment. We found the examples set out in [Annex 1](#). We also asked TOCs for their views as to which elements of indirect specification could be relaxed. These views are also set out in detail in [Annex 1](#).

104. Although it is appropriate for the relevant franchising authority to ensure that adequate standards of service are provided, our concern is that, if these are expressed in terms of inputs rather than outputs, they may unnecessarily restrict choice of rolling stock when the same outcome could be achieved more flexibly. Based on the analysis and responses set out in [Annex 1](#), the following aspects of specification of service inputs rather than service outputs could be considered to be potentially restrictive in terms of the choice of rolling stock:
- (a) certain train lengths or formations;
 - (b) fixed number of diagrams per day or fixed frequency of services; and
 - (c) specific seating requirements.
105. As an example of how these input specifications could be avoided, we were told that requirements (a) and (b) could be relaxed and expressed in terms of a requirement to move a given number of passengers over a certain time period. This would achieve the same outcome but provide scope for a wider variety of rolling stock to fulfil the Service Level Commitments.

The DfT providing 'pointers' during the franchise process

106. A number of TOCs commented that specification of rolling stock also occurred more informally during the bidding process:
- (a) First submitted that the clarification meetings with the DfT during the bidding process led to bidders forming an understanding over what adjustments to the Service Level Commitments were likely to be treated as compliant.
 - (b) Govia commented that bilateral bidder briefings with the DfT generally drew bidders to the low-risk course of using the existing rolling stock.
 - (c) Quasar Associates commented that bidders were given an impression that the DfT had a certain strategy in mind during feedback sessions with the DfT.

107. The NAO, in its review of rail franchising, also interviewed TOCs in relation to the importance of the base case specification. Although the NAO noted that there was a balance between providing a clear statement of what was required and leaving scope for bidders to innovate and that the DfT's service specifications were generally 'well thought through, reflecting the objectives set', it found that bidders did not always put sufficient effort into working up alternatives to the base case. This was mainly because any options proposed, even if taken up later, did not form part of the DfT's evaluation of bids.

What we were told

108. The DfT stated that it only sought to specify what was necessary and that it set out its services requirements as broadly as possible. It told us that in the current market context, neither direct specification nor indirect specification could have any material impact on inter-ROSCO competition because ROSCOs would not be subject to any greater competitive pressure unless there was a credible threat of rolling stock going off-lease.³⁶ The DfT added that 'flexibility' in the framing of the ITT only affected bidders' choice of fleets if the DfT was actually prepared to buy less or more output.

109. The DfT also told us that it was subject to the provisions of the Public Contracts Regulations 2006 because rail franchises were treated as 'service concessions'. The requirements of non-discrimination, transparency, proportionality and mutual recognition, which emanate from the EU Treaty, accordingly apply. The DfT submitted that the current level of specification allowed it to comply with its legal duties in respect of fair process, impartiality and being open and transparent. It added that, although it might be possible to design a more open specification which complied with the relevant law, an evaluation and scoring methodology which properly met the transparency test was akin to a reasonably detailed specification.

³⁶DfT response to Remedies Notice, Annex 2, paragraph 43.

110. The ORR acknowledged that there would be a limited range of rolling stock that was available and suitable for a particular franchise but considered that the level of specificity in a franchise could limit these choices even further. It supported our proposed recommendation though considered that the remedy would have limited benefits in isolation.³⁷
111. The ROSCOs generally supported this proposed remedy. Angel said that it believed that the DfT's franchise ITT specifications hindered the ability of TOCs to choose alternative rolling stock.³⁸ Porterbrook similarly supported the proposed remedy, arguing that it had the potential to increase competition between ROSCOs (and new entrants).³⁹ It added that financiers should be privy to franchise ITT specifications as this would allow them to use their experience to identify optimal solutions in their own right. HSBC did not favour a return to the very broad specification policy introduced by the SRA in the late 1990s but would prefer the DfT to strike a balance between ensuring adequate competition at the point of franchise re-let and allowing the DfT to retain a sufficient degree of control to ensure that the objectives and performance levels required on a franchise were met.⁴⁰
112. The TOCs also generally supported the proposed remedy. Govia added that the ways in which the DfT applied indirect specification of particular fleets of rolling stock in franchise ITTs were subtle, varied and wide ranging. We consider the TOCs' submissions on specification in more detail in [Annex 1](#).

³⁷ORR response Remedies Notice, p3.

³⁸Angel response to Remedies Notice, paragraph 71.

³⁹Porterbrook response to Remedies Notice, paragraph 2.1.

⁴⁰HSBC response to Remedies Notice, paragraph 7.4.

Our assessment

113. We consider that limiting the levels of specification as far as possible, whether that specification is direct, indirect or through ‘pointers’ in the bidding process, will help to increase choice for TOCs and place competitive pressure on ROSCOs.
114. We found that focusing on setting service outputs required, rather than specifying the nature of rolling stock inputs in franchise ITTs, is likely to increase the amount of competitive pressure by giving rise to situations where certain rolling stock may be under threat on a franchise.

Provisional decision—looser specification of franchise ITTs

115. Our provisional decision on looser specifications of franchise ITT’s is that it will effectively mitigate the AEC that we have provisionally found. In particular, we consider that, where appropriate, the relevant franchising authority should place greater emphasis on specifying outputs rather than inputs. In doing so, TOCs would be given greater choice and increased incentives to pursue alternative rolling stock solutions. We think that this would place some additional competitive pressure upon the ROSCOs. To achieve this, we recommend that the relevant franchising authority:
- (a) avoids unnecessary direct specification of rolling stock and considers whether or not rolling stock on section 54 undertakings need to be specified;
 - (b) considers whether there might be some aspects of Service Level Commitments which may be capable of being relaxed to some degree without loss of the ability to fulfil section 30 duties and meet passenger requirements; and
 - (c) avoids giving prescriptive ‘pointers’ to bidders which unnecessarily restrict choice of rolling stock.
116. In relation to these recommendations, we recognize that a balance needs to be struck between achieving effective competition between franchise bidders and gen-

erating effective competition between ROSCOs. It is for the relevant franchising authority to decide whether our recommendations regarding franchise specification which are aimed at improving competition for the leasing of rolling stock are offset by considerations in the market for passenger rail franchising.

117. We also note that the DfT has begun publishing franchise ITTs at the start of the franchise process. Whilst we understand the need for transparency in the franchising process, we think that this will reduce the level of uncertainty and competition that ROSCOs have previously felt when putting forward their rolling stock for a particular franchise and weaken TOCs' relative negotiating strength, for example by potentially reducing the pressure generated by threatening to switch to alternatives. Given this effect on the rolling stock market, we therefore recommend that the DfT reconsiders its decision to publish franchise ITTs prior to the franchise award.

Longer bidding period before franchise award

118. This proposal is not a separate remedy in itself but is a mechanism to achieve the benefits from longer franchises, consideration of lifetime benefits and more loosely-specified franchise ITTs.
119. At present, the bidding period between franchise bidders being shortlisted and franchise award is typically only around three months. The relevant franchising authority may need a longer period in which to assess a greater variety of franchise bids if there were alternative base cases or the base case was not as precisely defined, or if in reaching its decision on the winning bid the relevant franchising authority needed to assess dissimilar bids which satisfied the base case in different ways.

120. Some parties suggested to us that a lack of time means that TOCs might be unnecessarily restricted in their ability to develop a range of alternative proposals to meet either the base case specification or any variants of it. For example, First said:

we think there is an opportunity perhaps looking at the period of time between the competition starting, the franchise being awarded and the franchise commencement to give more time within that process to go out and negotiate.

and Chiltern said:

If the time which is allowed for bidding and more particularly the time which is allowed for franchise mobilization was extended, that would give much more time to firm up on fleet proposals and to get the switching arrangements in place rather than doing everything very, very quickly.

121. We also reviewed bid submissions to identify cases where TOCs have stated that the franchise timescales have affected their choice of rolling stock. We only found a small number of examples, including on the Northern franchise where Serco developed two new DMU options to replace all existing DMUs but was unable to propose it as a base case because it was 'unable to develop the proposal in sufficient detail and obtain sufficient certainty within the time available'.

122. We note that this proposal may lengthen the franchising process, which may create increased uncertainty or risk for both TOCs and the relevant franchising authority. The proposal may also result in increased bid preparation costs for TOCs, and bid assessment costs for the relevant franchising authority. If there is a significant delay between bids being submitted and the franchise agreed, then proposals and particularly any costs contained within them could become outdated.

Provisional decision—longer bidding periods

123. Longer bidding periods should be viewed as a concomitant part of our remedies package. We consider that the relevant franchising authority is best placed to assess for each franchise whether longer bidding periods create significant additional bidding and evaluation costs according to the particular circumstances of that franchise. However, it should bear in mind that one of the possible benefits is that TOCs may propose better options or solutions that the relevant franchising authority may not previously have identified.

A variant of this proposal

124. We also considered a variant of this proposal, for there to be a longer period between franchise award and mobilization in order to allow TOCs greater time to pursue alternative rolling stock solutions post-franchise award, and to facilitate the introduction of new or alternative fleets. We considered that lengthening the period between franchise award and commencement would not, on balance, address the AEC that we have provisionally found. For this remedy to be effective, it would require a significantly longer mobilization period than at present. However, if this mobilization period was too long, then it would simply prolong the franchising process and there would need to be strong mechanisms in place to maintain incentives for the outgoing TOC. We therefore rejected this variant.

A4. Removal of the non-discrimination requirement from the Codes of Practice

125. Before assessing this remedy, we first outline the basis upon which the Codes of Practice were formulated.

Background to the Codes of Practice

126. The Codes of Practice⁴¹ were introduced in February 2000 following the 1998 report of the Rail Regulator on his review of the rolling stock market. In that review the Regulator concluded that there were occasions when the ROSCOs would have potential market power, especially at the time of re-franchising and during 2003 to 2004 when the majority of rolling stock would be subject to re-lease.
127. The Codes were given a 'cautious welcome' by the then Rail Regulator, Tom Winsor. The ORR statement listed the core elements of the Codes, the first of which was the fairness and non-discrimination provisions which it said were particularly important in the case where a TOC was owned or controlled by a ROSCO.⁴² At that time Stagecoach owned Porterbrook.
128. The Codes contain guidance on the different factors that ROSCOs can take into account when determining a lease rental and they also contain a non-discrimination clause which states that quotes for rolling stock must be offered to potential franchise operators on a fair and non-discriminatory basis. Under this provision, ROSCOs must offer the same terms to all TOCs for identical rolling stock scenarios.
129. We now consider a remedy to increase TOC incentives to negotiate improved terms from the ROSCOs by removing the non-discrimination requirement from the Codes of Practice.

Rationale

130. The remedy would release the ROSCOs from their non-discrimination obligation under the Codes of Practice. This remedy could be introduced either through an

⁴¹Each ROSCO has its own Code, which have minor differences in their wording. There is not, therefore, strictly, an industry code.

⁴²ORR press statement, 10 February 2000.

amendment to the Codes of Practice, by Order or through undertakings. Removal of this obligation would increase the TOCs' incentives to negotiate and to assess alternative rolling stock proposals, thereby increasing the competitive pressure on ROSCOs.

What we were told

131. The DfT commented on this provision of the Code in its response to our provisional findings and Notice. It told us that if each lease has unique features and must be priced accordingly there is likely to be a wide margin of discretion as to what constitutes discrimination.⁴³
132. The ORR also considered the non-discrimination provisions in the Codes of Practice. It stated that although there was some scope for differentiation on the base case offers, there were compelling reasons to suppose that TOCs had weaker incentives to negotiate favourable terms than was the case for buyers in many markets.⁴⁴ It subsequently told us that it did not have any evidence to suggest that a remedy to remove the non-discrimination provision would be damaging.
133. For the TOCs, ATOC told us that, on the one hand, the Code of Practice requirement to offer similar terms does at least provide a 'stake in the ground' but on the other it clearly limits the ability of individual bidders to negotiate better terms and to seek competitive differentiation in bidding in this area. It went on to say that there were strong views each way among TOC-owning groups on this subject.

