

Agenda

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Roll on market investigations: the findings on rolling-stock leasing

The Competition Commission has published its final report on the market for rolling-stock leasing to rail companies in Great Britain. Despite finding insufficient competition in the market, the Commission considered that the costs of price regulation outweighed the benefits, and focused instead on the nature of franchise contracts let by the Department for Transport for passenger rail operations. This raises questions not only for future rail policy, but also for the market investigation regime

The market investigation regime under the Enterprise Act 2002 is a competition policy tool that is unique to the UK.¹ In essence, these investigations involve the Competition Commission (CC) undertaking a detailed, two-year inquiry into a particular competition concern in an industry, which cannot be dealt with under the 'standard' competition rules on restrictive agreements and abuse of dominance. In April 2009, the CC published its final report on the passenger rolling-stock leasing market, after a referral in April 2007 by the Office of Rail Regulation, the sector regulator which also applies competition law to rail.² This in turn had followed a complaint made by the Department for Transport (DfT).

The inquiry raises several policy questions, not just for the rail sector but for the market investigation regime as a whole.

- How should the CC assess a market where competition is inherently limited by structural features, including government policy? What is the most appropriate 'counterfactual well-functioning market'?

- When is price regulation—the solution favoured by the DfT but rejected by the CC—an appropriate remedy?
- The CC's proposed remedies are targeted largely at the rail franchising system rather than at the behaviour of the rolling-stock leasing companies (ROSCOs). They are recommendations only, and are not legally binding. When assessing the proposed changes to the franchise system, how should the government weigh the objective of greater competition in rolling-stock leasing against other rail policy objectives? Will the government accept the CC's recommendations?

Why investigate rolling-stock leasing?

Passenger rolling-stock leasing is one part of the GB rail industry that has been functioning relatively smoothly since privatisation in the mid-1990s, with no radical government interventions or major reforms to the regulatory framework.³ So why did it come under scrutiny?

Competition in rolling-stock leasing

- Lease payments by train operators for rolling stock amount to around £1 billion per year.
- Three ROSCOs—Angel Trains, Porterbrook and HSBC—own 97% of GB rolling stock.
- ROSCOs take on residual value risk since the lifetime of trains is typically around 30 years while rail franchises last around 7–10 years, after which a fleet may come off-lease.
- Opportunities for supply and demand to meet are restricted due to limited interoperability within the GB

rail network and the fact that leasing opportunities are infrequent and irregular.

- The DfT accused the ROSCOs of excessive pricing and pushed for price controls.
- The CC found adverse effects on competition—in particular, the limited choice for train-operating companies—but its proposed remedies focus to a large extent on the government franchise system, and do not include price controls.

Passenger rolling stock in Great Britain is predominantly owned by three ROSCOs, which were created at privatisation in the mid-1990s to own the fleets of ex-British Rail passenger vehicles: Angel Trains (which owns 36% of rolling stock), Porterbrook Leasing Company (32%) and HSBC Rail (29%).⁴

Passenger railway services in Great Britain are operated by train-operating companies (TOCs) on the basis of franchises, which are let by the DfT for (in most cases) 7–10 years. The TOCs bid competitively on the basis of the subsidy that they require (or the premium they will pay) to operate the franchise. Lease rentals for rolling stock—paid to the ROSCOs—constitute a significant proportion (around 15%, see Figure 1) of total franchise costs.

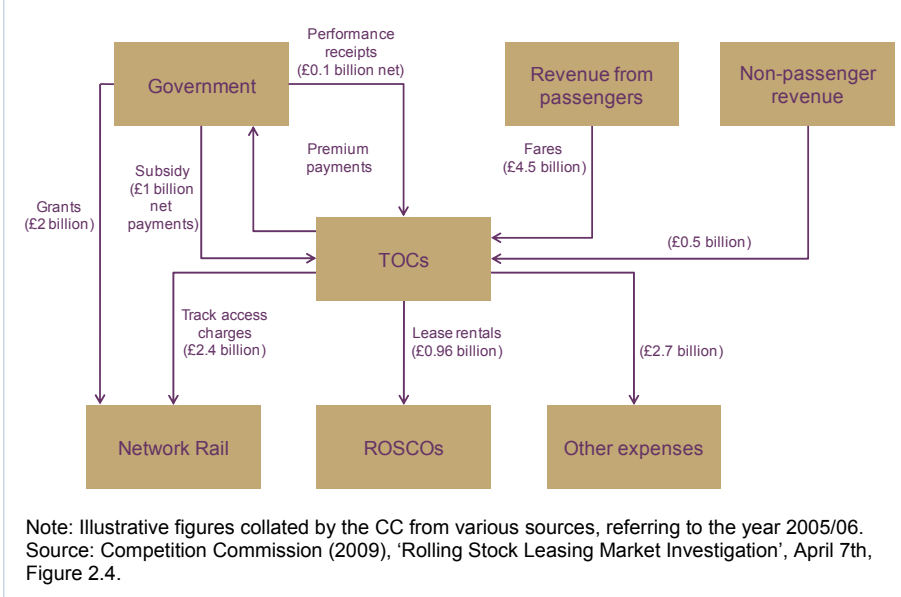
The main rationale for this vertical industry structure is that specialised operating leasing companies are better placed than TOCs to take on the residual value risk associated with owning rolling stock. Trains typically have a life expectancy of around 30 years, while franchises last for 7–10 years. At the end of the franchise, there is a risk that the stock will not be re-leased, if the new franchisee chooses an alternative used fleet or a new-build fleet, or changes its rolling-stock requirements altogether. The DfT can offer undertakings under Section 54 of the Railways Act 1993. These provide some assurances to lessors that the rolling stock will be leased for a minimum period (beyond the end of the current franchise), thus reducing the risk that the rolling stock will be stranded early in its life. Nonetheless, significant residual value risk remains in the industry.

