Consultation

Review of the rolling stock leasing market competition remedies

9 January 2020

Contents

1. Introduction

1.1 This consultation document explains the Office of Rail and Road's ("**ORR**'s") review into the remedies that were put in place by the Competition Commission ("**CC**") for the franchised passenger rolling stock leasing market in 2009.[1] In this document, we set out ORR's role in monitoring and reviewing the operation of the remedies. We also outline our provisional findings on market developments and industry compliance with the remedies since the CC's investigation. We conclude by giving our provisional view on whether to recommend that the Competition and Markets Authority ("**CMA**"), which replaced the CC in 2014[2], consider revoking or making changes to the remedies.

1.2 Unless otherwise stated, all definitions used in this consultation document are contained in the Transparency Order and the Undertakings, both of which are contained in the Annex.

Background

1.3 Rail franchises typically last for seven years, while the usable life of rolling stock is approximately 30 to 35 years. It is therefore necessary to have a means by which Train Operating Companies ("**TOC**s") operating passenger franchises are able to lease trains to deliver their franchise commitments, without taking ownership of them for their full life spans.

1.4 When the railways in Great Britain ("**GB**") were privatised,[3] three rolling stock leasing companies (the "**Initial ROSCOs**") were created for the purpose of competing to lease trains to TOCs.

1.5 In June 2006, following the first round of franchise awards post-privatisation, ORR received a submission from Department for Transport ("**DfT**"). The submission asked ORR to look at whether there was a lack of competition in the market arising from a number of its structural and behavioural features.

1.6 ORR carried out a market study to investigate these concerns, and in 2007 referred the franchised passenger rolling stock leasing market to the CC. The CC undertook a market investigation which it concluded in 2009. The CC found that there were a number of factors impacting choice and competition in the market, including:

[1] The CC's remedies were initially proposed in its *Rolling Stock Leasing* report in April 2009. The CC accepted undertakings from the Initial ROSCOs in July 2009 and the CC subsequently issued a Transparency Order that came into effect on 22 February 2010
[2] Under section 162 of the Enterprise Act 2002
[3] The privatisation of the UK's railways began in 1994 and was completed by 1997

(a) high barriers to entry;

(b) the direct, or indirect, specification of rolling stock in franchise Invitations to Tender (“**ITTs**”), and the operation of the franchise system;

(c) a lack of choice and alternative rolling stock available to TOCs; and,

(d) reduced incentives for TOCs to negotiate with the Initial ROSCOs.

1.7 The CC imposed a package of remedies which included a requirement on:

(a) current and future ROSCOs to provide TOCs with a set list of information when making any lease rental offer for incumbent[4] or alternative used rolling stock to operate on franchised passenger services. This remedy was implemented through the “**Transparency Order**”; and

(b) Initial ROSCOs to amend their Codes of Practice to remove non-discrimination requirements. The Initial ROSCOs all offered voluntary undertakings to this effect (“**Undertakings**”). This remedy only applies to the three Initial ROSCOs.

1.8 In addition to the above, the CC made a number of recommendations to the DfT. These included introducing franchise terms of 12-15 years or longer; taking account of benefits of alternative rolling stock beyond the franchise term and across other franchises; and, to stipulate franchise specifications in a way that bidders are allowed a wider choice of rolling stock.

ORR’s role

1.9 ORR is the independent economic and safety regulator for the railways in GB, and the monitor of performance and efficiency for England’s motorways and trunk roads.

1.10 The CC made the Transparency Order, using its powers under the Enterprise Act 2002 (the “**Act**”) in order to remedy, mitigate or prevent the adverse effect on competition, as specified in its report.[5] ORR is responsible for monitoring its operation and ensuring compliance.[6] The Transparency Order may apply to new entrant ROSCOs and its scope is not limited to the Initial ROSCOs. ORR is also responsible for monitoring and ensuring compliance with the Undertakings by the Initial ROSCOs.[7] Both the Transparency Order and the Undertakings give ORR

[4] Incumbent stock refers to the rolling stock which is already in use on the relevant franchise being bid for
[5] The Transparency Order was made in accordance with section 138 of the Act and in exercise of the powers conferred on the CC by sections 161, 164 and Schedule 8 of the Act
[6] Under Part 4 of the Transparency Order
[7] Under paragraph 8.2 of the Undertakings

powers to require information from relevant parties and to enforce in the event of non-compliance.[8]

1.11 ORR does not have powers to vary or revoke the Transparency Order or to vary, supersede or release parties from the Undertakings. These powers are reserved solely to the CMA. ORR's role is to advise the CMA on what we consider to be the best course of action (if any) based on any review we undertake.