Our assessment

134. We consider that this remedy would address the AEC and/or detrimental effects arising by providing greater incentives to the TOCs to seek lower rental charges from

⁴³DfT response to Remedies Notice, paragraph 2.10.

⁴⁴The ORR's reasons for making a market investigation reference to the CC, paragraph 4.166.

ROSCOs, which may then increase the level of inter-ROSCO rivalry. The TOCs would not be incentivized by the lower charges per se, but by the increased chance of winning the franchise bid if they could negotiate a lower price than was available to their rivals. By contrast, at present cost reductions agreed with one TOC must also be offered to rivals when negotiating on the same rolling stock proposals. It would also incentivize TOCs to consider a wider variety of alternative rolling stock options to help them negotiate better deals with the ROSCOs.

135. The non-discrimination provisions of the Codes of Practice were, originally, seen as especially important where a TOC and a ROSCO were in common ownership.⁴⁵ At that time, Stagecoach owned Porterbrook. It is no longer the case that there are any TOCs and ROSCOs in common ownership. In any case, the current Codes contain specific provisions covering this situation which could, if appropriate, be retained.
136. In terms of practicability, we considered whether this particular remedy would make the assessment of franchise bids more difficult for the DfT but provisionally concluded that it would not. The DfT would still consider the same base case put forward by bidders and any negotiation of the rental charges would not affect the comparisons of bids by the franchising authority.

Provisional decision on non-discrimination

137. We consider that removing the non-discrimination provisions from the Codes of Practice would provide greater incentives to the TOCs to seek improved terms from the ROSCOs, particularly when viewed alongside our proposed remedy on transparency. We have therefore provisionally decided to adopt this remedy.

⁴⁵See ORR press release, 10 February 2000.

A5. Greater transparency of lease rentals

Rationale

138. We now consider a remedy which would seek to enhance TOCs' buyer power by creating greater transparency of lease rentals which would give TOCs the ability to negotiate with the ROSCOs more effectively on those rental offers which they consider to be too high. This remedy would mitigate the customer detriment we have identified.
139. To implement this remedy, we propose making an Order to require rolling stock lessors (ie the ROSCOs and any other current or future rolling stock lessors) to provide TOCs with a set list of information on each lease rental proposal.⁴⁶ We set out what variables we think this list should contain in paragraph 146. The Order may also include a requirement to ensure that the information disclosed was not misleading and was consistent with the lessor's internal assumptions and costs. We are in ongoing discussions with the ORR regarding a role whereby it would monitor compliance with the Order and, where relevant, take enforcement action for non-compliance under section 167 of the Act.⁴⁷ The duty to monitor could be facilitated through one or more different mechanisms such as: TOCs bringing potential breaches of the Order to the attention of the monitoring body; rolling stock lessors providing the monitoring body with a copy of the information disclosed to the TOCs; rolling stock lessors sending periodic statements confirming compliance with the Order; and rolling stock lessors sending periodic independently-audited compliance reports stating whether it had complied with the terms of the Order. Some of these mechanisms may form part of the Order. We are currently discussing all these possibilities with the ORR.

⁴⁶We consider that an Order is the most appropriate mechanism for implementing this remedy. This is because the Order can be drafted to apply to future as well as current lessors of rolling stock.

⁴⁷Section 67 of the Railways Act 1993 gives the ORR concurrent functions with the OFT in relation to Part 4 of the Enterprise Act.

140. The Order would be separate from and additional to the existing Codes of Practice, which would remain in force.

What we were told

141. A number of TOCs suggested that increased transparency of the basis for charging lease rentals would be helpful. National Express said that it would welcome increased transparency in both capital and non-capital rental rates. It told us that this would enable a lessee to challenge a ROSCO more effectively when no alternative rolling stock was available. Govia said that it supported the idea of a requirement on ROSCOs to disclose details of variables underlying lease rental rates. It said that it had always experienced difficulty in getting clarity of this data and that this difficulty was becoming more pronounced. It said that this was particularly so when asking ROSCOs to quote annual lease rates to support modifications to existing rolling stock. However, two TOCs had concerns regarding the benefit of this proposal. Arriva raised concerns that it may lead to a possible increase in bidding costs if there were lengthy disputes over lease rates and Chiltern stated that it was difficult to see how this information would impact on lease rentals.
142. ATOC told us that its members continued to report difficulties in agreeing suitable terms for dry leases, charges for heavy maintenance and maintenance reserves and amortization of refurbishments and modifications. It suggested that transparency of these particular aspects should be further examined in the context of a revised Code of Practice.⁴⁸ ATOC told us that it was important that the role of the ORR in relation to the Codes of Practice was clear and that it should be ready to enforce the pro-

⁴⁸Ibid.

visions of the Code if necessary and that a clearer enforcement route, short of another reference to the CC, would be valuable.⁴⁹

143. Some of the TOCs themselves expressed concern over the visibility of maintenance charges. National Express noted concerns about visibility in the provision of maintenance services. It said that to a large extent there was no opportunity for the TOC to influence the choice of maintenance provider and no ability to negotiate on charges. It said that, even in the case of a dry lease (other than at the end of the life of rolling stock), a TOC would not be able to assess whether maintenance reserves, and payments into that reserve to cover the lifetime maintenance costs (which might fall outside the current franchise term), were reasonable. First stated that there was a concern that the ROSCOs were seeking to compensate for the loss of the margin on the non-capital rental by either adding a premium on to the capital rental or pricing this into the maintenance reserve. It told us that there was a lack of clarity over the opening and closing balances of the maintenance reserve which meant that it was difficult for TOCs to assess whether payments in or out of that reserve were reasonable.

Our assessment

144. We found that, provided the TOCs could make use of the information, this remedy would mitigate customer detriment by increasing the TOCs' ability to negotiate with the ROSCOs.
145. In assessing what sort of information the ROSCOs would be required to disclose to the TOCs, we compiled a list of the information that we considered could usefully be provided. We used as our starting point the information that TOCs are currently given in relation to new rolling stock. The basis for our list was that at re-lease TOCs

⁴⁹ATOC response to Remedies Notice p4.

should be able to compare the lease rental proposed with the previous lease rental to assess how and why the rental had changed, and conduct their own assessment of the rental so as to challenge the ROSCOs and put pressure on rentals.

146. Our initial view is that for each lease offer the following information would need to be provided to TOCs:
- (a) previous capital rental and proposed capital rental and an explanation for any change between these rentals;
 - (b) proposed additional capital expenditure and the allocation of its recovery between capital and non-capital rentals;
 - (c) previous cost of funding and current cost of funding (for example, expressed as a cost compared to LIBOR or the absolute cost of funding);
 - (d) changes in tax rates and capital allowances since the previous lease;
 - (e) the original cost of post-MOLA rolling stock;
 - (f) assumed remaining useful economic life of the asset;
 - (g) the amount of any short-term lease premium; and
 - (h) the amount of any maintenance reserve on a dry lease, accompanied by an explanation of its level. This explanation should include information on the previous contributions to the maintenance reserves/previous non-capital rentals, set against previous and forecast maintenance expenditure.
147. In addition to the list of information above, we considered whether TOCs would benefit from receiving information regarding asset values for MOLA rolling stock. This information would cover:
- (a) the opening book value of the asset and any subsequent revaluations; and
 - (b) the net book value of the asset (with and without revaluations) at the re-lease date.

148. We noted that this could, in theory, be helpful if a TOC wished to undertake its own judgement of the appropriate rental by using similar lease price models to the ROSCOs. However, it was unclear to us, given the uncertainty regarding MOLA rolling stock asset values, how useful a TOC would find such information in negotiations with ROSCOs. Therefore, our current view is that information on asset values should not be included in the proposed list of information to be provided.

Provisional decision—transparency

149. We provisionally decided to adopt this remedy option. We found that a requirement for rolling stock lessors to disclose to TOCs a set list of information behind each lease rental offer, actively monitored by the ORR, would help to increase the ability for TOCs to negotiate over the lease rentals. At a minimum, this would cover the information set out in paragraph 146.

150. It would be helpful to hear the views of the TOCs on this remedy, in particular as to whether further information to that covered in the list in paragraph 146 would be useful in their negotiations with the ROSCOs, such as whether asset values should form part of the required information set.

A6. Short-term lease premiums

Rationale

151. In our provisional findings we identified as an aspect of one of the features that the costs and risks involved in switching to leasing alternative used or new rolling stock may discourage TOCs from switching to these alternatives (see paragraph 22(b)). In the Notice, we invited views as to whether a possible remedy would be to limit the level of short-term lease premiums so as to reduce switching costs and encourage switching to alternative used and new rolling stock, hence increasing choice for TOCs and rivalry between the ROSCOs. We note that the outcome of this remedy is

in effect to control short-term lease prices, but because the purpose of this remedy is to stimulate competition, we consider the remedy in this section rather than alongside the price control remedies.

152. We considered two ways in which short-term lease premiums could be explicitly controlled:
- (a) a complete ban on short-term lease premiums so that lease rental quotes would have to be made without regard to lease length; and
 - (b) a price cap on short-term lease premiums. This would probably be dependent on lease length and would need to be set relative to a long-term lease, with a ROSCO always quoting both a long-term and a variety of short-term lease rentals to TOCs.

Analysis of past experience

153. In this section, we set out the reasons given by the ROSCOs for having charged short-term lease premiums in the past. We then assess the degree to which short-term lease premiums have previously acted as a switching cost and prevented TOCs from considering alternative rolling stock options. This is so we can understand the relative importance of short-term lease premiums in switching decisions and whether removal of them would be effective in addressing the AEC.

Reasons for short-term lease premiums

154. We noted that when a short-term lease is required, the rolling stock in question becomes 'must-have' rolling stock for the TOC requiring rolling stock to be in place before alternative rolling stock becomes available. Short-term lease rental premiums may therefore be generated as much by market power as by underlying changes in cost. It is difficult to determine whether and to what extent these premiums are due to market power or stem from different residual value risk evaluations.

155. The ROSCOs told us that the main factor determining the short-term lease premium applied was their assessment of residual value risk.
156. Angel submitted that there was a downward-sloping relationship between the length of leases and value at risk. Longer leases had fewer releasing points, and therefore the value of residual risk was lower. Shorter leases had a higher frequency of releasing, therefore had a higher risk and hence a higher premium was required to offset that risk. It also submitted that this was a common feature of operating leasing markets (for example, the US real estate and global aircraft leasing markets). Angel added that short-term leases increased systematic variance of lease rentals over the lifetime of the rolling stock and so the whole lifetime required return was higher for short-term leases than for long-term leases.⁵⁰
157. Angel submitted that the premium currently applied to a short-term lease did not compensate it for the losses it would incur if the risk should crystallize and that fleet, or part of that fleet, goes off-lease for any period of time. Instead, the premium applied is designed to provide protection from stranding risk arising from short-term leasing across the portfolio.
158. HSBC told us that short-term lease premiums were required because increased residual value risks exceeded the lower credit risks generated by the shorter lease period.

⁵⁰Angel has tended to apply a sliding scale of rental adjustments based on a one-year lease being [X] per cent higher than an equivalent long-term lease and two- and three-year leases being [X] and [X] per cent higher respectively. It stated that these percentages had been adjusted in isolated instances to take account of exceptional circumstances.

159. Porterbrook submitted that the pricing of each short-term lease was assessed on a case-by-case basis, but that the main commercial factors affecting the rentals on short-term leases were those listed in its Code of Practice.^{51,52}

Short-term lease premiums as a switching cost

160. A number of TOCs told us that short-term lease premiums were one of a number of switching costs. Although reductions in switching costs increase the likelihood of alternative used or new rolling stock being put forward, these TOCs told us that removal of the short-term lease premium would not necessarily result in increased switching as this was only one of the factors taken into consideration.