Figure 1 shows the main financial flows in the rail industry, between government, passengers, Network Rail (the infrastructure operator), the TOCs and the ROSCOs. It can be seen that the £1 billion paid by TOCs to ROSCOs represents a significant part of the financial flows. TOCs cover their costs mainly through a combination of passenger revenue and government subsidy. A concern that ROSCOs were making excessive profits at the expense of passengers and taxpayers lay at the heart of the DfT's complaint that eventually led to the CC investigation.⁵

Insufficient competition?

In its final report, the CC categorises into five groups those features of the rolling-stock leasing market that it

Figure 1 Flow of funds for passenger railway franchises



considers led to an adverse effect on competition (AEC).⁶

- **Shortage of rolling stock available to bidders**—arising from the technical or operational characteristics of stock, the costs and risks associated with switching between rolling stock, and the short payback period for investment in new stock as a result of franchise length.
- **Market structure determined by the franchising system**—through service specifications in the franchise agreement, the timing of franchise re-letting, Section 54 undertakings, and 'the expressed unwillingness of the DfT in some instances to meet higher lease rental of new rolling stock'.
- **Weakened incentives to compete on lease rentals of used rolling stock**—in cases where there are few alternatives for TOCs, the ROSCOs face less risk of rolling stock coming off-lease, thereby reducing price pressures.
- **High barriers to entry**—the CC found the ROSCOs' portfolios of fleets, understanding of the sectoral risks, economies of scale, and technical expertise to be possible entry barriers. The extent of residual value risk and political risk are other barriers.
- **TOCs' incentives to negotiate are limited**—there are few options for TOCs to differentiate between rolling-stock requirements in the franchise bidding process, due to the nature of the ROSCOs' codes of practice, which means that any lease offer made to one bidder has to be made available to another.

In addition, the CC considered the market for new-build rolling stock to be competitive (despite allegations by the DfT that the ROSCOs engage in anti-competitive coordination in this segment of the market). It also dismissed concerns about certain bundling practices by the ROSCOs in the maintenance of rolling stock. With respect to the AEC features listed above, the CC commented that:

we believe that ROSCOs have not so far increased rentals when rolling stock has been re-leased as much as they might have been able to, based on the features of the market we have identified, even in the absence of credible alternatives. We consider that this is largely due to the ROSCOs taking account of factors such as the potential for specific economic regulation or other actions by the franchising authorities. (para 53)

Insufficient competition compared with what?

In any market investigation, the assessment of AEC, and of the costs and benefits of any remedies to address these effects, requires a comparison with a counterfactual situation in which competition worked well. A significant part of the investigation focused on the concept of a 'well-functioning market'. As the CC observed:

It was particularly important in this inquiry to consider a well-functioning market against which to assess competition because of the unusual characteristics of the rolling stock leasing industry, such as the immaturity of the industry, infrequent leasing events, the interaction of the franchising system with the market, the extent of government involvement in the market (eg in specification of service levels and allocation of rolling stock), and the reliance of the railways on public financial support. (para 4.6)

There was little doubt among the various parties in the inquiry that rolling-stock leasing is not a perfectly functioning market—ie, one where there is relatively free entry and exit of suppliers and buyers, and where frequent transactions take place between suppliers and buyers such that price formation and demand and supply adjustments take place smoothly. The economics of rolling-stock leasing are such that there are inherent limitations on market liquidity, even beyond those features identified by the CC as constituting an AEC (as listed above):⁷

1. assets with a long lifetime (30–35 years), high up-front investment and long payback period;
2. residual value risk, as the assets are leased for shorter franchise periods than their lifetime (typically

- 7–10 years), which is characteristic of operating leasing (as opposed to financial leasing);
3. high costs of having assets off-lease (eg, direct warm-storage costs and opportunity costs);
4. limited interoperability between different parts of the GB rail network and with overseas networks, and virtually no secondary market for rolling stock;
5. infrequent, irregular and temporary leasing opportunities where competition takes place;
6. a degree of 'stickiness' in demand—if a certain fleet of rolling stock has been operating on a particular route for some time and is 'doing its job' well, there is no compelling reason to switch to another fleet (other than for reasons of price, age or significant change in TOC requirements).

