

**COMPETITION COMMISSION  
MARKET INVESTIGATION ON  
ROLLING STOCK LEASING**

Government response to  
the Competition  
Commission's report,  
"Rolling Stock Leasing  
market investigation"

JULY 2009

## **Introduction**

1. This document sets out the Government's response to the recommendations made by the Competition Commission (CC) in its report "Rolling Stock Leasing market investigation", which was published on 7 April 2009.

## **Background to the industry**

2. Passenger rolling stock in the UK is predominantly owned by three rolling stock leasing companies (ROSCOs): Angel Trains Limited, HSBC Rail (UK) Limited and Porterbrook Leasing Company Limited. The ROSCOs were created at privatisation to own the fleets of ex-British Rail passenger vehicles, which are leased to train operating companies (TOCs).

3. The Secretary of State for Transport (Secretary of State) has responsibility for ensuring the provision of appropriate rail services in England and Wales. The Secretary of State and the Department for Transport (DfT) have certain objectives and obligations in relation to railways, in particular ensuring the delivery of a safe, reliable and efficient rail service which delivers value for money for taxpayers, and is affordable. Scottish Ministers have responsibility for the award of future ScotRail franchises, and Welsh Ministers are now co-signatories to the Wales and Borders franchise.

4. The rolling stock leasing market is crucial to the provision of rail services, and the lease costs of stock account for a significant portion of overall rail funding – at a cost of around £1 billion per annum. As with all rail expenditure, these costs are met from two sources: government subsidy and passenger revenue. DfT therefore has a significant interest in ensuring that rolling stock leases are set at a fair, competitive level in order to protect both the taxpayer and the passenger.

5. However, DfT also has a wider role in respect of the rail system as a whole. DfT has a duty to ensure that rail services are appropriately designed, procured and managed to meet the needs of passengers and the wider economy, while delivering good value for the taxpayer. Therefore, when considering any changes designed to improve competition in the rolling stock leasing market, there are also other issues which DfT is bound to consider. The criteria for DfT in discharging its rail functions will continue to be overall value for money, affordability and the need to meet wider transport objectives. DfT is also operator of last resort under the terms of section 30 of the Railways Act 1993.

6. The Office of Rail Regulation (ORR) is an integral part of the industry structure as the combined economic and safety regulatory authority, and is a non-ministerial government department operationally independent of central government.

## **Background to the enquiry**

7. Following its White Paper, "The Future of Rail" published on 15 July 2004, DfT undertook a fundamental review of the structure and organisation of the rail industry. One of the conclusions of the review was that competition for the leasing of passenger rolling stock had not developed as anticipated at the time of privatisation, which suggested that rentals were higher than they would be in a competitive market. Whereas at privatisation it was envisaged that there would emerge a secondary leasing market in rolling stock that would provide competition for incumbent stock, the reality is that passenger numbers have increased strongly and, fundamentally, there is a lack of surplus rolling stock.

8. From March 2005 DfT embarked on a series of separate negotiations with the ROSCOs, focused on a reduction in lease prices to obtain better value for money, particularly for pre-privatisation fleets. Ultimately, however, no agreement was reached and in June 2006 DfT requested that the ORR make a market investigation reference to the CC under section 131 of the Enterprise Act 2002.

9. The ORR undertook a market study and on 26 April 2007 concluded that there were features which might prevent it from operating competitively and referred the market to the CC for an investigation. The CC conducted a thorough market investigation, including hearings with DfT, the ROSCOs, the ORR and the TOCs.

## **CC findings**

10. The CC identified an adverse effect on competition in the market for the leasing of rolling stock.

11. The CC concluded that competition is restricted by the limited number of alternative fleets available to TOCs when bidding for rail passenger franchises. The CC identified several factors which in combination have restricted the choice of rolling stock available for lease at the point franchises are being let, including: technical and operational factors which limit interoperability; costs and risks in switching rolling stock or introducing new rolling stock; and aspects of the way in which the franchising system currently operates. The CC said that TOCs have in many cases little incentive or ability to negotiate with ROSCOs and ROSCOs in turn have little incentive to compete with each other. While the CC did not provide a figure for the level of consumer detriment that arises from this, DfT's own analysis suggested that this detriment was very significant.