Previous reviews

1.12 In 2015, ORR carried out a review of compliance with the remedies and the overall market outlook.[9] That review was limited in scope, in part due to the small number of new leases that had been entered into since the CC's remedies came into force in 2010.

1.13 ORR's findings were that the Transparency Order had, in at least the majority of cases, been complied with and been broadly successful. Views on the extent of changes in the market since the CC's review, were mixed, with no clear theme emerging.

Purpose and scope of the review

1.14 The purpose of our latest review is to determine:

(a) whether there has been a material change in the market which has led to the alleviation of competition problems identified by the CC, such that the remedies are no longer appropriate, or should be varied to ensure that they remain effective; and

(b) whether ROSCOs are compliant with the Transparency Order and the Undertakings.

Our approach

1.15 Our work to assess whether the competition issues identified by the CC in 2009 are still apparent today centred on four themes:

(a) **Franchising policy** – the impact that the wider franchising framework and policy has on market outcomes;

[8] See articles 6.1, 8.2 and 9.1 of the Undertakings and paragraphs 8 and 9 of the Transparency Order
[9] https://orr.gov.uk/rail/promoting-competition/competition-consultations/review-of-the-rolling-stock-leasing-market-investigation-order-2009

(b) **Barriers to entry** – the factors, if any, that restrict entry into the market for leasing passenger rolling stock;

(c) **Choice/ availability** – the availability of alternative rolling stock from which TOCs can choose when bidding for a franchise.[10] This was found by the CC to be a key determinant of TOCs' ability to negotiate with ROSCOs on prices and terms; and

(d) **Incentives** – The incentives on ROSCOs to effectively compete, and on TOCs to effectively negotiate.

1.16 We also undertook an assessment of compliance based on evidence provided by TOCs and ROSCOs, and an assessment of whether new entrants are likely to be subject to the Transparency Order now or in the future.

1.17 We have worked closely with the CMA to develop our approach, and have engaged regularly with the CMA and DfT throughout our review.

1.18 We also held meetings with nine industry participants. Eight ROSCOs and six TOC owning groups[11] ("**Owning Groups**") provided information to assist us in our review.

[10] This includes Direct Awards and franchise extensions determined by DfT, as well as bids for full franchise terms

[11] Owning groups are the parent company of TOCs. For example, FirstGroup is the owning group for Great Western Railway, South Western Railway, Hull Trains, TransPennine Express, and Avanti West Coast

2. Provisional findings

Introduction

2.1 This chapter sets out the provisional findings of our review. It includes a description of how the market works, and our assessment of whether the competition issues identified by the CC have been alleviated by material changes in the market.

How the market works

2.2 The majority of rolling stock used in franchised passenger services is owned by ROSCOs and leased out to TOCs, typically for the length of the franchise term.

2.3 When bidding to win a franchise, TOCs will approach ROSCOs for quotations to lease rolling stock and may also approach a manufacturer(s) directly. Owning Groups told us that, before an ITT is issued, TOCs will put forward around five to six scenarios to ROSCOs to get an idea of what rolling stock is available, and an approximate cost.

2.4 Under the current franchising model, the DfT specifies in the ITT the services that a TOC is expected to deliver. The ITT specifications include certain requirements that the rolling stock is required to meet, as well as the minimum number of services, minimum capacity, stopping patterns and journey times (usually in the form of Service Level Commitments).

