



OFFICE *of the*
RAIL REGULATOR

**REVIEW OF THE ROLLING STOCK
MARKET**

AN INVITATION TO COMMENT

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Regulator's foreword

On 21 January, the Deputy Prime Minister wrote to me asking me to undertake a review of the operation of the rolling stock market. He asked me to report to him, by the middle of April, with recommendations on the most effective way of dealing with any problems identified in the review, taking account of the Government's transport objectives and the need to ensure that public support to the railway is used effectively and improves the quantity and quality of railway services.

The new structure of the railway industry in Great Britain involves vertical separation between network ownership and operation, train operations and rolling stock ownership. As part of this process, ownership of virtually all passenger rolling stock used on the national rail network was transferred to three rolling stock companies (ROSCOs), who in turn lease it to franchise operators. While the Railways Act provided for the licensing of operators of railway assets, and gave me powers both to enforce (and in appropriate circumstances modify) those licences, and to approve all access agreements, rolling stock leasing was left outside this framework: the activities of the rolling stock companies and the leases themselves are therefore subject only to general competition law.

In my discussions with train operators, I have heard a number of concerns about the operation of the rolling stock market, and been given a number of suggestions about the best way of dealing with them. But it is important that any action is only taken after a proper consideration of all aspects of the rolling stock market, and the alternative ways of dealing with those problems which can be substantiated. That is why I suggested to the House of Commons Transport Sub-Committee that these issues should be the subject of public consultation. I therefore welcome the invitation from the Deputy Prime Minister to carry out such a review.

The development of the rolling stock market since privatisation has been overshadowed by the profits to the original shareholders following the re-sale of the ROSCOs themselves. It is not the purpose of this review to examine the conditions of the original sale or the original leases themselves. It has a clear focus: whether the future price, quality and availability of rolling stock is likely to meet the reasonable requirements of train operators. Those are serious issues. They should be resolved so as to promote the use and development of the railway in the manner which best meets the needs of passengers, and which provides best value for money for taxpayers.

The Rolling Stock Companies own equipment which is vital to the effective operation of a passenger railway dependent on public subsidy. As such, I believe they have a public interest stewardship role, just as, for example, Railtrack has duties as the steward of the national rail network. This implies an obligation to take a proactive and positive approach to the provision of rolling stock in a way which reflects the needs of train operators and passengers. In my review, I will want to gather evidence on whether the rolling stock companies are properly discharging that responsibility, and, if not, what steps might be taken to remedy this. I believe that it is important to reach clear and early conclusions on these issues. I look forward to your contributions to this review, to ensure that this objective can be achieved.

JOHN SWIFT QC

Rail Regulator

February 1998

1. Summary, key issues for comment and next steps

- 1.1 The purpose of this paper is to outline some possible issues arising from the operation of the rolling stock market which might give rise to public interest concern in terms of protecting the interests of rail users and promoting the use and development of the railway network. The Rail Regulator invites contributions which throw light on whether these (or other) issues are legitimate concerns and, if so, on how they might be remedied.
- 1.2 Section 2 sets out some background on the establishment of the rolling stock companies and of the contractual arrangements with train operators and with the Franchising Director. Section 3 outlines some possible matters of concern about the operation of the market. Views are sought in particular on:
- (a) whether the ROSCOs do indeed have market power, and if so whether this is in respect of all of their activities or for example only some types of rolling stock or some customers;
 - (b) if ROSCOs do have market power, evidence of present behaviour which could constitute an abuse of that market power;
 - (c) whether there are particular future events (such as lease renewal) which would allow market power to be exercised; and
 - (d) whether the inability to impose public interest requirements, of the sort included in railway licences, on owners of rolling stock has caused problems and, if so, which are the particular areas of difficulty.
- 1.3 Section 4 outlines possible ways - either through existing statutory provisions or through legislation - of dealing with such problems as can be substantiated. Respondents are asked to comment on:
- (a) the likely effectiveness of the different approaches in remedying any problems or potential problems identified in their comments on the operation of the rolling stock market.

1.4 Contributions to the review should be sent to:

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by 2 March 1998.

