

ROLLING STOCK LEASING MARKET INVESTIGATION

Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure

Introduction

1. On 26 April 2007, the Office of Rail Regulation (ORR) referred the leasing of rolling stock for franchised passenger services ('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).
2. In its provisional findings, published on 7 August 2008, the CC has provisionally found that there are features of the rolling stock leasing market that, either alone or in combination with each other, prevent, restrict or distort competition. Hence, there is a provisional finding of an adverse effect on competition (AEC) within the meaning of section 134(2) of the Act. The provisional findings report identified those features that give rise to the AEC and the detrimental effect on customers that has resulted from, or may be expected to result from, the AEC.
3. This Notice¹ invites comments on the actions the CC is considering taking, or recommending for implementation by others, for the purposes of remedying, mitigating or preventing the AEC concerned or any resulting detrimental effects on customers.

The rolling stock leasing market

4. We note at the outset that this 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 DfT² plays an important role in decisions regarding the allocation of rolling stock and choice between new and used rolling stock, particularly so in the most recent franchise rounds.
5. We note that, in performing its role, the DfT has to take account of a wider range of public policy considerations than competition in the rolling stock leasing market alone. We recognize that it is quite legitimate that it should take these wider considerations into account and that these may limit the extent to which competition can function effectively.
6. Finally, we note 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

¹Expressions in this Notice have the same meaning as defined in the provisional findings and glossary unless defined separately.

²The National Assembly for Wales is a co-signatory to the Welsh franchising agreement. The Scottish Ministers now have responsibility for the award of future Scotrail franchises.

in passenger numbers. 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 attract a lessee.

Features

7. We have provisionally identified features of the rolling stock leasing market which prevent, restrict or distort competition. These are described below under four headings: shortage of alternative rolling stock; the franchising system and the leasing of rolling stock; weakened incentives to compete; and high barriers to entry.

Shortage of alternative rolling stock

8. There is a shortage of alternative rolling stock solutions 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 leasing of rolling stock

9. 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 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; and/or
 - (b) in some cases detailed specific service requirements for the franchise are laid down by the DfT in the franchise ITT which practically limit available rolling stock options; and/or
 - (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; and/or
 - (d) the non-coterminous nature of the franchises limits the availability of alternatives at the required time such that a TOC would have to first lease incumbent rolling stock for a short term resulting in an additional cost (lease premium) when trying to switch to such alternatives; and/or
 - (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

10. ROSCOs in many cases have weakened incentives to compete on lease rentals of used rolling stock. This arises where there are no potential alternative fleets, or where the demand for a particular type of rolling stock across the whole network requires all or virtually all of that rolling stock to be used, such that there is little risk of any rolling stock of that type coming off-lease for a sustained period. This situation has resulted from the increasing demand for rail travel coupled with the DfT's objective to ensure that as much of the existing rolling stock as possible is in use.

Barriers to entry

11. 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.

Detrimental effects

12. We have provisionally found that these features have the detrimental effect that in a substantial number of cases TOCs do not have the potential to choose from a range of fleets and so cannot make a choice of fleets that best suit their needs. Moreover, in the case of many leases, rentals are likely to be higher than we would expect to find in a well-functioning market. Detrimental effects arise for those leases where either there are no or very few alternative fleets available, or where the competitive pressure arising from alternative used rolling stock and/or new rolling stock is limited. However, we have provisionally found that the level of customer detriment in the form of higher rentals is not as high as what we would expect from those features alone because ROSCOs have tended not to increase capital rentals as far as they profitably could where rolling stock has been re-leased even in the absence of credible alternatives. We consider that this behaviour is due to the ROSCOs taking account of the Codes of Practice and the fear of the potential for economic regulation..

Criteria for consideration of remedies

13. In choosing appropriate remedial action, the Act states that the CC has a duty to achieve 'as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effects on customers resulting from it'.³
14. Our guidance states that it is unlikely that the CC, having decided that there is an AEC, will decide that there is no case for remedial action, at least before it has given attention to any relevant customer benefits that may accrue from the market features. It is, however, open to the CC in exceptional circumstances to decide that there is no case for remedial action. Examples, given in the guidance, of such exceptional circumstances are where the costs of any practicable remedy seem disproportionate in the light of the size of the relevant market or where the only appropriate remedial action would fall outside the UK's jurisdiction.⁴
15. The CC will consider the effectiveness of different possible remedies and their associated costs and benefits and will have regard to the principle of proportionality.