2.5 When bidding for a franchise, TOCs will consider whether:

(a) there is suitable rolling stock off-lease which could be used;

(b) there is suitable rolling stock deployed elsewhere on another franchise which is expected to come off lease during the relevant time period and could be cascaded to the franchise; or

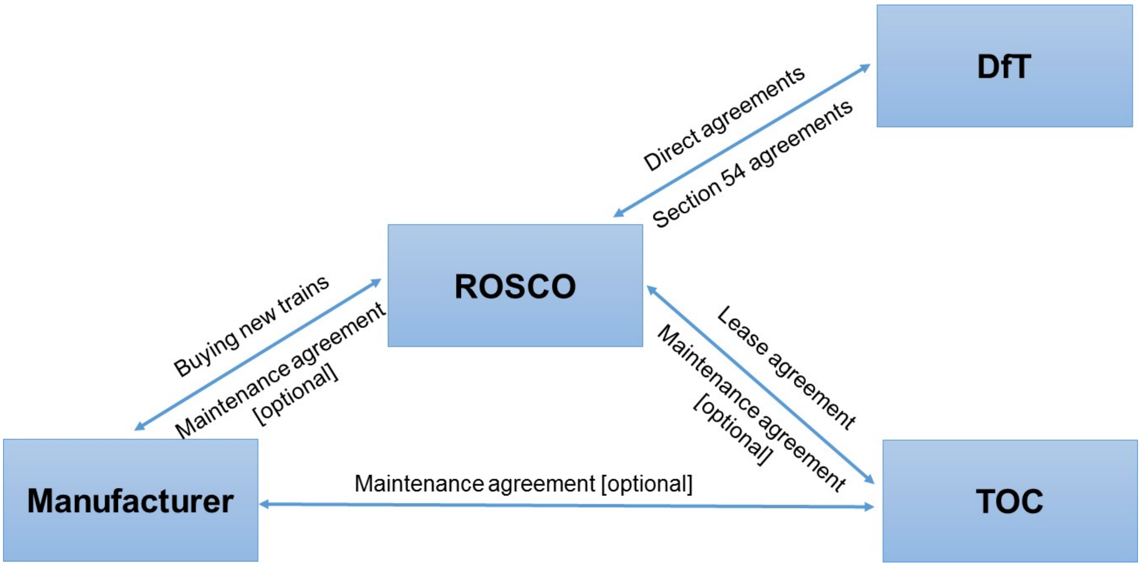
(c) it is commercially viable to purchase new rolling stock.

2.6 Whether rolling stock is suitable will depend on whether the rolling stock is capable of meeting the requirements of the route (for example, the route may require trains to fit through small tunnels or to meet certain speed requirements on long distance routes), and the requirements of the franchise.

2.7 Following the issuance of the ITT, the TOCs and ROSCOs refine their requirements and offers. The TOC which wins the franchise will enter into a contract with the ROSCO (and, where appropriate, the manufacturer).

2.8 The DfT has direct agreements with each of the ROSCOs to ensure it is able to step in and take over the running of the franchise, and therefore responsibility for its rolling stock, should a franchise fail. The DfT also has the power to offer Section 54 guarantees, under the Railways Act 1993, to ensure that vehicles are re-leased from the end of the current lease period through to the expiry of the Section 54 undertaking on substantially the same terms as the initial lease.

2.9 The diagram below illustrates the relationships between different participants in the market for the leasing of franchised passenger rolling stock.



The application of the Transparency Order

2.10 The Transparency Order applies when a ROSCO makes an Indicative Offer. A full definition of Indicative Offer is contained in the Transparency Order (see Annex). However, broadly speaking an Indicative Offer is a written indication of the level of rent for which a ROSCO would be prepared in principle to lease existing Rolling Stock[12]: (a) of a defined quantity; (b) of a defined specification; and (c) for a defined duration of time to a Potential Lessee[13] for it to provide franchise passenger rail services in GB. An Indicative Offer can be made before or after an ITT is issued.

2.11 When an Indicative Offer is made, the requirements of the Transparency Order are activated. Those requirements are that the ROSCO provide the TOC with a set list of information on the particulars of the rolling stock, capital rent, non-capital rent, maintenance, investment, and modifications to the rolling stock.[14] It was intended that the provision of this information to TOCs by all ROSCOs that provide an

[12] Rolling stock means any coach, locomotive, car, vehicle or similar type of unit that at the date of an Indicative Offer has operated or is currently operating on the railway network to enable the carriage of passengers in Great Britain - Section 2.1 Transparency Order
[13] As defined in Section 2.1 of the Transparency Order
[14] See articles, 5, 6, 7, 10 and Schedules 1- 7 of the Transparency Order

Indicative Offer would help TOCs to compare lease rental offers and to challenge the ROSCOs more effectively over lease rental terms.