161. We have reviewed bid submissions to identify any cases where franchise bidders stated that the short-term lease premium on incumbent rolling stock affected their choice of rolling stock. We found two cases where a short-term lease premium was explicitly mentioned by bidders as a reason for not proposing to take alternative rolling stock:

- (a) South Western 2007 franchise—MTR/National Express stated that ‘the likely introductory timescales of 6 to 12 months (for switching to Class 458s) together mean that the Class 442 fleet would have to be retained for a time at the start of the franchise’ and ‘the short term lease costs quoted to SWT for the Class 442 fleet are significantly increased compared to those for a full franchise term’.
- (b) On the East Midlands franchise, National Express’s bid stated that ‘new-build DMUs (Class 172s) would not be available until 2010 at the earliest. This would mean more expensive short-term leases for temporary alternative fleet until they are introduced to service’.

⁵¹Porterbrook response to Remedies Notice, paragraph 6.10.

⁵²The main commercial factors associated with leases of different durations which are listed in the Codes of Practice are as follows: the contracted proportion of the future anticipated life of the rolling stock; the likely demand for the particular stock at the end of the proposed leased period; the extent to which the payments during the term of the lease facilitate raising finance for the relevant rolling stock; the reduced residual value risk when rolling stock is leased for longer periods of time; the reduced marketing costs associated with leases which are re-let on fewer occasions; and whether the lease and franchise are co-terminous.

162. In each case, although the short-term lease premium was clearly an important factor in determining the bidder's choice of rolling stock, other factors also played a part.

What we were told

163. The DfT told us that this remedy would not by itself address the AEC.⁵³ It said that a remedy of this nature might have some value in the context of a market in which, on expiry of the short-term lease, there would be a situation of uncommitted surpluses of rolling stock of the required type. However, the remedy would not increase the prospects of such a situation coming about. It recognized that the cost of a short-term lease might in some cases make the difference in making the financial case for new rolling stock; however, in a number of instances it would make no difference at all. Further, the DfT submitted that if a ROSCO were to be restricted in the premium it could charge for short-term leases it might seek to increase lease rentals for other rolling stock.⁵⁴

164. All three ROSCOs were opposed to any form of direct control on the price of short-term leases. Angel told us that short-term leases should include provision for costs incurred and for added risk but that short-term leases should not be price regulated.⁵⁵ It was nonetheless open to discuss ways to improve the TOCs' ability to obtain short-term leases and stated that increasing the ability of TOCs to use short-term leases could be a good way to facilitate increased competition.⁵⁶

165. HSBC told us that the imposition of short-term lease premiums reflected increased risks and costs. It said that, as the CC had not found that the premium for short-term leases had been excessive, price control of short-term leases would be disproportional.

⁵³DfT response to Remedies Notice, paragraph 5.6.

⁵⁴DfT response to Remedies Notice, Annex 2, paragraphs 75–77.

⁵⁵Angel response to Remedies Notice, paragraphs 108 and 109.

⁵⁶Ibid, paragraph 109.

tionate and inappropriate.⁵⁷ HSBC suggested instead that a more proportionate and effective remedy would be to enshrine in the Codes of Practice the principles by which the ROSCOs should abide when setting short-term lease premiums.⁵⁸

166. Porterbrook too was opposed to regulating short-term lease rentals. It submitted that the cost or availability of rolling stock on a short-term lease had not been a major factor in discouraging switching. As an alternative approach to this remedy it suggested increasing the transparency of short-term leases by amending the Codes of Practice so as to oblige ROSCOs, if challenged by a TOC on the fairness of the premium, to justify their proposed charges by reference to the factors currently listed in the Code.⁵⁹

167. Of the TOCs that commented on this remedy, three were in favour and one against. Arriva had concerns that the ROSCOs had engaged in gamesmanship, trying to create favourable outcomes to themselves by inflexible restrictions of the period of leases. It sought the strengthening of the Codes of Practice to require ROSCOs to quote (in the case of incumbent fleets) for any length of lease. In addition, it sought a limitation on the maximum uplift that might be applied to leases shorter than the franchise length.⁶⁰ Virgin was also in favour of a maximum premium or a premium limited by reference to demonstrable incremental costs. National Express told us that restrictions on short-term lease premiums could reduce the cost of the rolling stock but it did not believe that it would alter the availability of vehicles and thus that it would not change the extent of competition between ROSCOs.⁶¹

⁵⁷HSBC response to Remedies Notice, paragraph 8.5.

⁵⁸Ibid, paragraph 8.6.

⁵⁹Porterbrook response to Remedies Notice, paragraph 6.20.

⁶⁰Arriva response to Remedies Notice, paragraphs 42 and 43.

⁶¹National Express response to Remedies Notice, p6.

Our assessment

168. This remedy would potentially facilitate switching or the introduction of new rolling stock. This in turn would increase competitive pressure on the ROSCOs and constrain rentals on existing rolling stock to those at or below the rental for new or alternative existing rolling stock (adjusting for utility). It would mean that ROSCOs could not raise rentals above the level of alternative rolling stock because of the extra switching costs created by a short-term lease premium.
169. However, our concerns over the effectiveness of a ban or cap on short-term lease premiums are similar to those set out in the section on price controls (see paragraphs 262 to 266). In particular, this remedy would:
- (a) create distortions in the market because, to the extent that there are sound commercial reasons for short-term lease premiums, the remedy would increase ROSCOs' perceptions of risk; and
 - (b) raise practical difficulties in its implementation, particularly in relation to the size of cap that would need to be applied to each individual lease quote for each different lease length.

Provisional decision—short-term lease premiums

170. We conclude that a ban or cap on short-term lease premiums would create significant distortions across the market and would raise practical difficulties in its implementation. We therefore provisionally decided to reject this remedy.

A7. Additional call option

171. Call options are contained within the direct agreements between the Government and the ROSCOs; these give the Government the right to require the ROSCOs to enter into a new lease with the Government for three years from the end of the current franchise at essentially the same price for the rolling stock as the previous

lease (allowing for some adjustments for the ROSCO to retain a net tax rate of return). The call option on MOLA rolling stock has now expired but it still applies to all direct agreements relating to post-MOLA rolling stock.

172. As we set out in our provisional findings, we received differing views from the ROSCOs and the DfT as to the circumstances in which the call option can be exercised and the likelihood of its being used by the Government.
173. The DfT submitted that there were significant legal constraints restricting how and when the call option could be used which meant that 'the right to call for the rolling stock is a limited one'. It stated that use of the call option was, in effect, limited to those circumstances which would trigger its section 30 duties and circumstances in which ROSCOs were abusing or had abused a dominant position in the market. The DfT considered that it would be difficult to meet the legal test to establish an abuse of dominance.
174. Two of the ROSCOs did not share the DfT's view that exercise of the call option was restricted to the two circumstances described by the DfT in paragraph 173. They said that they had perceived that it could be used with more discretion to limit lease rentals, that this was a credible threat and was taken into account in considering lease rentals.
175. In light of the circumstances in which the call option could be used, we thought it unlikely that the existing call option had been a threat to the ROSCOs' behaviour in setting lease rentals.

Rationale

176. Given our view of the existing call option, we considered whether an additional call option could be incorporated into the direct agreements, in order to enhance the strength of the competitive constraint offered by alternative rolling stock or new rolling stock on lease rentals for existing rolling stock. Nothing in this proposal would be intended to change the ability of the franchising authorities to use their powers in relation to the existing call options. This additional call option would be separate from the existing call options and would serve a different purpose.
177. The purpose of an additional call option would be to reduce barriers to switching by guaranteeing the availability of an appropriate length of short-term lease, and by removing any short-term lease premium that may otherwise be applied (ie the rental would be at the same rate as the previous rental). As a consequence, rentals on leases for incumbent rolling stock which were offered for the length of the franchise term could not rise above a new-build equivalent rental. If the rental did rise above this level, the call option could be exercised and the alternative stock could be introduced without incurring the additional cost of a short-term lease premium. This would make switching to alternatives a significantly more credible threat and therefore act as a potential competitive constraint on existing rentals.
178. Because the rationale for this remedy is to increase the competitive constraints that apply on the long-term rentals for existing rolling stock, we consider that this additional call option should only be applicable in certain circumstances, where the effect is to displace existing rolling stock. We considered under what narrow circumstances the call option could be invoked. For example, we thought that the call option should not be invoked where the effect is to acquire new rolling stock to replace rolling stock that is to be retired, nor would the call option be applicable to cases

where changes of rolling stock were dictated by a franchising authority (eg where rolling stock was specified in a franchise ITT).

179. This additional call option would be triggered by a TOC making a request to the relevant franchising authority to exercise the call option. In effect, it would only be triggered in cases where the longer-term lease rentals charged for the incumbent rolling stock were above those of competing fleets (allowing for relative utility adjustments) such that a commitment to switching fleets was attractive to the TOC. If it then could not agree a suitable short-term lease with the ROSCO, it would ask for the call option to be exercised.
180. The additional call option would be different from a direct cap on short-term lease premiums in several respects:
- (a) It would act indirectly to constrain short-term lease premiums rather than directly as in the case of a ban or cap.
 - (b) It would only be applicable in cases where the effect is for alternative rolling stock to displace existing rolling stock.
 - (c) The decision as to whether to exercise the call option would initially be in the hands of the TOC which would then request that the relevant franchising authority invoke the option, whereas a ban or cap on short-term lease premiums would be enforced by a regulator.

What we were told

181. In response to the proposal to widen the terms of the call option, the DfT stated that it might be of some help to amend the circumstances in which the call option could be exercised to mirror those which the ROSCOs suggested. The DfT considered that in order to strengthen the call option sufficiently, it needed to be more available for use 'on demand' and be available for a shorter period than the current three years. It

submitted a possible amended call option which provided the Government with the general ability to exercise the option on franchise or lease termination and greater flexibility about the length of lease entered into. It also suggested that it would want to consider further changes such as a staged hand-back period when introducing new rolling stock. However, it cautioned that this was based on the assumption that the ROSCOs already priced into leases the risk of the call option being exercised, and that it would not support any changes which would have the effect of increasing prices on rolling stock.

182. The ORR also considered that the call option should be revisited to ensure that there was no misunderstanding on the part of either party to the agreement as to the circumstances of its future use. It said that there might be a case to align the call option more closely to the ROSCOs' interpretation that it could be used merely on the giving of notice, rather than in the limited circumstances cited by the DfT.⁶²
183. Of the ROSCOs, Angel stated that there was a benefit in having a major deterrent, such as the call option, which modified behaviour, although it would not want to see it used as a matter of course. Porterbrook noted that it had always been of the opinion that the call option could be used and this had been accounted for in its pricing policy. Therefore it would not make a difference if it was clarified so that the call option could be exercised in the circumstances described in its submissions.
184. HSBC, however, stated that there was no need for the scope of the call option to be broadened or clarified further. The DfT could seek to exercise the call option if the ROSCO was abusing its dominant position or there was a case under section 30, but it would be inappropriate to extend it so that it became an instrument to be used in commercial disputes. It would not wish the DfT simply to be able to invoke the call

⁶²ORR response to Remedies Notice, paragraphs 31 and 32.

option whenever it wished in order to have a short-term lease without paying any premium.

Our assessment

185. We considered that the ability to use an additional call option could contribute to mitigating the AEC by making the threat of new rolling stock or alternative rolling stock more credible, and thereby enhancing the effectiveness of this competitive constraint on rentals for existing rolling stock. This would be due to the remedy limiting upfront switching costs from short-term lease premiums and increasing the possibility of switching rolling stock. This remedy also addresses any ability the ROSCOs may have to charge higher rentals because of the existence of switching costs arising from short-term lease premiums.
186. However, we noted the following limitations of this remedy:
- (a) The TOCs told us (see paragraph 160) that short-term lease premiums were not the tipping point in many switching decisions, albeit they were a relevant factor and it was important that there was availability of a suitable length of short-term lease.
 - (b) The remedy could distort market behaviour, increase the ROSCOs' perceptions of risk and impose costs on ROSCOs. Enforced call options may prevent the ROSCOs and TOCs reaching a market-determined price. Although short-term lease premiums may reflect an element of market power arising from a TOC's lack of alternatives while switching, they may also reflect additional costs or costs being recovered over a shorter period (as the ROSCOs told us in paragraphs 154 to 159). The residual value risks of a short-term lease are likely to be higher than for a lease which lasts the length of the franchise term because the most obvious subsequent leasing opportunity is no longer available to the ROSCO. If the remedy is effective, the threat of the call option would prevent premiums being

charged on all short-term leases which meet the conditions for when the call option could be exercised. In those cases, the ROSCOs would not be rewarded for bearing any additional costs and risks, whether or not the call option is actually invoked.