³Section 134(6).

⁴Market Investigation References: *Competition Commission Guidelines*, CC3, paragraph 4.7.

Between two remedies that the CC considers equally effective, it will choose that which imposes the least cost or restriction.

16. The CC will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(8) of the Act arising from a feature or features of the market giving rise to the AEC. This is discussed further in paragraph 50 of this Notice.

Possible remedies on which views are sought

17. We have identified two broad sets of possible remedy options:
 - (a) remedies that could only be implemented through recommendations to the DfT and others; and
 - (b) remedies which may be put in place by the CC through Orders or the acceptance of undertakings.
18. We note that, for those remedies which can only be recommendations by the CC, there may be uncertainty over whether the recommendations will be accepted and implemented and in what timescale. It will be necessary to take this inherent uncertainty into account when deciding whether to make such recommendations.

Recommendations to the DfT and others

19. We now consider recommendations to the DfT and others in the following five areas:
 - (a) changes to the franchise process;
 - (b) the timing of franchise end dates and short-term lease premiums;
 - (c) the low risks of assets coming off-lease;
 - (d) leveraging competition from new-build supply to subsequent lettings; and
 - (e) a strengthened Code of Practice.

Changes to the franchise process

20. We have identified two potential changes to the franchise process which may be effective in addressing the AEC:
 - (a) reducing the degree of detail which the DfT and other franchising authorities specify in their franchise ITTs; and
 - (b) more effective use by the DfT of its powers to enhance rivalry between ROSCOs.

ITT specifications

21. We are considering making recommendations to the DfT and other franchising authorities that the franchise specifications in an ITT, such as the type of rolling stock to be used, are framed flexibly in such a way that provides the TOCs with a greater choice over which rolling stock they may employ. For example, as far as possible the ITT should not exclude the possibility that new rolling stock could be used or require the use of rolling stock currently in use on the franchise, either explicitly or implicitly.

22. Views are invited as to:
- (a) whether a remedy relaxing the specificity of franchise requirements would be effective in increasing competition between ROSCOs;
 - (b) which types of specification should be removed or modified to increase TOC choice of rolling stock; and
 - (c) the implications, if any, of such a remedy for the DfT's statutory duties regarding the provision of passenger rail services.

The DfT's use of its powers

23. The DfT may be able to exercise its statutory powers in such a way as to encourage greater competition between ROSCOs. Longer franchise periods of, say, 15 to 20 years may attract new entrants to the rolling stock leasing market, encourage TOCs to consider new rolling stock as a feasible option or otherwise encourage a more innovative approach to rolling stock deployment.
24. The DfT has told us that the price of a franchise contract, and the cost benefit ratio of the franchise contract, is only assessed over the life of the contract. If the DfT's evaluation of TOCs' rolling stock proposals extended to the lifetime of the assets proposed for introduction, rather than the period of the franchise, the options available to the TOCs, particularly as regards new rolling stock, may be increased.
25. We are considering recommendations to the DfT⁵ that it:
- (a) lengthens franchise periods; and
 - (b) alters the basis of its evaluation of franchise proposals to take greater account of the lifetime benefits of introducing assets, including new rolling stock, proposed by TOCs.
26. Views are invited on:
- (a) the effectiveness of increasing the length of leases and the appropriate length of the extension;
 - (b) whether the recommendation on lease lengths would be more appropriate in the case of some types of franchise, for example inter-city franchises, than others;
 - (c) whether longer franchise periods would undermine or enhance the degree of competitive tension between TOCs arising from the current seven- to ten-year franchises; and
 - (d) how any revised criteria for evaluating new rolling stock proposals on a lifetime basis could be practically formulated.