Changes in market and impact on competition issues

2.12 We set out below our findings on whether the original competition concerns identified by the CC have been alleviated. This includes the extent to which franchising policy and barriers to entry have changed; how these have impacted the level of choice TOCs have; and, TOCs' and ROSCOs' incentives to negotiate.

Franchising policy

The original concerns

2.13 The CC found that the interaction between the franchising system and the leasing of rolling stock for franchised passenger services determines many aspects of the structure of the market. The CC found that detailed specific service requirements laid down in franchise ITTs practically limited the rolling stock options available to TOCs. It found that, in some cases, ITTs would expressly or implicitly indicate a requirement for new rolling stock to be deployed, for example, to increase capacity or because it was necessary to replace life-expired rolling stock.

Changes observed in the market

2.14 In 2012, the DfT published a new approach to franchising to drive improvements in rolling stock; modernise fleets; make the best use of new technology; and improve the passenger experience. This approach places more weight on quality when assessing value for money of a franchise bid. This change in policy has been implemented through franchise ITT specifications.

2.15 Owning Groups told us that the changes to ITT specifications have made it more viable for new trains to be considered as an option in a franchise bid. The DfT considers that the change in policy has driven the procurement of new rolling stock, and highlighted this as a key achievement in a document setting out its view of the rolling stock market in 2015.[15]

2.16 However, Owning Groups told us that franchise ITTs continue to be very prescriptive – though we note that the level of specificity appears to vary across franchises. Owning Groups told us that this level of specificity risks limiting innovation, and impacts on the level of choice available to TOCs when bidding for franchises. For

[15] DfT's 'Rolling Stock Perspective' 2015: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/524086/rolling-stock-perspective.pdf

example, requirements on timing may act to prevent cascaded or new stock from being a viable option, while requirements on quality or for particular features may discount existing stock as an option since it is often not commercially viable to refurbish existing stock to meet stated requirements.

Impact of changes on the original concerns

2.17 Franchising policy undoubtedly continues to determine many aspects of the rolling stock leasing market. We were told that, for many franchise awards, the specificity of requirements contained within ITTs still limits the rolling stock options available to TOCs. However, changes to franchising policy have been a key driver in the procurement of around 8,100 new vehicles, which, at the time of the CC's investigation, were not considered to provide a competitive constraint on existing rolling stock. We discuss this issue further in the section of this paper on choice and availability.

Barriers to entry

The original concerns

2.18 In 2009, passenger rolling stock in GB was owned predominantly by the three ROSCOs created at privatisation (now Eversholt Rail, Porterbrook and Angel Trains). Only one other rolling stock lessor existed – Voyager Leasing Limited – which was set up to lease a new fleet of Voyager trains but did not undertake further leasing activities.[16]

2.19 The CC found that barriers to entry into the market – whether entering with new or used rolling stock – were high. In particular, it found that a combination of scale economies; portfolio risk diversification; and experience of managing residual value risk, awarded incumbents an advantage that could not be replicated by new entrants.

Changes observed in the market

2.20 Since 2009, there has been significant entry into the market, particularly for new rolling stock, which suggests that entry barriers have been lower in recent years since the CC's investigation.

2.21 ROSCOs told us that new entrants had been attracted by low interest rates and favourable exchange rates (both of which lower the cost of financing new rolling stock) and the perceived stability of trains as asset investments. Entry by new financiers and manufacturers was also noted as having lowered the cost of new build trains. Combined with the changes in franchising policy described above (with a

[16] Voyager's fleets were subsequently bought by Beacon Rail

greater focus on quality than in the past), new entrants have seemingly recognised an opportunity to enter the market.