- (c) Although we would expect the additional call option only to be used on a limited basis, there are a number of practical difficulties in defining the limited circumstances in which the call option could be invoked. These include design issues in relation to: specifying clearly the precise circumstances in which the call option could be invoked; ensuring that the call option could be tied to a particular fleet that was being displaced; and deciding at which point in the lease negotiation process the call option could be requested by the TOC and invoked by the relevant franchising authority.

Provisional decision—additional call option

187. The benefits of an additional call option, even if it could be appropriately designed, would introduce distortionary effects on market behaviour. Moreover, we were unable to formulate a limited set of circumstances in which the call option should be invoked. We therefore provisionally concluded that an additional call option should not be added into the direct agreements.

A8. Coterminous franchises

Rationale

188. In our provisional findings, we identified that a constraint on the TOC's choice of rolling stock, and hence the degree of rivalry between ROSCOs, was that rolling stock that may represent an alternative to the incumbent stock is often in use on another franchise and thus not available for several years (without taking a short-term lease).

189. A remedy that ensures that pairs or groups of franchises with similar rolling stock requirements coterminate could potentially address the AEC by widening the choice of rolling stock available to TOCs at each franchise re-let and enabling bidders to switch between rolling stock without incurring any short-term lease switching costs.

Analysis of past experience

190. The most relevant experience of franchise cotermination was in the November 2007 Midlands Three franchises. There was some overlap in rolling stock requirements on these franchises in terms of DMUs and high-speed trains. The DfT had a considerable role as arbiter of rolling stock on these franchises and each bidder had to submit iterations of rolling stock as the DfT worked out which rolling stock was most suitable and best value for each franchise. The multiple claims on trains added to confusion for bidders and resulted in the DfT having to allocate certain rolling stock to particular franchises, once those franchises had been awarded.⁶³ As we set out in paragraph 66 of [Appendix 2.1](#) of our provisional findings, the DfT also had to make a number of interventions in order to allocate rolling stock and this had effects on other franchises. Although we found that lease rentals for certain rolling stock fell on the Midlands Three franchises, this appeared to be more related to the surplus of that type of rolling stock than to the cotermination of the franchises.

What we were told

191. The DfT told us that cotermination of franchises would not increase competition between ROSCOs absent an uncommitted surplus of suitable rolling stock.⁶⁴ It went on to say that examination of circumstances in which cotermination of franchises had occurred confirmed that it would not result in greater inter-ROSCO competition. It told us that competition between ROSCOs on the Midlands Three franchises (East

⁶³For example: 'in order to give certainty to bidders and the industry more widely, the proposed allocation of existing 15x and 170 planned to be in place to deliver the operational service from 11 November 2007 will be in place in the Data Site shortly and form the basis of a common approach for all three franchises'.

⁶⁴DfT response to Remedies Notice, Annex 2, paragraph 22.

Midlands, West Midlands and New Cross Country)⁶⁵ did not increase and lease prices did not reduce.⁶⁶

192. The ROSCOs' views on cotermination varied. Angel told us that this remedy could provide an effective boost to competition and, from its perspective, could also be relatively easily implemented.⁶⁷ Porterbrook was also broadly receptive though noted that it would be necessary for there to be arrangements to ensure that the rolling stock plans of the winning bidders were mutually compatible, perhaps through second bids or the DfT acting as a clearing house.⁶⁸ HSBC's view was this remedy would neither be practical nor increase the TOCs' choice of rolling stock. It said that, absent new rolling stock being considered an alternative, there would only be enough rolling stock available just to supply both franchises, which would not be a significant change from the current situation. It went on to say that the process of deciding which TOC had first choice of rolling stock in the event of conflicting requirements would add significant complication for little gain.⁶⁹ However, HSBC also noted that cotermination might create some competitive pressure as ROSCOs might prefer their stock to go on to one franchise over another franchise.

193. The TOCs generally did not believe that this remedy would be practical or effective in addressing the AEC. Virgin Trains (Virgin), however, told us that it would be practical to arrange that pairs or very small groups of franchises coterminated.

Our assessment

194. The remedy is unlikely to be effective in addressing the AEC as the previous experience of cotermination on the Midlands Three illustrated. The main drawback with

⁶⁵ICEC was let at the same time but these leases were simply novated following the failure of GNER.

⁶⁶Ibid, paragraph 23.

⁶⁷Angel response Remedies Notice, paragraph 88.

⁶⁸Porterbrook response to Remedies Notice, paragraph 3.1.

⁶⁹HSBC response to Remedies Notice, paragraphs 7.16–7.19.

pairing of franchises, as was noted on the Midlands Three franchises, is that it requires greater intervention by the franchising authorities in rolling stock allocation and is not effective unless there is a credible threat of switching to alternative rolling stock.

Provisional decision—cotermination

195. We concluded that cotermination as a remedy is not necessary for creating more competition. We think it is also likely to be cumbersome and difficult to implement.

A9. A permanent pool of surplus rolling stock

Rationale

196. In the Notice we considered whether the creation of a permanent pool of surplus rolling stock would be effective in addressing the AEC that we identified in our provisional findings. The creation of a permanent artificial pool of surplus rolling stock (rather than just allowing frictional surpluses to develop) would create a permanent competitive threat to the ROSCOs and would increase the risk to ROSCOs of their rolling stock coming off-lease. However, we said that we saw significant drawbacks to this approach and were therefore not minded to pursue it.

What we were told

197. None of the parties disagreed with the CC's conclusions on this possible remedy.

198. The DfT submitted that a minimum of 400 vehicles would be needed to have an impact on lease rentals for the different types of rolling stock.⁷⁰ The DfT estimated that the total capital cost of procuring these vehicles would be in excess of

⁷⁰These vehicles would be 100 vehicles of 100mph DMUs, 150 vehicles of 125mph diesels, and 150 vehicles of 100mph dual voltage. These figures excluded the impact on 125mph EMUs.

£540 million.⁷¹ The DfT told us that the fleet of 400 vehicles was estimated based on the current distribution of fleet sizes. It told us that, in cases where TOCs needed a large number of vehicles of a particular type, then a larger spare fleet would be required.

Our assessment

199. Aside from the large estimated capital investment required, this remedy has a number of apparent practical difficulties and limitations in how it would effectively address the AEC.
200. The ROSCOs would incur storage costs (cold or warm) by holding a permanent pool of surplus stock. In addition, the changing nature of demand for rolling stock means that the types of vehicles would need to vary over time such that some types of spare rolling stock would over time cease to be required (for example, if increased electrification made diesel rolling stock less attractive). When deciding which rolling stock to invest in, the DfT would need to be able to understand which rolling stock was required over the next 30 years, in line with the life of the assets.
201. The ROSCOs would also face much higher residual value risk if there were a permanent pool of surplus rolling stock. If this affected all ROSCOs and was seen as a 'marginal' cost, there is the possibility of higher rentals. Moreover, a permanent surplus capacity is likely to deter entrants and reduce investment incentives, leading to an unsustainable market in the longer term. Finally, holding spare rolling stock might incentivize the ROSCOs to dispose of any surplus rolling stock meaning that any spare capacity could not persist.

⁷¹This capital cost was based on £1.3 million x 100 DMUs, £1.5 million x 150 high-speed diesels and £1.25 million x 150 dual-voltage EMUs.

Provisional decision—permanent surplus pool of stock

202. We concluded that this remedy should not be implemented. It is likely to be costly, impractical and would introduce considerable distortion into the market. It is therefore unlikely to be effective. We think it is better to let the market adjust naturally with frictional shortages and surpluses developing over time. We also consider that this remedy is likely to be allocatively inefficient and politically unpalatable.

A10. Alternative franchise bidding models

Rationale

203. In the Notice we invited comments as to whether alternative bidding models might result in supply and demand of rolling stock becoming more responsive to price. We acknowledged that our thinking was not fully developed but sought views as to whether, for example, to invite bids on the basis of a fixed price (subsidy) would enhance competition.

204. The intention of this proposal was to introduce procurement processes that would enhance competitive pressures between ROSCOs and enhance the relative negotiating power of TOCs in dealing with the ROSCOs. This might happen, for example, by increasing the ability of TOCs or the DfT to alter the quantity of rolling stock demanded in response to changes in proposed rentals, such that there would be an increased threat to the ROSCOs of at least some of their rolling stock coming off-lease. ROSCOs would therefore have to factor into their rental determination the possible impact on the quantity of rolling stock leased.

What we were told

205. The DfT told us that the key to improving pricing discipline under this model was for it to 'credibly threaten' to reduce the quantity of rolling stock. However, reducing overall rail provision was 'simply not an option for Government given the high priority to

increase rail capacity to meet projected rail demand.’ Because of this, any threat to reduce franchise provision would not be credible.⁷² Further, the DfT did not believe that providing a stated budget, but leaving service design up to bidders would be workable in procurement terms for rail services. It was possible that none of the bids would represent an acceptable level of service from the point of view of rail policy. The DfT considered that it should decide what level of service was appropriate to meet its overall policy obligations.⁷³ Finally, it said that it would not be enough to reduce the quantity of stock on one franchise if ROSCOs knew that it would be immediately used elsewhere on the network.⁷⁴

206. No parties were in favour of this possible remedy though Quasar Associates noted that it was, in effect, a more extreme variant of the possible remedy relating to less-specific ITT requirements. However, it pointed out that such a remedy would raise concerns over the DfT’s ability to control the delivery of its statutory duties.⁷⁵
207. No parties proposed any other franchise bidding models or alternative procurement methods which would have the effect of increasing competition in the leasing of rolling stock.

Our assessment

208. In theory, a fixed-subsidy-based franchise bidding system would create greater sensitivity of demand for rolling stock depending on rental levels, and this would enhance the demand elasticity constraint that would apply to ROSCOs’ rental determinations. In addition, where there was potential for competition between ROSCOs, the incentive to compete with rival ROSCOs would be strengthened because of a greater risk that displaced rolling stock could go off-lease. This risk

⁷²DfT response to Remedies Notice, Annex 2, paragraph 22.

⁷³DfT response to Remedies Notice, paragraph 5.7.2.

⁷⁴Ibid, paragraph 23.

⁷⁵Quasar response to Remedies Notice, paragraph 36.

would apply to some of the fleet, rather than necessarily the whole fleet. While a marginal reduction in the use of rolling stock could exert some constraint on ROSCOs and in principle could be more readily deployed than threatening to leave a whole fleet unused, we accept that the credibility of the threat that the DfT would be willing to reduce the level of rolling stock use is limited. It would be very difficult for the DfT in practice to countenance the reduction in service levels that might be the outcome were this remedy to be adopted.

209. The DfT could also specify a minimum level of service in franchise ITTs with TOCs bidding flexibly for additional services, depending on rental rates. However, for the same reasons, the DfT is unlikely to be willing to set these minimum service levels below the current levels that effectively utilize nearly all available rolling stock, and therefore this would in effect merely amount to the DfT being prepared to consider new rolling stock proposals. We also note that this approach to procurement is inconsistent with wider procurement best practice in government.

Provisional decision—alternative franchise bidding models

210. We do not consider that a fixed-subsidy-based franchise bidding system would effectively address the AEC because the credibility of the threat that rolling stock demand would be reduced is limited, and so ROSCOs would be unlikely to adjust their rentals in response to a perceived threat of marginal rolling stock remaining unleased. We have not identified other franchise bidding models that could effectively increase demand elasticities and that could be credibly deployed.

Category B: Remedies which address the detrimental effects on customers of the AEC by extending the benefits of rivalry at first lease into subsequent lets

211. In our provisional findings, we provisionally found that there is active rivalry between ROSCOs in the provision of new rolling stock at first lease.⁷⁶ The remedy options we now consider are aimed at transferring the pricing benefits from first lease to subsequent lets or for a longer duration. This would have the effect of addressing any detrimental effects arising from the AEC relating to rentals.
212. We discuss two types of remedies in this section; the use of section 54 undertakings (including an alternative proposal of longer leases for MOLA stock) and alternative procurement methods.
213. From a competition perspective, we do not recommend that these methods should be more frequently deployed. Although these remedies might bring some benefits in securing value for money in particular circumstances, we consider that they also have a negative impact in terms of the potential for competition in the leasing of rolling stock.