Of these, only points 2, 4 and 5 are expressly covered by what the CC has defined as the AEC features (listed above). In a counterfactual situation in which those AEC features did not exist, there would still be other inherent limitations on market liquidity.

This tightness between demand and supply cuts both ways. TOCs may find themselves in situations where they have few or no alternatives to the incumbent rolling stock—much of the CC's competition analysis focused on this aspect. However, by the same token, the limited interoperability and lack of secondary market mean that the ROSCOs may find themselves in situations where some of their fleets are no longer required, have no alternative destination, and go off-lease. Thus, any detriment arising from such limited liquidity does not necessarily fall only on passengers and taxpayers, but also affects the market participants themselves.

The CC considered that a well-functioning market is one where:

TOCs would choose between different fleets of rolling stock, whether new or existing, according to the rentals, operating costs, revenue-earning capability, etc (ie the relative utility) of different fleets. (para 4.30)

It then observed that:

In the existing market, we note that the range of effective substitutes may be narrower than in the well-functioning market, for example because of significant barriers or costs in switching between alternative fleets of rolling stock (eg in route acceptance costs and staff training costs for new vehicles, or short-term lease premiums to overcome timing problems when alternative fleets are not available at the time a franchise is re-let). These factors may also restrict the ability to switch to new rolling stock, and we note that the DfT has in some cases indicated that it is not willing to fund new

rolling stock (or TOCs perceive that it is unlikely to do so). (para 4.33)

Thus, the CC emphasises the importance of new build as a substitute for used rolling stock in a well-functioning market. This holds even if the new-build stock comes at a significantly higher price than the used stock. In such a situation, the new stock may not be the 'binding' constraint on rentals; nonetheless, it is a relevant constraint for the purpose of the competition analysis, as it would become binding should other constraints fall away.

If a well-functioning market is considered in this way, the focus should be on the availability of choice in lease negotiations, not just among used rolling stock, but also choice of new build. In this regard, an informative statistic found by the CC in the course of its investigation is that in 83% of all the leases it analysed, the TOCs had the choice of at least one alternative used or new-build fleet.⁸ This implies that in only 17% of leases, the TOCs had no choice but to use the incumbent fleet. Another informative statistic is that in 31% of leases, the TOCs would have been able to consider more alternatives were it not for the DfT's specifications of rolling-stock inputs.⁹

Rail policy implications

The CC's proposed remedies for the AEC include recommendations to the franchising authorities (including the DfT) to make changes to the franchise system, wherever consistent with their functions and objectives, by:

- introducing longer franchise terms of 12 to 15 years or longer;
- assessing the benefits of alternative new or used rolling stock beyond the franchise term and across other franchises when evaluating franchise bids;
- ensuring that franchise invitations to tender are specified in such a way that franchise bidders are allowed a choice of rolling stock.¹⁰

The CC's key recommendation on franchise duration—that longer franchise terms of 12 to 15 years or longer represent an important remedy to overcome the AEC—is clearly at odds with current franchising policy. The DfT prefers a '7+1+1+1' model, whereby franchises last for seven years (subject to adherence to the franchise agreement), with scope for extensions of up to three years towards the end of the franchise term. However, the CC concluded that:

the franchising authorities should formally consider the benefits and costs of a longer franchise term for each franchise re-let in order to identify the optimum franchise length. In doing this their assessment should include the benefits of competition in the leasing of rolling stock. (para 62)

It is clear that franchising authorities generally need to take a number of considerations into account when determining franchise length. These include the need to avoid foreclosure of other TOCs from the market resulting from waiting too long to replace a franchise; the increased flexibility in franchise agreements needed to respond to events over a longer period; the relative merits of short franchises with 'cost-plus' arrangements versus longer franchises, offering the opportunity to invest in a long-term business; and perhaps a desire to maintain a procurement model that has been approved by the National Audit Office in a recent report.¹¹

The CC's recommendations come at a time when there are a number of other drivers for franchise policy reform and may, ultimately, contribute to changes in how passenger rail franchises are let in Great Britain. However, considerable pressure remains to maintain the status quo, and it may be that by designing the timetable for franchise replacement processes such that two to three franchises co-terminate, thereby providing a pool of rolling stock for bidders to choose from, many of the benefits espoused by the CC will be realised, but without the need for substantial change in the franchise term.