2.22 The ROSCOs which have entered since 2009 sit on a spectrum ranging from 'full' competitors (which own and lease multiple fleets, which may consist of a mix of new and used rolling stock) to more marginal competitors (which own a single fleet, and may be constrained from participating in further leasing opportunities by long-term contracts). Entrants into the rolling stock leasing market in the last ten years include Rock Rail, Beacon Rail Leasing, SMBC Leasing, Corelink Rail Infrastructure, Agility Trains, and Cross London Trains.

2.23 Agility Trains[17] and Cross London Trains were set up as Special Purpose Vehicles to deliver set projects tendered for by the DfT. Agility Trains' rolling stock is guaranteed by the DfT for use on the Great Western and East Coast Mainlines for 27.5 years, while Cross London Trains' stock is guaranteed for 20 years on Thameslink. These rolling stock lessors are not likely to compete in the wider market in the short- to medium-term, although the Initial ROSCOs told us that their impact is already being felt through a reduction in the number of potential franchise awards available to bid for.

2.24 Analysis of DfT data shows that 60% of new trains ordered since 2010 have been financed by recent entrants; 28% by the Initial ROSCOs; and 13% by public transport bodies. When delivered, new entrants will own around 30% of the national passenger fleet.

Impact of changes on the original concerns

2.25 The significant new entry which has occurred in the last ten years is expected to (continue to) disrupt the market as new rolling stock is delivered onto the network. However, it is difficult to predict to what extent lower barriers to entry will remain a feature of the market in future given uncertainties around the macroeconomic and wider political environment. The impact of entry (and, in particular, the delivery of new fleets) on price and choice, particularly in the longer term, also remains to be seen, as we set out in the section on choice and availability below.

[17] Agility Trains consists of two separate corporate entities, Agility Trains West (set up to procure the InterCity Express Programme for the Great Western Mainline), and Agility Trains East (set up to procure the equivalent IEP project on the East Coast Mainline)

Choice/ Availability

The original concerns

2.26 In 2009, the CC found that there was a shortage of alternative rolling stock available to TOCs at the point of franchise renewal because few viable alternatives to the incumbent stock existed.

2.27 While the market for new rolling stock was found to be competitive, the CC found that new rolling stock did not act as a competitive constraint in the market because it was only appropriate for certain franchises (depending on DfT's franchise specifications) and, in most cases, was deemed commercially unviable. The CC also found that, in some instances, the DfT's expressed unwillingness to meet the higher lease rental costs of new rolling stock ruled out the possibility of bidding on the basis of introducing new rolling stock.

Changes observed in the market

2.28 TOCs told us that in many cases, incumbent rolling stock is still the only option. In particular, incumbent rolling stock is almost always the only option where rolling stock is required to be leased for a short time – as is often required for Direct Awards,[18] for example – since it is not commercially or logistically viable to arrange a cascade or to purchase new stock. In such cases, ROSCOs usually charge a short term lease premium which, evidence suggests, can be more than 100% of the original capital lease rental. ROSCOs told us that short term lease premiums reflect the residual risk arising from the uncertainty of leasing for a short period.

2.29 Where TOCs do have flexibility to consider alternative options to the incumbent rolling stock, they told us that it is rare to use stock which already exists (either surplus stock, or stock which is in use on another franchise). This is because there are still few viable alternatives to incumbent stock. Whether existing stock is suitable for use on any particular route is limited by a number of factors, including:

(a) **The bespoke nature of rolling stock**, which arises as a result of the technical and operational requirements of the route and the specifications in the franchise ITT. TOCs seeking to lease rolling stock are required to factor in the cost of modifying it to meet the relevant route requirements and franchise specifications, which could render their bid uncompetitive;

[18] While the nature of Direct Awards differs, it generally means that the Government negotiates directly with the incumbent operator; there is no competition for the award. Direct Awards are typically short-term agreement (around 12 months)

(b) **Logistical issues**, which are exacerbated by changes to franchise schedules and delays to the delivery of new rolling stock on another part of the network which means rolling stock cannot be released as intended; and

(c) **The limited availability of off-lease rolling stock**. We were told by all ROSCOs that storage for long periods is both uneconomic and ineffective; vehicles (and particularly those in cold storage, which is less costly) deteriorate at a very fast rate and ideally need to be re-leased within a few months of coming off lease. ROSCOs noted that unless rolling stock coming off lease has a guaranteed future use, it may be scrapped rather than stored due to the high costs involved. This means there is limited available rolling stock which is off-lease.