The timing of franchise end dates and short-term lease premiums

27. We have provisionally found that the fact that franchises are not coterminating and that significant premiums are sometimes charged by ROSCOs for short-term leases

⁵ And other franchising authorities, where relevant.

reduces the choice of rolling stock available to TOCs when they are bidding for a franchise.

28. We have considered whether all rail franchises might be coterminous. We consider that it would be impracticable for all rail franchises to coterminate but note that it may be possible to arrange that pairs of franchises, which require similar or equivalent rolling stock, coterminate.
29. We invite views as to whether a recommendation to the DfT that it arranges for the cotermination of pairs of franchises with similar requirements would be practicable and would increase TOCs' choice of rolling stock.
30. We are considering whether measures to ensure that short-term leases are available to TOCs at no premium, or at prices that limit the premium to demonstrable incremental costs, would be an effective remedy. These are described later, in paragraph 42 of this notice.

The low risk of assets coming off-lease

31. We are considering how to introduce measures to provide an incentive for ROSCOs to compete on price in order to attract a lessee. We have identified two possible remedies:
 - (a) creating a permanent pool of surplus rolling stock; and
 - (b) introducing alternative franchise bidding arrangements that would encourage price flexibility by increasing the risk to ROSCOs of their vehicles coming off-lease.

A permanent pool of surplus rolling stock

32. We see significant drawbacks to this approach. It is by no means clear that the inevitable costs of creating and storing such a surplus pool would be outweighed by the potential benefits of lower lease rental charges, should these arise. Certainly, the pool would have to be sizeable enough to constitute a credible threat and diverse enough to be capable of meeting the various requirements of different franchisees. Further, were demand for passenger rail services to continue to grow, the pool may be depleted as surplus vehicles were introduced into service. In these circumstances the pool would then require replenishment.
33. We are therefore not minded to pursue this possible remedy further.

Alternative franchise and bidding models

34. We are considering whether different franchise letting models may improve the DfT's ability to obtain value for money. Pricing discipline would be improved if the DfT could credibly threaten to reduce the quantity of rolling stock to be provided by a ROSCO. In such circumstances, ROSCOs might perceive a greater threat of their vehicles not being leased.
35. Possible letting models might take a variety of forms. For example, in some areas of public procurement the procuring department or agency may reduce its demand for services in response to the price of those services, perhaps inviting bids on the basis of a budget rather than a specification.

36. Our views on this as a possible remedy option are not fully developed and we wish to consider further how the franchise bidding process might be modified. We would welcome views on ways in which the current arrangements could be altered so as to allow and encourage the supply of and demand for passenger rolling stock to respond more flexibly to price.

Leveraging competition from new rolling stock at first lease to subsequent lettings

37. We are considering whether it would be possible to extend the benefits of rivalry for the supply of new rolling stock at first lease to subsequent lessees. We have identified two potential ways of achieving this:
- (a) alternative procurement arrangements aimed at encouraging vigorous competition for long-term leases, structured so as to maintain flexibility for the lessee at the end of the initial lease period, such as has been achieved through Transport for London's London Overground project; and
 - (b) recommending to the DfT that it make greater use of section 54 undertakings, and giving undertakings over longer periods (eg in excess of 20 years) when new rolling stock is being acquired.
38. Views are invited on:
- (a) the effectiveness and the timescale required for implementation of these possible remedies;
 - (b) whether the extended use of section 54 would lessen further TOCs' options at franchise re-let;
 - (c) whether the benefits of alternative procurement arrangements would be inappropriate for smaller-scale procurement projects because of their high transaction costs; and
 - (d) whether any recommendation to the DfT that it exercises its powers under section 54 in the way described conflict with any preference for off-balance-sheet asset financing.

A strengthened Code of Practice

39. We note that the ROSCOs' Codes of Practice are voluntary and that they are not subject to independent monitoring and enforcement. We considered whether the content of the Codes of Practice was adequate and whether the arrangements for their monitoring and enforcement were appropriate.
40. Neither the DfT nor the TOCs have submitted that compliance with the Codes of Practice has given rise to concerns. We have found that they may, to an extent, mitigate the detrimental effects on customers of the AEC and have thus had the effect intended by the ORR, following its inquiry in 1998. We are therefore not minded to recommend any changes to the content of the Codes of Practice nor to their monitoring or enforcement, though views on the Codes of Practice would be welcome, including those to the contrary.