- 1.5 Where consultees provide confidential information, it should be appropriately marked and placed in a confidential annex to their response, with an explanation of the grounds on which confidentiality is claimed. The Regulator will, as part of the review, be seeking specific information from the main parties, in particular train operators, funders (the Franchising Director and the Passenger Transport Executives) and the ROSCOs themselves. He will then prepare a report to the Deputy Prime Minister. The report may include confidential material which it would not be appropriate to publish. The Regulator would, however, expect to publish his main conclusions and the reasons for them.

2. Background to the review

Structure, ownership and statutory controls

- 2.1 As part of the restructuring of the activities of the British Railways Board, three rolling stock companies (ROSCOs) were established to take ownership of the majority of the rolling stock needed to operate passenger services. The three companies - Angel Train Contracts Ltd, Eversholt Leasing Ltd and Porterbrook Leasing Company Ltd - were sold in the early part of 1996. All three ROSCOs have subsequently changed ownership. Porterbrook was acquired by Stagecoach Holdings in August 1996; Eversholt was acquired by the Forward Trust Group, part of HSBC Holdings plc, in February 1997, and has subsequently been renamed Forward Trust Rail Ltd; and Angel was acquired by the Royal Bank of Scotland Group plc in December 1997.
- 2.2 The Regulator's review of the operation of the rolling stock market does not cover the initial sales, which are the subject of a report by the National Audit Office.
- 2.3 Under the provisions of the Railways Act 1993, operators of railway assets must be licensed. Licences are issued by the Secretary of State or, under the terms of a general authority issued by the Secretary of State, by the Regulator. Railway assets are defined as passenger or goods trains, networks, stations and light maintenance depots. However, licences are not required by those who merely own or lease rolling stock, but do not operate it. This decision reflected the view taken at the time that the protections given to train operators by the initial lease arrangements, together with an expectation of increasing competition between the existing ROSCOs and new entrants to the market over time, would provide sufficient protection for operators and users.

Responsibilities of rolling stock companies

- 2.4 The ROSCOs have two roles. Their main initial role was to acquire the existing rolling stock, and lease it to train operators, thereby reducing the capital commitment required by franchisees. This facilitated the franchising process, and would make it easier to transfer operations at subsequent franchise awards. It was also contemplated that they would provide finance for the procurement of new rolling stock. Secondly the initial leases also placed responsibility for 'heavy' maintenance on the ROSCOs. The ROSCOs generally procure these services from contractors (mainly the former

British Rail Maintenance Ltd depots, but also manufacturers and some train operators).

Contractual provisions

- 2.5 The activities of the ROSCOs are subject to a number of contractual arrangements. The principle ones are:
- (a) the rolling stock leases with individual train operators, the main terms of which are contained in the Master Operating Lease Agreement (MOLA); and
 - (b) direct agreements between each ROSCO and the Franchising Director.
- 2.6 The Regulator has not previously had access to these agreements. His understanding of their contents is based on published material such as that contained in the Franchising Director's *Passenger Rail Industry Overview*. (An extract from this document is at Annex A).
- 2.7 In addition to these contracts, following the merger of Stagecoach and Porterbrook in 1996, further undertakings were given to both the Secretary of State for Trade and Industry and the Franchising Director. The undertakings given to the Secretary of State under the provisions of the Fair Trading Act 1973 covered such matters as fair trading by Porterbrook as between Stagecoach-owned train operators and other train operators, and the maintenance of appropriate confidentiality arrangements between the rolling stock and train operating activities of Stagecoach. Stagecoach gave further commitments to the Franchising Director, in particular, assurances that Porterbrook would, at franchise renewal, offer terms to a new franchisee no less favourable than available to the previous franchisee.
- 2.8 The Franchising Director has indicated that the direct agreements with the three ROSCOs provide for purchase options, rights for the Franchising Director in the event of early termination, and provision of information to assist the franchise bidding process. Whenever a franchisee procures new rolling stock, the terms of the franchise agreement require that the Franchising Director has the opportunity to enter into further direct agreements. The Regulator understands that these direct agreements generally give the Franchising Director the option to extend leases for all new rolling stock acquired by franchisees for up to three years beyond the current franchise. Such an extension is intended to give the incoming franchisee the option of acquiring new rolling stock if the lease renewal terms are not considered to represent value for money.