Another suggestion made by the CC is that the non-discrimination clause in the ROSCOs' codes of practice should be removed. Despite its intention to prevent a leasing company from favouring one operator over another during, for example, bids for train-operating franchises, the CC considers it to prevent bidders and leasing companies from working together to develop innovative solutions to rolling-stock needs.

One potential consideration for the future is whether this principle might be adopted elsewhere in the rail industry. For example, in the case of Network Rail,¹² a situation could be envisaged in which the company was expected to work closely with each franchise bidder to develop bespoke plans to meet the needs of the franchise invitation to tender, and possibly to go beyond it to deliver extra patronage growth, either through timetable development or small infrastructure schemes.

As the inquiry was drawing to a close, the DfT announced that it is creating an in-house ROSCO, Diesel Trains Limited, to finance the purchase of at least 202 carriages for use by the First Great Western, First Trans-Pennine Express and Northern franchises.¹³ This is ostensibly due to the conditions in financial markets and the desire for this order to form part of the government's fiscal stimulus, and the DfT has stated that it is keen to sell the business on when financial market conditions ease. However, this action, combined with the different rolling-stock procurement approach taken to the new 1,400-strong fleet of Super Express Trains,¹⁴ raises the question of whether the

DfT sees a future role for ROSCOs in financing new rolling stock in the GB market. The CC notes that such alternative financing approaches have the potential to increase rivalry in the supply of new rolling stock, but do not necessarily enhance rivalry at the point of re-leasing existing trains.

Questions for the market investigation regime

This CC investigation raised the issue of whether competition could ever function effectively in the market in question, and what the authority should do in these situations: try to enhance competition, even if limited, or give up on competition and impose monopoly price regulation? The CC opted for the former:

Given the unusual nature of this market, we recognize that it is unlikely ever to develop into a market where competition is fully effective. Indeed, our remedies are unlikely to be able to remove the entirety of the customer detriment

arising from the AEC because there will remain certain situations where choice of rolling stock is limited. However, our remedies are intended to help enhance the process of competition in the leasing of franchised passenger rolling stock by opening up choice, leading to greater competition and hence greater efficiency and innovation. (para 69)

The CC rejected the DfT's repeated requests for price controls on the ROSCOs. It considered that price regulation 'would suffer from severe practical difficulties and costs in implementation and have significant distortive effects on the market'.¹⁵

Instead, the CC's remedies focus to a significant extent on the franchising systems. During the inquiry, the DfT stated that it disagreed with the CC's recommendations, describing the proposed extension of franchise length as 'misconceived'.¹⁶ This raises the question of what action the DfT will take in response to the recommendations, providing a test for the effectiveness of the market investigation as a whole.

¹ See Oxera (2008), 'Market Investigations: A Commentary on the First Five Years', *Agenda*, September. Available at www.oxera.com.

² Competition Commission (2009), 'Rolling Stock Leasing Market Investigation', April 7th. Oxera advised Angel Trains on this matter.

³ The market was reviewed by the ORR in 1998, from which emerged the codes of practice for the ROSCOs that are still in place today.

⁴ Competition Commission (2009), *op. cit.*, para 5. The other 3% is held by Voyager Leasing, which was set up to lease a new fleet of 'Voyager' trains but has not undertaken any further leasing activities.

⁵ See, for example, the DfT's initial submission to the CC, dated June 12th 2007 (available on the CC website).

⁶ Competition Commission (2009), *op. cit.*, para 50.

⁷ See Oxera (2008), 'Further Analysis of Competition in the Rolling-stock Leasing Market', June 2nd, section 2.1.

⁸ Competition Commission (2009), *op. cit.*, Appendix 4.1, para 27.

⁹ Competition Commission (2008), 'Provisional Decision on Remedies', December 16th, para 100.

¹⁰ Competition Commission (2009), *op. cit.*, para 59.

¹¹ National Audit Office (2008), 'The Department for Transport: Letting Rail Franchises 2005–2007', October 15th.

¹² Although perhaps not in the case of infrastructure managers elsewhere in Europe that also own railway undertakings—in this case non-discrimination is vital to ensuring fair competition for passenger concessions.

¹³ Department for Transport (2009), 'Delivery of New Trains to be Speeded up by New Company', press release, March 5th. The CC's report states that the DfT argued that 'it was not setting up Diesel Trains Limited ... to compete against current rolling stock leasing companies' (para 5.54).

¹⁴ Agility Trains, a consortium comprising John Laing, Barclays and Hitachi, will design, build, finance and maintain the fleet of trains and its depots.

¹⁵ Competition Commission (2009), *op. cit.*, para 66.

¹⁶ See the DfT's submission dated January 27th 2009, para 26.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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