B1. Use of section 54 undertakings

214. The relevant franchising authority currently has the ability to give section 54 undertakings which ensure that vehicles are re-leased from the end of the current lease period to the expiry of the undertaking, on substantially the same terms as the initial lease (subject to performance). Section 54 undertakings cover various periods but have been granted for up to 22 years.

⁷⁶Provisional findings, paragraph 5.56.

Rationale

215. In the Notice we considered whether the relevant franchising authority could make use of section 54 undertakings when new rolling stock was being acquired. This remedy would extend the benefits of rivalry in the financing of new rolling stock over a longer period of the asset's life, reducing residual value risk for lessors and potentially resulting in lower lease rentals. This might address the detrimental effects on customers which have arisen from the AEC. Reducing residual value risk may also enhance competition by reducing barriers to entry and attracting new financiers to the leasing market.

Analysis of past experience

216. Since privatization a number of section 54 undertakings have been granted, in relation to new rolling stock, additional investment in existing rolling stock and in cases of TOC failure. In our provisional findings we assessed in more detail the circumstances in which section 54 undertakings had been granted and the extent to which these had affected capital rentals.⁷⁷ We noted that there had been evidence in the ROSCOs' internal papers that they viewed section 54 undertakings as reducing residual value risk and how, in a number of instances, the rental offered for a given lease had reduced when a section 54 undertaking was offered.

217. We understand that the DfT is offering section 54 undertakings for the IEP and Thameslink procurements, and there may potentially be further section 54 undertakings to facilitate the introduction and cascade of vehicles outlined in the Rolling Stock Plan.

⁷⁷More information on section 54 undertakings can be found in our provisional findings, [Appendix 2.1](#) paragraphs 92–102.

What we were told

218. The DfT told us that the value of a section 54 undertaking may come about in two ways. First, the reduction in residual value risk brought about by such undertakings may lead to a lower capital rental than would otherwise have been the case. Second, it may encourage new financiers to enter the rolling stock market and with more participants the market is more likely to be properly competitive. However, the DfT noted that there was a balance to be struck in the use of section 54 undertakings to ensure that they continued to have an impact and to ensure that the discount offered by the undertaking could be properly tested against market conditions.⁷⁸ As section 54 undertakings exist to encourage investment which would not otherwise occur, the DfT had to be satisfied that it was receiving value for money in giving that undertaking. It also stated that the avoidance of assets going on to the Government's balance sheet was a necessary constraint on the length and number of section 54 undertakings.⁷⁹

219. The ORR told us that the benefits of section 54 undertakings in procuring rolling stock on more attractive financial terms should be carefully balanced against any ensuing loss of flexibility. It said that, generally speaking, the value of flexibility was likely to be greatest in the case of the most fungible vehicles, where there was the greatest scope for redeployment across the network. Conversely, where rolling stock with a high degree of specificity was required, the loss of flexibility that would arise from the use of section 54 undertakings was likely to be small.⁸⁰ This remedy would reinforce the role of the DfT in taking decisions about rolling stock. The ORR told us that it would rather see decisions taken on properly working commercial incentives.

⁷⁸DfT response to Remedies Notice, Annex 2, pp43–45.

⁷⁹DfT response to Remedies Notice, Annex 2, pp43–45.

⁸⁰ORR response to Remedies Notice, p6.

220. There was a varied response from the ROSCOs to this remedy. Angel noted that the DfT was increasingly willing to give section 54 undertakings, and to this extent it may not be necessary to make a recommendation. It argued that section 54 undertakings could and did deliver value for money.⁸¹ HSBC stated that there was a good case for the DfT providing more section 54 undertakings, as, by reducing the risk to investors and encouraging new entry, it would deliver better value for money across the board. However, where appropriate, section 54 undertakings should also be available to existing as well as new-build rolling stock so as not to disadvantage existing rolling stock. HSBC noted that more widespread use of such undertakings would inevitably reduce the stock options available for the franchise concerned, but that there was likely to be a significant benefit for the TOC and the DfT.⁸²
221. Porterbrook, however, was unclear how greater use of section 54 undertakings would extend the benefits of rivalry to subsequent lessees and noted that this was likely to restrict choice further for TOCs at re-lets. It also considered the undertakings to be of limited value as they were subject to failed rolling stock provisions and to political risk in that future governments might not be bound by them.⁸³
222. A number of the TOCs had concerns about extending the use of section 54 undertakings as they could further reduce the options available to TOCs at franchise re-let and discourage bidders from proposing different solutions. Arriva noted that the value gained on the initial deal might be eroded by the loss of flexibility at subsequent franchise changes.⁸⁴ Govia also stated that in the long term it would simply result in a

⁸¹Angel response to Remedies Notice, paragraphs 97–102.

⁸²HSBC's response to Remedies Notice, paragraph 7.32.

⁸³Porterbrook response to Remedies Notice, paragraphs 5.1–5.3.

⁸⁴Arriva response to Remedies Notice, paragraphs 37 and 38.

greater degree of intervention by the DfT and was likely to lead to ossification in the market rather than invigoration of competition.⁸⁵

Our assessment

223. A number of our remedies are aimed at increasing the competitive threat to ROSCOs and ensuring that TOCs have a greater choice of stock. However, section 54 undertakings effectively remove any competitive pressure at re-lease during the period of the undertaking. Additionally, as rolling stock with a section 54 undertaking is normally specified for use in the ITT for a particular franchise, this rolling stock may not be an available alternative for TOCs to consider on other franchises and it narrows the field of potentially competing rolling stock. We therefore consider that section 54 undertakings may in many cases counteract the benefits of those remedies seeking to enhance competition.
224. We note that there is some evidence to suggest that section 54 undertakings have the effect of reducing residual value risk which may result in lower lease rentals and attract new financiers into the leasing market. There may be circumstances where a section 54 undertaking provides greater overall value for money than the benefits of competition. For instance, this might apply in cases where rolling stock is more likely to remain leased on specific routes (eg the Class 395s, which are the new trains to be used on CTRL domestic services).
225. There is also a difficulty in using section 54 undertakings to incentivize TOCs as they are not able to put forward directly the proposal for the section 54 undertaking, since these undertakings result from a bilateral negotiation between the franchising authority and the ROSCO. It therefore points towards more involvement of the franchising authority in negotiations over rolling stock.

⁸⁵Govia response to Remedies Notice.

Provisional decision—use of section 54 undertakings

226. We have provisionally determined that section 54 undertakings may reduce residual value risk and hence lower the cost of leasing; on the other hand they could also have a significant detrimental effect on competition, which a number of our other remedies are designed to encourage. We consider that it is important for the relevant franchising authority to be mindful of the negative effects on competition we have highlighted and take this into account when assessing whether to grant a section 54 undertaking, although we recognize that there may be circumstances where it is appropriate. For this reason we have rejected a remedy proposing greater use of section 54 undertakings.

Alternative proposal regarding longer leases on MOLA stock

227. We also received a submission from a city law firm proposing a similar remedy which had two parts:

- (a) First, the ROSCOs would enter into leases for that part of their MOLA fleets which are commercially viable for the remainder of their remaining operational life and those fleets would be refurbished to extend their life. This firm said that residual value risks to the ROSCOs would thus be reduced and leasing costs to the TOCs would fall correspondingly. It noted that restructuring the MOLA leases in this way would be likely to bring the assets on to the Government's balance sheet. The basis for this aspect of the remedy was that market conditions had changed since privatization, through increasing passenger demand and the lack of constraint from new rolling stock, which meant the Government was paying a premium for a risk that stock may go off-lease, which in most cases the ROSCOs do not face in practice.
- (b) Second, the firm stated that 'the ROSCOs' excess profits would either be applied as a contribution to the cost of refurbishment of the MOLA fleet or offset against the extended MOLA leases'. This would take effect from a date set by the CC. It

argued that a one-off adjustment of this kind was preferable to any form of ongoing price regulation, which would be exceptionally difficult to set up and monitor in a market where almost every transaction has unique features. The main basis for this aspect of the remedy asserted by the firm was that new build returns (which appeared to be below the cost of capital in the analysis at provisional findings) could be cross-subsidized by MOLA returns, thus acting as a barrier to entry to new rolling stock.

228. We provisionally decided not to adopt either aspect of this remedy proposal:

- (a) In relation to the longer leases on MOLA stock, we considered that, consistent with our view on section 54 undertakings, it could have a significant detrimental effect on competition, which a number of our remedies are designed to encourage. The remedy also only addresses the AEC and/or detriment relating to MOLA stock, whereas our findings related to the leasing of all used stock. In addition, were it to be the case that the proposed leasing arrangement would result in the assets concerned being financed on the Government's balance sheet, we consider it very unlikely that this would be found acceptable.
- (b) In relation to the profits being offset against rentals, we considered that the basis for this was unsound following our further assessment of profitability on new rolling stock, which indicated that profits were not below the cost of capital. Moreover, we have not made a finding of excess profitability on the part of the ROSCOs and this proposed remedy may thus be considered disproportionate. Even if we had made such a finding, there would be substantial conceptual and practical difficulties in quantifying the exact reduction for excess profits. Accordingly, we do not consider it would be practicable to establish the appropriate amount of any offset against the proposed longer-term MOLA leasing rentals.

B2. Alternative procurement arrangements

Rationale

229. In the Notice we invited views as to whether alternative procurement arrangements, such as have been put in place by Transport for London's (TfL) Overground procurement, would be effective in addressing the AEC that we have provisionally found. By alternative procurement arrangements we are referring to different structures of procuring and financing new rolling stock, other than the traditional leasing model used by the ROSCOs. There are a number of alternative procurement initiatives which have been implemented or are under way (see, for example, paragraph 18). The components for each of these vary to some extent; however, in all initiatives the usage of the trains is guaranteed for a longer period of the asset's life (either through section 54 undertakings or a longer lease held directly with the transport authority). This type of guarantee could be structured so as to retain some flexibility for the lessee at the end of this period, for instance by containing options for a new lease at a rental based on a predetermined formula, or for the stock to be purchased.

230. This remedy is aimed at encouraging more vigorous competition at first lease, the benefits of which would apply for a longer period of the asset's life, whilst being structured so as to maintain flexibility at the end of the initial lease period. This would stimulate competition between financiers, including new entrants, at the point of new rolling stock acquisition, the benefits of which would be carried forward into subsequent periods. This remedy would seek to mitigate the detrimental effects on customers of the AEC.

Analysis of past experience

231. There are three examples of alternative procurement methods which differ from the conventional ROSCO model: TfL's London Overground procurement, IEP and

potentially the Thameslink procurement.⁸⁶ It is difficult to assess any potential benefits arising from these developments, particularly with the IEP or Thameslink procurements as these have yet to be completed. There is some evidence that these arrangements may attract new financiers, which might increase rivalry in the supply of new rolling stock (although in provisional findings we found active rivalry in the provision of the leasing of new rolling stock in any event). In the case of IEP, two bidding consortia have been shortlisted which involve new financiers as well as one ROSCO. In the case of London Overground procurement, three bidders were short-listed, two of which involved ROSCOs but the successful bidder was not a ROSCO. TfL indicated that its leasing arrangement offered enhanced operational flexibility and better overall value for money than direct ownership.

What we were told

232. The DfT told us that, when developing procurement strategies it considered the issues specific to each transaction and sought to optimize risk transfer to deliver best value for money. For the two current, large strategic fleet procurements, IEP and Thameslink, it told us that it was offering section 54 undertakings, which broadly provided the same protection to financiers as the long-lease structure used to procure London Overground trains. It had not included priced options to purchase or re-lease IEP or Thameslink trains after the primary lease period, as it had been advised that such options would conflict with affordability (balance sheet) constraints. However, at re-lease it would have full transparency of costs and underlying financing assumptions.⁸⁷
233. The ROSCOs broadly considered that this remedy was unnecessary. Angel noted that the CC had found that there was rivalry for the financing of new rolling stock and

⁸⁶Further detail on each of the procurement methods can be found in the provisional findings report, paragraphs 5.53–5.55 and paragraphs 12–14 of Appendix 4.4.