Lease renewal and procurement of new rolling stock

- 2.9 In seeking to promote the development of competition in the rolling stock market, the previous Government adopted a form of pricing for the initial rolling stock leases which was designed to leave train operators indifferent as between existing and new rolling stock. The basis of pricing - the 'equivalent cost pricing' method - takes account of the cost differences in operating rolling stock of different ages and also their differing revenue generating potential. Alternative methods of pricing were rejected as giving too great an incentive either to retain existing rolling stock or to acquire new rolling stock.
- 2.10 As part of the terms of the initial franchises agreed, a number of train operators have committed to procure new rolling stock. In principle, there is a range of formats for such procurement. For example, train operators might decide to alter the arrangements for heavy maintenance by seeking bids for both the supply and maintenance of rolling stock, with only the financing provided by ROSCOs. Train operators also face choices on the financing of rolling stock. Apart from financing through one of the three ROSCOs, finance could be arranged by the manufacturer, through another existing leasing company, or direct by the franchisee through borrowing or equity.
- 2.11 No initial leases will extend beyond franchise expiry, and the majority, some 60%, will have been renegotiated at least once by 2004. It is unlikely that there will be large amounts of surplus rolling stock to allow competition at franchise renewal, therefore most leases will need to be renegotiated at that stage. In addition, there are restrictions on the parts of the network on which different types of rolling stock may operate.
- 2.12 For all these reasons, the current expectation is that when the 7 year franchises come to an end, nearly all leases then in place, whether for existing or new rolling stock, will need to be renewed.

3. Possible areas for concern in the operation of the rolling stock market

- 3.1 In examining the operation of the rolling stock market, the Regulator will want to consider the issues under two broad headings:
- (a) whether the ROSCOs have market power, and if so the potential for them to abuse it; and
 - (b) whether there are market failures in the multi-operator railway which make it difficult to achieve and maintain the appropriate level of cooperation needed to protect the interests of users and to promote the use and development of the railway network.

Potential for abuse of market power

- 3.2 A key issue for this review is whether ROSCOs have market power and the opportunity to abuse it. For example, if train operators with obligations under franchise agreements to provide specified service levels do not have effective choice about the source of rolling stock at the end of initial leases, the ROSCOs will have market power. But there may already be situations where the structure of initial leases, and the absence of alternative sources of supply, give ROSCOs the ability to distort development in passenger services contrary to the public interest. In his review, the Regulator will want, in particular, to consider:
- (a) whether such market power is enjoyed by the ROSCOs;
 - (b) the opportunities this might give for abuse; and
 - (c) whether such market power is likely to persist indefinitely, or is likely to diminish.
- 3.3 The extent of market power depends on the extent to which train operators in practice have the option to obtain rolling stock from different sources. This will reflect both the ability of the other two ROSCOs to offer rolling stock to a train operator at the end of a lease, and on the ability for new entrants to come into the market (essentially through offering new rolling stock). The three year 'call' option agreed with the Franchising Director for all new rolling stock, for example, designed to act as a price cap, also has the effect of reducing one of the barriers to new entry.

3.4 If ROSCOs do have market power, it is possible that there might already be evidence of abuse. Equally, there may be potential for abuse at some point in the future. Examples of possible abuse include:

- (a) low levels of 'speculative' new build by ROSCOs despite the cashflow generated by the initial leases;
- (b) disposal of existing unused rolling stock, thereby keeping the pool of surplus rolling stock to a minimum;
- (c) reluctance of the ROSCOs to compete vigorously for the financing of new build orders, for example, because of unwillingness of ROSCOs to take on residual value risk;
- (d) lease charges for existing rolling stock increasing at lease renewal, whereas in a competitive market, any savings achievable could be reflected in lower lease charges;
- (e) failure to pass on to customers reductions in heavy maintenance costs, or refusal to allow train operators to procure heavy maintenance separately;
- (f) offering leases only for the whole of a franchise, rather than for shorter periods;
- (g) reluctance of ROSCOs to cooperate with train operators to make improvements in rolling stock quality or availability to improve services to passengers, for example, through offering lease terms reflecting actual availability of rolling stock, or which involve revenue sharing with train operators; or
- (h) failure to pass on to customers any reductions in insurance costs obtained at renewal of insurance policies.