12. In order to address the adverse effect on competition that it identified, the CC made three recommendations to the franchising authorities (DfT and Transport Scotland) regarding franchising arrangements which are aimed at improving competition and choice in the market. The CC will also be requiring the ROSCOs to undertake certain other actions using its own powers under the Enterprise Act 2002. This document looks at each of the

recommendations aimed at DfT in respect of England and Wales. The Scottish Government will be responding separately to the recommendations aimed at Transport Scotland.

### **CC's recommendations to the franchising authorities**

13. As part of its package of remedies, the CC has made three "recommendations to the franchising authorities [DfT and Transport Scotland] to make changes to the franchise system, wherever consistent with their functions and objectives" (paragraph 59). These recommendations are as follows:

#### **Recommendation 1**

14. *"Introducing longer franchise terms of 12 to 15 years or longer" (paragraph 59). This is intended to allow TOCs to realise the benefits and recover the costs of switching to alternative new or used rolling stock over a longer period, which should increase the incentives and ability for TOCs to exercise choice.*

#### **Government response**

15. On the whole, DfT has favoured franchise lengths of around seven years with an option to extend this duration, if certain performance conditions are met, to ten years. This allows for regular testing of the market and so helps to secure best value. It also allows a reasonably frequent opportunity to seek innovation and new benefits for passengers in the competitive market.

16. The Government recognises that longer franchises could, in some circumstances, encourage bidders to propose replacement fleets, and that such proposals could improve the currently weak competitive pressure on lease prices. There have been cases when longer franchises have been used, for example in the case of the London, Tilbury and Southend franchise (currently operated by C2C) which was let for 15 years. In other cases a much shorter term would be appropriate. The South Central franchise, which was awarded in June this year, has a franchise term of five years and ten months in order to allow flexibility to redefine the South Central and Thameslink franchises in 2015, when the Thameslink infrastructure programme is complete.

17. DfT intends to make explicit this flexible approach. In future, DfT's franchise specification process will ensure that franchise lengths of over ten years are explicitly considered for each future franchise replacement. This will include a consideration of the likely impact on the rolling stock leasing market in each competition. DfT's intended franchise length will be set out in the franchise consultation document which is published by DfT during the development stage of franchise replacements. The views of industry and stakeholders will be considered before a final decision is taken.

18. However, as the CC recognises, DfT has a duty in discharging its rail functions to ensure that all issues are considered, not just the effect of its

actions on rolling stock competition. DfT must therefore consider the wider impact on taxpayers and passengers.

### **Recommendation 2**

19. *“Assessing the benefits of alternative new or used rolling stock proposals beyond the franchise term and across other franchises when evaluating franchise bids” (paragraph 59). This is intended to encourage a wider choice of rolling stock to be considered in franchise proposals, irrespective of franchise length.*

### **Government response**

20. The Government recognises there will potentially be some cases when including benefits arising after the end of the franchise, or on other franchises, as a factor in franchise award would encourage bidders to make proposals for replacement rolling stock. But DfT welcomes the CC’s recognition that DfT must also consider wider issues than competition in the rolling stock leasing market. And DfT notes that while the CC’s final report refers only to benefits, there will be costs from replacement fleets arising within and beyond the franchise which must also be taken into account.

21. Beyond-franchise benefits and costs are already routinely considered when DfT takes specification and funding decisions, for instance to directly specify and fund additional rolling stock units. This recommendation focuses on making wider / longer-term effects a factor in discriminating between franchise bids.

22. DfT will decide whether an appropriate mechanism can be developed for inclusion in the next scheduled franchise competition, the letting of the London, Tilbury and Southend franchise in 2011. In line with the CC’s recommendations, DfT would aim to make changes where they are consistent, in the round, with its functions and objectives. A final decision will be taken before the invitation to tender (ITT) is issued to bidders in 2010. This decision will be taken on the basis of overall value for money, affordability and wider transport objectives.

### **Recommendation 3**

23. *“Ensuring that franchise ITTs are specified in such a way that franchise bidders are allowed a choice of rolling stock” (paragraph 59). This is intended to allow all suitable stock to be considered, encouraging competition.*

### **Government response**

24. The Government endorses this approach and the CC’s recommendation that it be implemented *“wherever consistent with the franchising authorities’ functions and objectives” (paragraph 9.86).*

25. As a procurer of passenger rail services at considerable cost through franchising, it is right that DfT should specify the outputs that are purchased. DfT uses the franchise specification process to protect the quality of rail services. DfT agrees that franchises should be specified as loosely as

possible, consistent with the securing the right services for passengers and best value for money.