⁸⁷DfT response to Remedies Notice, Annex 2, paragraphs 66 & 67.

therefore questioned whether a remedy based on alternative procurement options was needed. It also noted that alternative procurement models were already in use for those deals that merit them such as the IEP, Thameslink and TfL procurements, where sufficient size or other characteristics make their use worthwhile but that these new procurement models (TfL in particular) were in many respects similar to the current ROSCO model.⁸⁸ HSBC also pointed out that the DfT was already well advanced in its consideration of various alternative procurement models and that the effect on competition would be similar to section 54 undertakings.⁸⁹ Porterbrook also noted that different types of financing methods were already currently being considered and this would happen as a matter of course in any case.

Our assessment

234. The assessment of alternative procurement methods as a remedy is similar to section 54 undertakings, although their effectiveness may differ to some extent depending on the particular components of the alternative procurement arrangements. These arrangements may also potentially lead to lower overall leasing rentals throughout the asset's life; however, we are unable to determine whether this is likely to be the case.
235. Alternative procurement methods may also result in greater use of section 54 undertakings. Section 54 undertakings, or long-term leases otherwise guaranteed by alternative procurement methods, are both likely to have a detrimental effect on competition in that they restrict the potential for competition at future franchising rounds to challenge this rolling stock, or for it to compete with other rolling stock. It would also further restrict the choice of rolling stock open to TOCs.

⁸⁸Angel response to Remedies Notice, paragraphs 93–96.

⁸⁹HSBC response to Remedies Notice, paragraphs 7.27–7.29.

Provisional decision—alternative procurement arrangements

236. We consider that the use of alternative procurement arrangements may in particular circumstances limit the detriment from the AEC, and it may provide opportunities for franchising authorities to secure greater value for money. However, this remedy may also have a negative effect on competition. We note that franchising authorities are already assessing the use of alternative procurement arrangements and they are best placed to consider the effect on rolling stock. However, any benefits should also be carefully weighed against the wider impact that these arrangements may have on competition for the leasing of rolling stock.

Category C: Remedies which address the detrimental effect on customers by controlling outcomes

237. In this section we consider remedies which would address the detrimental effect on customers of the AEC by controlling outcomes through a price control. For the reasons set out below, we consider that a price control remedy would create distortions with significant adverse consequences in the market; it would not address detriment effectively; and would not be practicable to implement.

C1. Price control

Rationale

238. A price control, provided it can be set on clear and justifiable parameters, directly addresses the nature of the customer detriment we have identified and could potentially be put in place with immediate effect, before re-leasing occurs.

239. We considered two alternative proposals for a price control put forward by the DfT:
(a) an 'active' price control, where the ROSCOs' credit/profit margin would be capped at the competitive level prevailing in the market for new rolling stock; and

(b) a strengthened Codes of Practice to require disclosure of information to the DfT/TOCs and to allow an independent expert to determine a 'fair' rental in the event of a dispute between the parties to a lease.

240. In addition, we identified and considered a third variant on a price control. This was a modification to the Codes of Practice requiring ROSCOs to provide objective cost-based justification for rental increases on MOLA rolling stock, with the TOCs able to challenge the basis for the increase by referring it to an adjudicator.

241. We consider further detail on the rationale, scope and timing of each of these proposals in the remainder of this section.

The DfT's price control proposals

242. The DfT proposed that ROSCOs' ability to set rentals at lease renewal should be constrained because a competitive environment was unlikely to prevail in respect of both existing rolling stock and 'additions to existing stock'. It stated that a price control (whether an 'active' price control or a strengthened Codes of Practice) should apply as follows:

- (a) It should apply at lease renewal for all existing stock (ie MOLA stock and any stock that has been introduced since privatization).
- (b) It should apply to new stock introduced to expand or supplement an existing fleet (eg new vehicles introduced to the current Pendolino fleet). In this situation, price control would apply at first lease as well as at lease renewal.
- (c) It should apply at lease renewal (but not at first lease) for all other new stock introduced to the network (ie new vehicles that are not introduced to expand or supplement an existing fleet).

243. The DfT submitted that in order to determine that a lease price was 'fair', transparency was required in 'key variables', which it put forward as 'the opening asset value, amortisation/asset life assumptions, risk free interest rate, debt/equity split, taxation and capital allowances, credit/profit margin and premium for short lease if applicable'.
244. The DfT proposed two alternative approaches to delivering such 'fair' prices, ranging from the CC specifying by order an 'active' price control to a strengthened Code of Practice.
- (a) 'Active' price control*
245. The DfT suggested that one approach would be for the CC to specify by order how ROSCOs should set prices for all such leasing situations described in paragraph 241 and allow the ORR to monitor and enforce the carrying out of such an order. Under such an approach the CC would need to establish the key input variables described in paragraph 242.
246. In doing so, the DfT proposed that the CC could establish the base asset value through applying the purchase price less an allowance for capitalized monopoly profit, as the CC had assumed as a sensitivity in its analysis of asset values. It would then be possible to build upon the precedents in the regulated utilities to deduct amortization and add capital expenditure to arrive at the relevant asset value at any point.
247. The DfT considered that under this approach the credit/profit margin should be capped at the competitive level prevailing in the market for new rolling stock.

(b) Strengthened Code of Practice

248. The DfT also described a less interventionist approach in which the existing Codes of Practice could be strengthened to recognize the role of the DfT in the industry and to require disclosure of the key variables described in paragraph 242 at the time lease rental proposals were put forward. The strengthened Codes would also be made binding.
249. The DfT proposed that, under this approach, if the parties were unable to agree that a proposal reflected the rental which would prevail in a well-functioning market, they should have recourse to an independent expert, appointed by the ORR. The independent expert would then make a binding decision on the level of rentals that should prevail.
250. This approach would generally see lease rentals re-set only at the point of re-lease, thus delaying the removal of any consumer detriment.
251. The DfT identified a specific variant to this approach in terms of the timing of its implementation: the ROSCOs, as well as each entering into a strengthened Code of Practice, would be ordered by the CC to re-set their current lease rentals within a set period following the CC's final report, with transparency for these lease rentals as required by the strengthened Codes. The DfT and TOCs would be permitted to challenge these reset lease rentals by referring matters to the independent expert.

A further variant on price controls

252. An alternative remedy which we considered is a modification to the Codes of Practice so as to require the ROSCOs to provide objective cost-based justification for rental increases, with the TOCs able to challenge the basis for the increase to an adjudicator. The remedy would only apply to all MOLA rolling stock and so would expire at

the end of the life of the MOLA rolling stock. There would be an adjudicator in the event of a dispute between the TOC and the ROSCO.

253. The rationale for this remedy is different from the DfT's proposals because it would not meet the DfT's stated objective of reducing current rentals. However, by restricting rental increases of MOLA rolling stock, it would prevent the ROSCOs making a return substantially in excess of the WACC when rentals are reset in future franchise rounds.
254. This remedy is also different in design from that put forward by the DfT because it would have the following features:
- (a) It would be limited to MOLA rolling stock, which was let on the basis of one Master Lease with lease rentals established on the basis of a full life assumed flat rental, as explained in the Hambros Information Memorandum.⁹⁰
 - (b) It would take effect when MOLA fleets come up for re-lease and would expire with the retirement of the MOLA fleets. It is therefore inherently limited in the period of time it would have effect and it would fall away over the medium-term period during which the other remedies we have proposed take effect.
 - (c) It would only involve examination of rental increases and not the reasonableness of the current rental level.

What we were told

255. The DfT told us that, given its view of the other remedies as ineffective or disproportionate, the AEC could only be addressed properly through constraining ROSCOs' ability to set rentals at lease renewal. The DfT told us that it considered that the approaches it proposed were practical and proportionate and could draw

⁹⁰The Hambros Information Memorandum contains information on each of the ROSCOs, including financial projections, prior to their sale at privatization.

upon established practice in other sectors. It considered that the burden of administering them would be significantly outweighed by their effectively addressing the customer detriment.

256. None of the ROSCOs was in favour of a full price control remedy. Angel was opposed to any form of price control. It submitted, on the basis of its profitability and cost of capital analyses, that there was no consumer detriment in this market and that in any event potential for detrimental effects in this market meant that price control was an inappropriate remedy. In addition, Angel submitted that price control would lower investment incentives and that there were considerable practical difficulties in devising an appropriate price control.
257. Porterbrook told us that the DfT's independent expert proposal would be unworkable. It said that it was unclear how an independent expert would be capable of determining a fair and robust level of rentals at all, let alone in a sufficiently timely manner, in circumstances where the CC had concluded that the level of uncertainty in determining the necessary parameters was fraught with exceptional problems.
258. HSBC considered that the DfT's proposal could have potentially even greater adverse effects on the market than a more formal price control arrangement. HSBC said that, given the CC's difficulty in reaching any firm conclusion on the appropriate return and how to calculate it, it would be wholly inappropriate for the CC to pass responsibility for making such assessments to a third party, the independent expert, who would not have the same time and resources available to it as the CC has had.
259. The TOCs' comments on transparency of lease rentals are set out in paragraph 141. In terms of the introduction of an independent expert, Govia said that the proposal for an independent expert to handle disputes on rental rates was worth further consider-

ation and National Express said that, as a last resort, independent valuation could be of benefit.

Our assessment

260. If a price control could be effectively designed, it would:
- (a) be timely because it could potentially be implemented earlier than the next re-lease of rolling stock, the great majority of which is leased until 2012 or beyond; and
 - (b) directly address the detriment arising from the AEC rather than the AEC itself.
261. However, we identified a number of factors which raise significant concerns over the effectiveness, practicability and proportionality of a price control implemented in any of the formats described in paragraphs 242 to 254. These issues comprised significant distortionary effects in the market, severe practical difficulties in implementation of the price control, and considerable uncertainty over the size of detriment the price control was intended to remove. We consider each in turn.

Distortionary effects of a price control

262. Implementation of a price control would distort and/or reduce competition in the market and weaken price signals, thereby disincentivizing investment in rolling stock and discouraging entry. This may also have the consequential effect of increasing funding costs for rolling stock:
- (a) Implementation of an 'active' price control (such as the one proposed by the DfT) would be likely to reduce price competition (to the extent that it exists) at re-leasing.
 - (b) All variants of the price control will dampen price signals to some extent such that prices will not be able to adjust freely to those we would expect to see in a well-functioning market. In particular, as ROSCOs operate portfolios of rolling stock,

there is an expectation that some rolling stock will earn higher returns and some will earn lower returns. Controlling prices at re-lease limits the potential for higher returns and so may lead to an increase in initial lease rentals. This lack of upside would disincentivize further investment by the ROSCOs and also potentially deter new entrants. If a ROSCO felt that the controlled price was too low it may also seek to sell the stock abroad or withdraw it from service.

- (c) The removal of potential upside gains would lead to a higher cost of capital, either through a less highly-g geared capital structure or a higher cost of debt. Furthermore, under a price control, the cost of capital is likely to be set more prudently (ie higher) by a regulator, so as to ensure that rolling stock investment can be financed, than by the CC in attempting to measure profitability in a market inquiry.

Practical difficulties in setting a price control

263. There are also substantial practical difficulties in designing and setting an effective price control. These practical difficulties would not only increase the direct cost of the remedy, but would also increase the risk that detriment was not accurately remedied.
264. The most significant design issue arises in assessing the variables required to set the appropriate level of prices. This problem arises in different degrees whether there is an 'active' price control equation or an independent expert to adjudicate on fair prices, or an 'objective cost based increase' control. In terms of the variables that require estimation:
- (a) Some (such as estimating the return required to cover residual value risk) would be based on unverifiable views of future market and economic developments. In this respect, the rolling stock market is crucially different from other regulated industries, where stranding risk is very low indeed. In order to understand stranding risk, there would need to be an ongoing assessment of asset values,

residual value risk and asset condition risk. This would be likely to lead to considerable information asymmetries between the ROSCOs and any regulator or independent expert.