3.5 The Regulator would in particular welcome submissions on the following issues:

- (a) whether the ROSCOs do indeed have market power, and if so, whether this is in respect of all of their activities or, for example, only some types of rolling stock or some customers;**
- (b) if ROSCOs do have market power, evidence of behaviour which would constitute an abuse of that market power; and**

- (c) **whether there are particular future events (such as lease renewal) which would allow market power to be exercised.**

Market failures in the restructured railway

3.6 A number of the provisions of network, train operating, station and depot licences are designed to protect the public interest by remedying the effects of market failures which may arise in a vertically separated, multi-operator railway. These include, for example:

- (a) provisions in respect of safety;
- (b) the requirement for all licensed operators to have third party liability insurance arrangements approved by the Regulator;
- (c) obligations to participate in various industry-wide arrangements, such as the Claims Allocation and Handling Agreement;
- (d) various other measures designed to promote network benefits and to protect the interests of particular groups, such as disabled passengers; and
- (e) the stewardship obligation on Railtrack to maintain, review and develop the network in line with customers' and funders' reasonable requirements.

3.7 Because owners of rolling stock are not licensed, they have no obligation to participate in these arrangements. This could lead to licensed operators taking on responsibilities which it might be more appropriate for owners of rolling stock to bear, leading either to additional costs for operators or a poorer service for passengers.

3.8 The Regulator would welcome views on whether the inability to impose public interest requirements, of the sort included in railway licences on owners of rolling stock has caused problems, and, if so, which are the particular areas of difficulty.

4. Possible remedies

4.1 This section outlines the existing controls on the activities of the ROSCOs, through general competition law. It also identifies matters which might be included in new primary legislation.

Existing and proposed competition law provisions

4.2 Like all other companies in the railway industry, ROSCOs are subject to the provisions of general competition law. These are contained in:

- (a) the Competition Act 1980;
- (b) the monopoly provisions of the Fair Trading Act 1973; and
- (c) the merger provisions of the Fair Trading Act 1973.

The provisions of these Acts are described in more detail in Annex B.

4.3 In the light of the perceived weakness of current general competition law, the Government has introduced a new Competition Bill. This is expected to gain Royal Assent later this year, although its powers might not become effective, particularly in respect of existing agreements, before Autumn 1999. The Bill prohibits anti-competitive agreements and abuse of market power, modelled on the provisions of Articles 85 and 86 of the Treaty of Rome. The Bill also introduces strengthened investigation and enforcement provisions and the ability to levy fines up to 10% of turnover.

4.4 The Competition Bill provides that the Rail Regulator will have concurrent powers, as under the current Competition Act.

4.5 As currently drafted, the provisions of the Bill would therefore allow the Rail Regulator to take action if a ROSCO sought to abuse a dominant position in the rolling stock market.

Possible provisions of new legislation

4.6 Introducing a requirement for rolling stock owners to be licensed, in the same way as operators of networks, trains, stations and light maintenance depots, would require primary legislation. Licence conditions could extend beyond simply the control of

anti-competitive behaviour to include stewardship obligations (on the lines of the modified Condition 7 of Railtrack's network licence) and price controls. They could also include provisions in respect of other matters identified in the previous section, such as insurance.

4.7 In introducing new legislation, it would be important to consider:

- (a) coverage - would the requirements apply to all who own or lease rolling stock, or simply the ROSCOs;
- (b) whether legislation would allow for the terms of existing contracts to be changed; and
- (c) given the Government's proposal to establish a Strategic Rail Authority, whether controls should be exercised by the SRA or the Rail Regulator.

4.8 Respondents are asked to comment on the likely effectiveness of the different approaches in remedying any problems or potential problems identified in their comments on the operation of the rolling stock market.