26. DfT intends to reach a judgement about the content of its ITTs on a case-by-case basis, in view of its functions and objectives and taking account of the CC's recommendations. It is DfT's current policy that direct instructions on rolling stock, or pointers that would tend to limit bidders' discretion, are only included in ITTs where there are strong reasons for doing so. DfT will ensure that this principle is carefully followed, and also that the potential impact on the rolling stock leasing market is fully considered in specifying ITTs in future.

### **CC's other recommendations**

27. The CC also made two recommendations that it has powers under the Enterprise Act 2002 to implement itself. These are:

- through Orders or undertakings requiring the ROSCOs to remove the non-discrimination requirement from the Codes of Practice, which would provide greater incentives for the TOCs to seek improved terms from the ROSCOs. Each of the ROSCOs is subject to a Code of Practice, drawn in similar terms. These provide that all customers can expect to receive fair and equitable treatment, and that any differences in the terms offered to individual customers (e.g. on rental rates, and other terms such as maintenance and modifications) need to be justifiable on fair and reasonable criteria. The Codes of Practice list the factors that the ROSCO may take into account in agreeing a rental;
- through Orders, requiring rolling stock lessors to provide TOCs with a set list of information when making a lease rental offer for used rolling stock, which would give TOCs the ability to negotiate more effectively.

28. The Government notes the CC's proposals to improve the ROSCOs' Codes of Practice by removing the non-discrimination requirement. The Government accepts that this may lead to an improvement in competition. However, there are also risks that some TOCs might be unfairly favoured or discriminated against, and DfT will monitor whether this is occurring.

29. The Government welcomes the CC's recommendation that there should be transparency provided by the ROSCOs as to how rentals are calculated. However, it is important that the transparency is real. The Government looks forward to discussing with the CC how the desired transparency may be achieved.

### **CC's rejection of price control**

30. It should be noted that the CC rejected DfT's proposals for price control. DfT proposed this because even if franchising measures to inject competition lead to lower rentals when buying, because of the few franchises being re-let in the short to medium term, such benefits are only likely to come

about in the long run. And yet, in the meantime, DfT's view is that there is substantial consumer detriment.

## **Conclusion**

31. The work that the CC has carried out makes clear that there are problems in the rolling stock leasing market which are having an adverse effect on competition, that ROSCOs in many cases have weakened incentives to compete on lease rentals, and that costs faced by TOCs (and hence taxpayers and passengers) could be higher than they should be.

32. The CC has suggested that changes to the franchising system would foster competition in the market, and recommends that the franchising authorities "make changes to the franchise system, wherever consistent with their functions and objectives." The Government welcomes this acknowledgement that in considering such changes, DfT would have to take account of a range of issues, not just the effect on the rolling stock market.

33. When franchises are being re-let, DfT will consider carefully the potential for stimulating competition in the supply of rolling stock, while recognising that this is only one of a number of factors which determine how franchises are best designed in the interests of passengers and taxpayers. For each franchise re-let, DfT will specifically consider franchise lengths of over ten years. DfT will also introduce changes to the franchise evaluation and award process to take account of beyond-franchise benefits, where this is consistent with its wider rail responsibilities. And DfT will ensure that the potential impact on the rolling stock market is fully considered in specifying ITTs in the future.

34. However, the Government notes that even if the CC's recommendations could be fully implemented and were successful in improving competition, there is no doubt that they would take some time to take effect. In the meantime, DfT has an ongoing duty, as franchises come up for renewal, to ensure that taxpayers and passengers are protected from the consequences of the adverse effect on competition which currently exists in the rolling stock leasing market.

35. DfT had asked the CC to consider whether price control might be an appropriate way to address consumer detriment. While the CC panel did not agree on whether controls to restrict increases of rentals are required in the short to medium term, the CC's main report concludes that it would be open to DfT to seek its own legislative powers to influence or control rentals. DfT will closely monitor the rentals proposed when rolling stock is re-leased. While DfT currently has no plans to legislate, it will keep under review the option of seeking new powers to control prices should it prove necessary.