- (b) Some (such as cost of capital) would require substantial work from experts, which would be both time consuming and costly, and would need to be revisited for each lease.
- (c) Some (such as additional capital expenditure on trains and the amortization period of this expenditure) would require detailed explanation by the ROSCOs, and this would also require external audit.
- (d) Some (such as ascribing the asset value to each MOLA fleet) would be extremely difficult to determine. Our inquiry has been unable to determine more than a rough estimate of this value, and valuations by independent experts have varied considerably in quantum and methodology.
- (e) Some (such as making comparisons with the new rolling stock rate of return over WACC) would need to assume that new and used rolling stock faced identical risks. Alternatively, if the price control were based on a utility-adjusted new build rental (ie an indifference price), it would involve significant problems in determining the adjustment needed to reflect the used rolling stock's functionality. In relation to either approach, it is unclear, given the relative infrequency of new rolling stock procurements, how items such as lease length, fleet type, existence of section 54 undertakings, TOC counterparty and any unique features of the trains could be controlled for when determining the price control level.

265. In the absence of an agreed methodology for establishing a fair valuation for these critical elements to a price control we do not see how an acceptable price control, providing a demonstrably 'fair' return on capital, would be arrived at by an appointed regulator or independent expert. In addition, the complexities of the relevant variables

are such that a considerable level of resources would be required whether implementing an 'active' price control or using as an independent expert.

266. We also identified significant issues in setting the scope of any price control:

(a) As the competitive dynamics at each lease negotiation can vary, a separate price control process would need to be undertaken for each lease. Where fleets are subsequently split between franchises the pricing would also need to be revisited as the residual value risk would have changed. We think that the level of granularity required to undertake this assessment, whether it be in the form of an 'active' price control or an independent expert, would impose a significant regulatory burden on the ORR and the ROSCOs.

(b) Rolling stock older than 30 years would have a very low rental charge under some forms of price control (ie if margins were controlled), since it would be assumed to have minimal value. This could lead to ROSCOs scrapping serviceable old rolling stock, and also reducing maintenance and capital expenditure on rolling stock approaching the end of its life.

(c) There would be difficulties in distinguishing maintenance costs and capital expenditure. If maintenance charges are excluded from the price control, ROSCOs would have a strong incentive to classify capital expenditure as maintenance costs. Alternatively, there may be incentives to describe expenditure as capital expenditure so as to increase the regulatory asset base on which the WACC would be applied. These effects may also distort ROSCOs' expenditure decisions.

Proportionality of a price control

267. A price control remedy seeks to remedy the detriment arising from the adverse features rather than the features themselves. However, as we noted in provisional findings, our profitability analysis does not provide an estimate of detriment. In the

absence of any precision over the size of the detriment, a price control with the objective of reducing or eliminating any customer detriment would not be a proportionate remedy.

Provisional decision—price control

268. In our Notice we said that, in view of the scope of the detriment that we had identified, the practical difficulties of creating and maintaining a control and the possibility that new distortions would be introduced into this market, we were strongly minded not to pursue a price control remedy. Having considered the DfT's price control proposals in detail, we have provisionally concluded that they would be ineffective, impracticable and disproportionate. In addition, we have provisionally rejected a third approach to a control on price increases of MOLA stock because it would have a distorting effect on the market and similar (but to a lesser extent) practical difficulties. Moreover, this remedy proposal would only be addressing MOLA rolling stock at re-lease as opposed to all rolling stock at re-lease.

Conclusions on remedies

Remedies we are proposing

269. For the reasons given above, we have provisionally concluded that the following remedies should be implemented:

- A recommendation to the relevant franchising authority that it should, where appropriate, consider granting franchises in the region of 12 to 15 years or longer, so as to provide greater incentives for TOCs to consider a wider variety of rolling stock including new rolling stock.
- A recommendation to the relevant franchising authority that it should take account of the benefits of proposals for alternative and new rolling stock over periods beyond the life of the franchise term and across other franchises (eg where proposals may carry implications for rolling stock to be used on other franchises).

This would increase the incentives for TOCs to consider alternative rolling stock and spread the switching costs over a longer period.

- A recommendation to the relevant franchising authority to relax specifications in franchise ITTs as far as is practicable and where appropriate place greater emphasis on specifying franchise outputs not inputs, whilst still recognizing its need to ensure that appropriate rail services are delivered. This would encourage TOCs to consider and propose alternative rolling stock solutions, and thus increase competitive pressure on the ROSCOs.
- An Order or accepting undertakings to remove the non-discrimination requirement from the Codes of Practice, creating greater incentives for TOCs to negotiate.
- An Order requiring rolling stock lessors to provide TOCs with a set list of information which would enhance TOCs' ability to negotiate with ROSCOs.

270. The implementation of the first three remedies identified above would require the relevant franchising authority to evaluate proposals flexibly. These remedies could be implemented by the relevant franchising authority in several different ways. For example, when implementing longer franchises, the relevant franchising authority could:

- (a) adopt a longer franchise period in the franchise ITT following appropriate industry consultation;
- (b) ask for bids on two base cases—one covering a shorter franchise period and one covering a longer franchise period; the relevant franchising authority could then assess which of these alternative solutions best met the franchise evaluation criteria;
- (c) ask that bidders who wish to introduce alternative used or new rolling stock put forward a proposal for the appropriate franchise length in light of the investment proposed; or

(d) initially invite bids for the franchise length and then re-tender on the basis of a specified franchise length, with bidders being given appropriate credit for any alternative used or new rolling stock proposals they made in the initial bids.

271. Alternatively, when implementing a longer-term assessment of the benefits of rolling stock, the relevant franchising authority could:

(a) ask for two base cases at the start of the franchise bidding process—one based on its existing approach and the other which would be based on the replacement of one or more fleets with alternative used or new rolling stock;⁹¹ it could then assess which of these alternative solutions best met its evaluation criteria (which would take into account the benefits of alternative rolling stock beyond the franchise term);

(b) use a standard pro-forma approach so that bidders that wish to introduce alternative used or new rolling stock forecast the benefits that would accrue beyond the franchise term from the introduction of the alternative rolling stock. The relevant franchising authority would then commit to assess these as part of the franchise bid and bidders would be given appropriate credit; or

(c) proceed as in (b) but ask all bidders to reformulate their bids on the basis of the alternative rolling stock where the relevant franchising authority considered that there were benefits beyond the franchise term. TOCs would still have an incentive to propose the alternative rolling stock because they would be credited for doing so after initial bids (albeit the incentive would be less than in approach (b)).

272. We consider that implementing these remedies and creating a more flexible evaluation of franchise bids will require a longer period for TOCs to prepare their bids

⁹¹The DfT has used priced options before (West Midlands Snow Hill lines for additional services) but the franchise was awarded on the base case; and it has used an 'alternative base case' (New Cross Country) but it considers that this leads to increased bidding costs for bidders, the DfT and Network Rail and adds complexity to the bidding process.

after shortlisting, and is likely to require a longer period for the relevant franchising authority to evaluate these proposals. The relevant franchising authority would need to take a view as to what was appropriate to each case. In addition, there may be a need to consider other aspects of the franchising process. These include the frequency of performance review periods within franchise terms and the structure of the cap-and-collar mechanism.

Effectiveness of the package of remedies

273. We recognize that none of these remedies on its own will have the effect of fully remedying the AEC we have identified or its consequences. Each of the remedies will mitigate the AEC and/or detriment, and when taken together, we consider that the package of remedies will achieve as comprehensive solution as is reasonable and practicable to the AEC and/or the customer detriment arising from the AEC.
274. We consider that the remedies we have provisionally decided to adopt are mutually reinforcing in creating a market where there is greater flexibility to adopt alternative rolling stock solutions, switch rolling stock or introduce new rolling stock. For example, looser ITT specifications would allow TOCs to propose different methods of delivering rail services. Our other measures would increase TOC incentives to consider different solutions, for example by adopting longer franchises and/or assessing the lifetime benefits of new or alternative rolling stock. To be fully effective, these remedies would also require a franchise bid appraisal process that is flexible enough to enable the relevant franchising authority to evaluate and give appropriate credit to alternative proposals.
275. We believe that this greater flexibility will increase options for TOCs, increasing their choices, and also increase competitive pressures on ROSCOs, because of an increased risk of displacement of incumbent fleets by new or alternative fleets. Our

proposals on transparency will also allow the TOCs to challenge the ROSCOs on changes in rental rates, such that it becomes clearer whether rental changes are supported by objective cost justifications.

276. In total, we believe that these measures should help to restrict the ability of ROSCOs to exploit market power which may arise on occasions, due to the nature of the industry, the restrictions on technical interoperability of rolling stock; the balance of supply and demand and the properties of the franchising system, which may otherwise limit opportunities for competition in many cases.
277. We consider that the remedies in this package are the most likely, of the practicable remedy options available, to be effective in remedying, mitigating or preventing the AEC that we have provisionally found. We do not include, for example, a price control in this set of available remedies because we do not consider that a price control would be practicable.
278. The extent to which these measures will remedy the AEC depends in part on the extent to which the relevant franchising authority may find it appropriate to implement our recommendations in the context of its overall policy objectives and the broader implications for franchising (see paragraphs 286 to 293).⁹² It will also depend on future developments in the rail industry. Against this background, government policies on railway transport and practices in relation to franchising may evolve and develop over time such that the ability and willingness to enact our recommendations may also change in the future.

⁹²We recognize that in some ways the ability of competition to provide market solutions to the leasing of rolling stock which occupies a unique position in a highly regulated and Government supported industry is always going to be subject to constraints.

279. We have not identified alternative remedies which we consider to be workable and effective in addressing the AEC.

Timing of implementation

280. The DfT put it to us that it was important that the higher rentals for rolling stock arising from the AEC were remedied as quickly as possible, and that only a price control remedy could be rapidly implemented. Our guidelines say: ‘The Commission will tend to favour a remedy that can be expected to show results in a relatively short time period—so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.’⁹³

281. For the reasons given above (paragraphs 262 to 267), we do not believe that a price control remedy would be desirable in principle, nor practicable to implement. Many of the other remedies will not become effective until franchises are re-leased, and so the pace at which the existing AEC is remedied could be slow. However, there may also be opportunities to introduce greater competition when franchises and leases are renegotiated in order to accommodate new and cascaded rolling stock under the rolling stock plan, particularly if during this process TOCs can exercise greater choice.

282. We have not been able to identify practicable and proportionate measures that could take effect more quickly.

Means of implementation

283. The following proposed remedies would be implemented through a recommendation to the relevant franchising authorities to take action:

- consideration of longer franchises;

⁹³CC3, paragraph 4.16.

- relaxation of the specifications in the franchise ITTs; and
- consideration of lifetime benefits of rolling stock where appropriate.

284. Our guidance notes that, in circumstances where the CC is recommending that action be taken by others there will inevitably be uncertainty over whether the recommendation will be accepted and over the time period before which it will be implemented. In this case, we are making recommendations to the relevant franchising authorities because of their central role in the rail franchising process and because of our lack of relevant order-making powers.

285. Our other two remedy proposals could be implemented by the CC itself:

(a) To implement the remedy for increased transparency of lease rentals we would make an Order to require all rolling stock lessors to provide TOCs with a set list of information on each lease rental proposal.

(b) The non-discrimination clause in the Codes of Practice would be removed either through an amendment to the Codes of Practice, by Order or through accepting undertakings.

Assessment of relevant customer benefits

286. We considered whether we should modify any of our remedies in light of any relevant customer benefits accruing from the five features we have provisionally identified (as set out in paragraphs 22 to 29). In considering relevant customer benefits, we identified both the TOCs and the franchising authorities as customers.

287. Although we did not receive any specific claims that relevant customer benefits accrued from any of the features identified in our provisional findings, we received some submissions stating that the remedies we were considering could have certain adverse effects. In light of these comments, we considered whether there were any

relevant customer benefits within the meaning of the Act (section 134(8), as described in paragraphs 34 and 35).