5. Annex A - Provisions of the Master Operating Lease Agreement and the Direct Agreement with the Franchising Director

(Extract from Passenger Rail Industry Overview)

1. The Master Lease

Each of the ROSCOs has entered into a Master Lease with those TOCs which are its customers. The Master Lease contains standard terms and conditions for the leasing of rolling stock to TOCs and is drafted as an operating (rather than finance) lease. In conjunction with the Master Lease, the ROSCOs and TOCs have entered into Lease Supplements for each fleet of vehicles on lease. These set out the particular terms of individual leasing transactions, such as rentals and lease length.

Certain TOCs have taken rolling stock on lease from the ROSCOs under different terms to those described below due to special circumstances.

The summary below provides an overview of some of the provisions of the Master Lease.

Summary of Obligations

The principal obligations of a TOC under a Master Lease include:

- a) payment of rent to the ROSCO;
- b) performance of Running Maintenance and Repairs;
- c) use of the rolling stock in accordance with the criteria specified in the Lease Supplement;
- d) insurance of the rolling stock against third party liabilities and repayment to the ROSCO of premiums paid by the ROSCO in respect of property damage insurance;
- e) indemnification of the ROSCO against certain losses relating to the leasing, use and operation of rolling stock in certain circumstances;
- f) return of the rolling stock to the ROSCO at the end of the lease period in the condition specified in the Lease Supplement; and

- g) rectification, or contributing to the cost of rectifying, certain faults on the rolling stock.

The principal obligations of a ROSCO under a Master Lease include:

- a) delivery of the rolling stock to the TOC in an agreed condition;
- b) allowing the TOC quiet enjoyment of the rolling stock;
- c) procurement of Heavy Maintenance and Heavy Repairs;
- d) effecting and paying for any Mandatory Modifications. During the term of the Initial Leases, however, HM Government has agreed to share in the cost of Mandatory Modifications above a threshold with up to 10 per cent of the cost being payable by affected TOCs (such liability being capped by the Franchising Director at five per cent of the total of the affected TOC's relevant lease rental charges for the relevant year); and
- e) procurement of property damage insurance of rolling stock (although responsibility for damage (save in respect of Heavy Repairs) and payment of an agreed value (as specified in the relevant lease) in the event of a total loss remains with the TOC).

2. Rolling Stock Direct Agreements

The Franchising Director entered into an agreement with each ROSCO in relation to all rolling stock acquired by the ROSCOs from BRB under transfer schemes on 1 April 1994 (as amended) which was still owned by the ROSCOs at the time that the agreements came into effect. Each ROSCO direct agreement came into effect on the date on which the relevant ROSCO ceased to be owned by HM Government (the last sale being completed on 2 February 1996).

If any of the rolling stock to which the agreement relates is subsequently sold from one ROSCO to a second ROSCO, it will remain subject to the ROSCO direct agreement in the hands of the second ROSCO. The principal terms of the agreements with the ROSCOs are as follows:

1. *Purchase options*: in certain circumstances the Franchising Director has a right to tender (on the same terms as other parties) to acquire rolling stock which the ROSCO is proposing to sell. In addition, unless the ROSCO intends to use the rolling stock for spares, it must, before scrapping it, give the Franchising Director the option to acquire the rolling stock at its current open market value for scrap.

2. *Early termination*: in the event of a proposed termination by the ROSCO of a rolling stock lease for default by the TOC, the ROSCO will give the Franchising Director advance warning of its intention and will, if the Franchising Director elects, delay termination for an agreed period. The Franchising Director will effectively compensate the ROSCO for any liability arising or accruing during the period of delay. If the lease is terminated by the ROSCO for default by the TOC, the Franchising Director has an option to take a new lease on the same terms for all of the rolling stock. Such new lease will last until the earlier of the date of termination of the terminated lease or the next timetable change which falls at least 12 months after the date of termination. The Franchising Director, in the latter case, has the right to extend the lease (on six months' notice) in relation to all or part only of the rolling stock so that its term corresponds to that of the terminated lease;