Remedies which the CC may implement

41. We are considering remedies which the CC may implement itself.

Short-term leases

42. We are considering a remedy requiring ROSCOs to make available short-term leases at no premium over the current lease rental price or a low premium, for example limited to a demonstrable increment in transaction costs. This may increase the number of fleets which TOCs may consider, thus fostering rivalry between ROSCOs. Such measures could be implemented through a price control mechanism specified in an Order. An alternative means to achieve this might be to alter the circumstances in which the DfT may use its 'call options' by amending the direct agreements between the ROSCOs and the Government. This will involve a further recommendation to the DfT.

43. Views are invited as to:

(a) whether a requirement that the ROSCOs should provide short-term leases with no premium would be effective in addressing the AEC that we have provisionally identified;

(b) whether a requirement that the ROSCOs should not be allowed to charge more than a maximum premium (or a premium limited by reference to demonstrable incremental costs) would be effective in addressing the AEC that we have provisionally identified;

(c) in the event that ROSCOs were allowed to charge a premium for short-term leases, what should be the criteria and process for defining the maximum level of premium allowed;

(d) whether this remedy would give rise to any practical difficulties, such as a conflict with the DfT's 'deliverability' criteria;

(e) whether this remedy would introduce new distortions into the market and the nature and magnitude of any such distortions; and

(f) the most appropriate means by which such a remedy could be implemented.

Price control

44. In order to present a comprehensive range of remedy options, we are including in this notice the option of price regulation of the passenger rolling stock leasing market, implemented by an Order.

45. Our guidance states that behavioural remedies of one kind or another are a likely outcome of some market investigations, for example where effective structural remedies are unavailable. Our guidance also notes, however, that measures to control outcomes, such as price restraints for example, are not likely, by their nature, to provide a solution to the underlying problem and on that account are less preferable.⁶

⁶CC3, paragraph 4.25.

46. We have not found that rental charges for all leases are higher than we would expect in a well-functioning market. We have found that the scope of the detrimental effects is limited to those leases where we have not found a significant competitive pressure arising from alternative used rolling stock and/or new rolling stock. A price control would not be necessary for cases where significant competitive pressures already apply and might be detrimental if it distorted competitive outcomes.
47. We can foresee significant practical difficulties in introducing a price control. A control taking as its reference point new-build prices would have to adjust the permitted maximum price of used rolling stock by factoring in the utility of individual pieces of used rolling stock compared with new-build equivalent. A margin control would require those administering the control to value the assets appropriately, which would be particularly difficult for MOLA rolling stock. The costs of monitoring and enforcing the control and particularly adjudicating decisions in the event of a dispute are likely to be significant.
48. In view of the scope of the detriment that we have identified, the practical difficulties of creating and maintaining a control and the possibility that new distortions would be introduced into this market, we are strongly minded not to pursue a price control remedy but would welcome views, including those to the contrary.

Other possible remedies

49. The CC is willing to consider any practical alternatives to the possible remedies outlined above that the parties to the inquiry or other persons would like to propose, which they consider would appropriately address the identified AEC or resulting detrimental effects.

Relevant customer benefits

50. The CC will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(8) of the Act arising from the feature or features of the market concerned. Such benefits comprise lower prices, higher quality or greater choice of goods or services in any market in the UK or greater innovation in relation to such goods or services. The CC welcomes views on the nature, scale and likelihood of such benefits and on the potential impact of its possible remedies on any such benefits. These may include, for example, benefits to the cost and quality of passenger rail services arising from a feature or features of the market that we have identified, such as the requirements of the franchise laid down by the DfT in the ITT, that may be lost as a result of a possible remedy.

Next steps

51. A copy of this notice will be posted on the CC website. The parties to this inquiry and any other interested persons are requested to provide any views in writing, including any additional or alternative remedies they wish the CC to consider, by 12 September 2008.

(Signed) DIANA GUY
Group Chairman
7 August 2008