288. We first considered whether the remedial action the CC was proposing to take itself would affect any relevant customer benefits.
289. We did not identify any relevant customer benefits that may be affected by the remedy to increase price transparency.
290. We considered whether the removal of the non-discrimination clause in the Codes of Practice could affect any relevant customer benefits. We examined whether any benefit had resulted from the TOCs' lack of incentive to negotiate, in particular because of the non-discrimination clause. We also considered whether there was a customer benefit in terms of lower franchise subsidies or higher-quality service because of a larger number of franchise bidders, as a result of the non-discrimination clause encouraging smaller TOC-owning groups or new entrants to bid for a franchise. We have seen no evidence to indicate that the non-discrimination clause gave rise to these customer benefits, and we thought that such benefits could be attained in other ways than through the non-discrimination clause.
291. We also considered whether our recommendations to franchising authorities affected any relevant customer benefits. In particular, we looked at whether there were any customer benefits stemming from the way the franchise system operated. We were aware that the way in which the franchising system operated may have an effect on price, quality, choice and innovation. We do not believe that longer franchises or relaxed specifications would necessarily result in higher franchise subsidies/lower premiums and/or lower service quality. For example, longer franchise periods may give the TOCs greater scope to introduce innovations which raise service levels

and/or reduce costs. However, due to the varying aims and wider policy objectives of the franchising system, we were not able to determine whether any possible benefits as to how the current franchising system operated were relevant customer benefits within the meaning of the Act.

Conclusions on relevant customer benefits

292. We believe that the franchising authorities are the most appropriate bodies to make the judgement on how the franchising system should operate and therefore to judge whether any of our recommendations would adversely affect any relevant customer benefits accruing from the features relating to the franchising system. We believe that the franchising system could be designed in such a way so as to avoid the proposed remedies having an adverse consequence on any customer benefits.

Next steps

293. This provisional decision document serves as the basis for the consultation on our provisional decision on remedies and the revisions to the features identified in our provisional findings. Any responses to this consultation should be submitted to the CC by 5pm on Friday 16 January. Any responses received will be taken into account in our final report.

Analysis of specification

1. In this annex we set out in more detail our analysis of specification based on assessment of franchise bids and submissions by the TOCs.

Direct specification

2. On direct specification, we identified three broad types of direct specification in our provisional findings:¹

(a) *Restriction of use to incumbent vehicles (3,498 vehicles or 30 per cent of incumbent vehicles on these franchises)*. These instances comprised:

- (i) *Rolling stock specified following an early franchise termination (2,110 vehicles, 18 per cent)*. In our provisional findings, we considered that, irrespective of whether TOCs would have chosen alternative rolling stock, a franchise re-let was only created by a previous franchisee's failure so the use of specification here is a direct result of the DfT fulfilling its section 30 duty.² A relaxation of this type of direct specification is therefore *not* likely to be helpful as they relate to cases of TOC failure and usually involve continuation of the existing leases in any event (often through section 54 undertakings).
- (ii) *Rolling stock specified because it is covered by a section 54 undertaking (1,281 vehicles, 11 per cent)*. In this case, it is possible that the DfT could choose not to specify the rolling stock, but it would then be faced with the challenge of trying to find a lessee for the rolling stock in order to fulfil the section 54 undertaking. We considered whether relaxed specification would have made any difference in the three instances where rolling stock has been specified due to section 54 undertakings: [REDACTED].

¹See Tables 2 and 3 in [Appendix 2.1](#) in our provisional findings.

²On Integrated Kent, all three bidders stated that the section 54 undertakings on the rolling stock constrained their choice. They did not state what rolling stock they would otherwise have chosen, although one bidder investigated use of Class 458s and new rolling stock.

(iii) *Rolling stock specified as franchise assets*³ (85 vehicles) are part of the franchise and are non-ROSCO owned vehicles so are not particularly relevant here.

(iv) *Rolling stock specified for other reasons* relate solely to 22 Class 175 vehicles specified on Wales and Borders.⁴ The DfT told us that the only incumbent vehicles that matched the characteristics of the Class 175s were the Class 158s, so it is possible that some competitive pressure could have been placed on the Class 175s absent specification.

(b) *Specification of vehicles to be replaced or cascaded out* (1,471 vehicles, 13 per cent of incumbent vehicles). These instances comprised:

(i) *1,304 vehicles required to be replaced as part of the Mark I replacement programme*. Specification of these is clearly vital to fulfil health and safety requirements.

(ii) *143 vehicles on TransPennine to be replaced by new rolling stock and 24 Class 150 vehicles on ScotRail which were to be replaced by new Class 170 vehicles*. In each case the vehicles were to be replaced by new rolling stock. On TransPennine the whole fleet was to be replaced as part of a step change in service levels so the specification is unlikely to have had much of an effect. On ScotRail, the Class 170s could have replaced Class 150s, 156s or 158s. Although the Class 150s would be the obvious vehicles to replace, it is again unclear as to why bidders were not left to decide particularly given the shortage of DMUs at the time. This might have created competitive pressure at the margin across all DMU fleets.

(c) *Restriction of choice in terms of alternative rolling stock that could be taken on*.

These instances comprised:

³These are rolling stock owned by the franchise and not by the ROSCO.

⁴In this case, the Class 175s were specified to keep costs down. See [Appendix 2.1](#) in our provisional findings, footnote 35.

- (i) *Specifying new rolling stock (1,355 vehicles, 13 per cent of vehicles)*. In the cases where these did *not* relate to Mark I replacement (these franchises were TransPennine and ScotRail as mentioned above and also Chiltern and Integrated Kent, covering 436 vehicles), specification of new rolling stock may send a distortionary signal to the market that these are the only circumstances in which new rolling stock should be considered.
- (ii) *Exclusion of new rolling stock*. This has occurred primarily because of the DfT's plans for IEP (on the Greater Western franchise and ICEC franchises in 2005 and 2007), and also on two other occasions: Wales and Borders and Thameslink/Greater Northern. In total, the ruling out of new rolling stock effectively specified 1,712 vehicles.⁵ Stagecoach considered purchasing Class 222s to replace Class 180s and HSTs on the Greater Western franchise. It did not do so, because, among a number of reasons, the DfT bid instructions limited the number of HSTs that could be replaced. The other bidder, National Express, stated that it offered the Class 222s in an alternative option, but this was not considered by the DfT as it did not win the franchise on the base case. Govia told us that guidance by the DfT is the main factor influencing whether new rolling stock is included in its bid and GNER stated that explicit or implicit conflict with specification was the key reason for not deploying new rolling stock, such that it would have proposed new build on both ICEC franchises but for the ITT.

⁵This comprises all 619 vehicles on Thameslink/Greater Northern, the HSTs on Greater Western (444 vehicles), the HSTs on ICEC 2005 and 2007 (450 vehicles and 496 vehicles) and all 199 vehicles on Wales and Borders. Excluding the ICEC 2007 franchise which was specified for other reasons (and therefore avoiding double counting), this amounts to a further 1,712 incumbent vehicles (15 per cent) that were effectively specified by ruling out new rolling stock.

Indirect specification

3. We again examined TOC bid submissions for comments that suggest that alternatives might have been put forward in the absence of specification in the Service Level Commitment. We found the following examples:
- (a) Northern franchise—First commented that it had not proposed new DMUs because ‘an assessment of such new units against the service criteria specified in the ITT has shown that, in all other respects, the benefits are likely to be minimal given the nature of the Northern operation.’
 - (b) Intercity East Coast 2005—the ‘Variant 2 timetable descriptor’ specifies an assumed train length of HST 2+9 or Class 91 2+10. Virgin also noted that five-car and nine-car Meridians were non-compliant to the ITT on seating capacity in comparison to the HSTs.
 - (c) On the TransPennine franchise, First/Keolis stated: ‘we have seriously considered the alternative of a small number of new trains in 2004/05 and completing the entire replacement later on in the franchise in 2008 but have strongly discounted this option and we do not believe it meets stakeholder requirements’. It is not clear what is meant by ‘stakeholder requirements’ but it is clear that the ITT is restricting the choice of the TOC.
 - (d) On the Greater Western franchise, Stagecoach weighed up replacing the Class 180s with HSTs or new rolling stock but found that it was not able to do so given the need to operate 52 diagrams instead of 47 (which compared to the 36 diagrams prior to franchise re-let).
 - (e) On the East Midlands franchise, National Express’s bid noted that the Class 180s could have been alternative but ‘with this reliability level 11 diagrams could be covered with consistency from a fleet of 14 but a fleet of 14 is insufficient to meet the full Mainline diagram requirement of 13 per SX day’.⁶

⁶National Express added that only 14 units were built and the production line had been dismantled.

- (f) On the West Midlands franchise, Govia's bid stated that 'Class 170 units could potentially operate these Snow Hill routes, however, while sufficient vehicles are available to lease, we believe it is unlikely that enough could be leased without impacting on the deliverability of the New Cross Country franchise'.
- (g) On the New Cross Country franchise, Virgin's bid stated that 'we have considered every possible vehicle type and suitability that could be used on all or any part of the route network of services. Many fail because they are unable to meet elements of the SLC2 timetable or meet the capacity requirement. Many of the options fail because they do not represent value for money or because they represent a performance risk not only at the start of but also throughout the NCC franchise life'.
- (h) On the Intercity East Coast 2007 franchise, National Express's bid stated that '125mph 5-car diesel Class 180s would need to operate in multiple to meet ICEC seating requirements'.

4. We also asked the TOCs to comment on further examples where they felt indirect specification had limited choice:⁷

- (a) National Express stated that it had never experienced the problem of indirect specification and Arriva gave no specific examples.
- (b) Chiltern noted that the requirement (perceived or stated) to use certain depots had been an issue, for example the Tyseley depot on the Midlands Three franchises.
- (c) Stagecoach submitted that the East Midlands franchise provided a 'broad hint' that the Class 222 rolling stock should be used. It stated that (i) the fast Sheffield path in the ITT was timed for Class 222 traction and (ii) the ITT required splitting and joining at Leicester which meant that an HST timetable was not really

⁷In its response to the ORR (question e) in 2006, GNER submitted that 'In all franchises the detailed train service timetable specification restricts the range of suitable rolling stock solutions'.

possible. Stagecoach noted that it was able to offer a variant within the base case and that it did not necessarily disagree with the DfT's reasons for such specification.

(d) First, although not providing specific examples, submitted that the DfT's approach to the construction of the Service Level Commitment necessarily tended to lead to an expression of the specification in terms which reflected the existing timetable and rolling stock. It noted that journey times, capacity and 'dwell time' specifications had all restricted rolling stock choice in the past.

5. We also asked the TOCs which aspects of the Service Level Commitment could be less specific:

(a) National Express commented that as Service Level Commitments were based on the existing operating timetable, there was a presumption towards the existing rolling stock. The minimum journey time could therefore be relaxed to allow slower trains to be considered.

(b) A former TOC employee submitted that specification could be as detailed as providing for the number of seats leaving and/or arriving at a given station within a given time period, with a set number of services in the same time period. In combination, these requirements could narrow the choice down to only one type of train.

(c) Arriva noted that the maximum journey times of the Service Level Commitment typically ensured that only rolling stock with at least as good acceleration and maximum speed as the incumbent fleet could be used. It further added that the DfT's concern that services should not be worsened for any passengers led to continued specification of calls at certain minor stations by long-distance trains, resulting in a less attractive service for the majority and poorer financial offer for the franchise.

- (d) Chiltern commented that specification should be restricted to an outline timetable (dictating speeds, stopping patterns and dwell times) and the required capacity (percentage standees). In its view, the number of vehicles should not be specified as different classes had different capacities. It also noted that capacity calculations should be made clear so bidders could consider alternative fleets.
- (e) Stagecoach noted that this issue was beyond the scope of our inquiry but commented that only broad specification should be set for intercity routes (first and last trains and a very minimum frequency) with greater specification for commuter and regional routes (although the timetable should not be 'hard wired').
- (f) First commented that any relaxation in ITT specification would result in a transfer of risks to franchisees. It considered that an alternative approach was to allow more flexibility in service or fleet variations during a franchise to allow for changes in market conditions.
- (g) Govia submitted that the DfT could provide more proactive statements to encourage alternative used or new rolling stock.