If the Franchising Director terminates the franchise agreement but the ROSCO has not terminated its lease with the relevant franchise operator, the Franchising Director has an option to require the ROSCO to terminate such leases. The Franchising Director will have to indemnify the ROSCO for any claim made against the ROSCO by the TOC in respect of such termination. If the Franchising Director requires the ROSCO to terminate, the Franchising Director must lease the relevant rolling stock on similar terms to those which would apply were the Franchising Director entering into such lease as a result of a termination by the ROSCO due to a TOC's default;

3. *Franchise bidding procedure*: the ROSCO agrees to make available to the Franchising Director certain confidential information to facilitate the franchise bidding process now and in the future; and
4. *Livery*: in order to avoid unnecessary re-branding costs, particularly at the end of a franchise, the ROSCOs will accept re-delivery in a livery acceptable to the Franchising Director if the stock is to be used by, amongst others, a successor franchise operator provided that no additional cost is incurred by the ROSCOs.

The ROSCO direct agreements also contain provisions for the transfer of the obligations and rights under such agreements in circumstances where the ROSCO sells or grants security over the rolling stock or related leases. The ROSCOs have agreed to inform the Franchising Director if they propose to change any of the insurance requirements agreed at the inception of a rolling stock lease.

The ROSCO direct agreement will apply for future leases of the rolling stock which was transferred from BRB by the transfer schemes of 1 April 1994 (as amended). The provision

of rolling stock to a franchise operator or a franchisee will be regarded as a key contract. As such the franchise operator may only enter into such a contract provided that the counterparty has entered into a direct agreement with the Franchising Director on terms acceptable to the Franchising Director. A direct agreement will therefore be needed between the counterparty and the Franchising Director for rolling stock which is not covered by the ROSCO direct agreements (including new stock) unless this requirement is waived by the Franchising Director. The Franchising Director envisages that these direct agreements will be agreed on a franchise by franchise basis.

6. Annex B - Provisions of Competition Act 1980 and Fair Trading Act 1973

The Competition Act 1980 provides for the investigation of behaviour which may restrict, distort or prevent competition. If the allegations are substantiated, the matter may either be referred to the Monopolies and Mergers Commission (MMC), or undertakings can be accepted in lieu of such a reference. The main concern that has been expressed about these powers is that action can only be taken to control anti-competitive behaviour after a full investigation has been completed to prevent public interest detriments from occurring. Little use has been made of these powers because of their perceived weakness.

The Fair Trading Act 1973 allows for references to be made to the MMC where one or more companies have a monopoly in the relevant market. For the purposes of a 'scale monopoly' reference, a 25% market share is sufficient to warrant investigation. It would, therefore, be possible to make such a reference in respect of each of the ROSCOs. The rolling stock market as a whole could also be referred if it constituted a 'complex monopoly', in other words a market where two or more persons have a market share of 25% or more, and conduct their respective affairs in any way which prevents, distorts or restricts competition.

The remedies that could be recommended by the MMC, should they find that the monopoly operates or may be expected to operate against the public interest, include divestment or undertakings in respect of pricing. It would not be possible to recommend undertakings which cover the full range of matters that might be covered in licences. Final decisions on remedies lie with the Secretary of State for Trade and Industry.

Under the provisions of the Railways Act 1993, the Rail Regulator exercises Competition Act powers concurrently with the Director General of Fair Trading in respect of matters 'in connection with the provision of railway services'¹. Although rolling stock activities fall outside the definition of 'railway services', they are clearly matters connected with their provision. The Rail Regulator and Director General of Fair Trading are required to agree, in individual cases, who should exercise these powers. There is a general understanding with the Director General of Fair Trading that, where the behaviour under investigation is mainly directed at the railway industry, the Rail Regulator should exercise these powers.

¹ The monopoly powers of the Fair Trading Act are exercised concurrently by the Rail Regulator on matters 'in relation to the provision of railway services'

The merger provisions of the Fair Trading Act are exercised solely by the Director General of Fair Trading. He is required to provide advice to the Secretary of State for Trade and Industry on whether mergers or proposed mergers are likely to be against the public interest, and if so whether these should be referred to the MMC or whether undertakings should be accepted in lieu of such a reference. The undertakings given by Stagecoach and Porterbrook following their merger were in lieu of a reference to the MMC.