2.30 The roll-out of new trains onto the network over the next few years might be expected to go some way to addressing the last of these constraints above; the Initial ROSCOs told us that there is now a significant risk that mid-life fleets will be displaced by new trains, and one ROSCO estimated that this would be the case for more than 2,000 vehicles currently in use on the network. However, as a result of the difficulties in storing and cascading existing rolling stock a significant proportion of displaced trains may be scrapped irrespective of their duration in service, thus doing little to address the constraints on the availability of alternative existing rolling stock.

2.31 More generally, unlike existing stock, new rolling stock now appears to act as a greater constraint to incumbent stock where TOCs have the flexibility to consider alternative options. A number of factors have driven this change, namely:

(a) **Franchise policy** has changed such that it now places greater weight on quality, which encourages the purchase of new trains. Franchise specifications (as detailed in ITTs) also sometimes expressly or indirectly require the procurement of new rolling stock;

(b) **Interest rates have fallen and remained stable**, such that the costs of financing new rolling stock are lower. In the ten years prior to the CC's investigation, the Bank of England's base rate averaged almost 5%; in the ten years since the average has been just 0.5%. As noted above, this has encouraged new entrants to enter the market with new rolling stock, which they can offer at lease rates which are competitive with existing alternative rolling stock; and

(c) **The low cost of maintenance for new rolling stock** as compared to maintenance for existing rolling stock. This has been attributed to the digitisation of many functions and the application of modern maintenance techniques. One TOC told us that maintenance costs were between 30-50% cheaper for new trains.

2.32 These factors have contributed to a reduction in the cost of new rolling stock so that, in more cases, it is more cost effective to meet franchise requirements by purchasing new rolling stock, rather than modifying existing stock. The data supports this; approximately, 8,100 new vehicles have been ordered since 2010, which constitutes almost half of the trains currently operating on the network.[19] In the ten years prior (2000-2010) fewer than half this number of trains were ordered (3,600).

Impact of changes on the original concerns

2.33 While there has been some improvement in the choice of rolling stock available to TOCs, particularly when bidding for full-term franchises, a number of factors continue to limit choice in certain situations. For example, for short-term leases, choice is often still restricted to incumbent stock. In these cases, the greater willingness of ROSCOs and financiers to fund new rolling stock has little or no impact. Further, the availability of surplus and cascaded stock remains limited in the vast majority of cases, and franchise policy/ ITT specification is still a key determinant of choice.

2.34 Nevertheless, in some situations, new rolling stock is now a viable option for franchises where it wasn't previously. However, it is not clear to what extent the factors that have driven the procurement of new rolling stock (including the favourable macroeconomic environment and changes in franchise policy) will endure.

2.35 It was also suggested to us by a number of ROSCOs that a market readjustment will need to take place to account for changes in the expected useful life of rolling stock. Indeed, ROSCOs told us that historically they have made commercial decisions predicated on an expectation that rolling stock would be in operation under a commercial lease for all or the majority of their expected useful economic life of around 30 to 35 years. An increased threat of early displacement would result in either a reduction in the rolling stock lessors' returns, or a recoupment of costs through higher rentals. This could result in a price adjustment rendering new rolling stock, once again, economically unviable in franchise bids in future.

Incentives

2.36 We consider, in turn, below the incentives on ROSCOs to effectively compete, and on TOCs to effectively negotiate.

[19] ORR analysis of data provided by DfT

ROSCO's incentives

The original concerns

2.37 The CC found that ROSCOs' incentives to compete with rivals for train operators' business were affected by the risk of rolling stock going off-lease; the availability of alternative ROSCOs' fleets at the time of franchise bidding (which we covered in the section on choice/availability above); and the regulatory framework.

2.38 At the time of the CC's report, actual occurrences of fleets going off-lease were rare since demand for rolling stock was high relative to supply. As a result, the CC did not consider this threat to be a significant constraint on, or determinant of, ROSCOs' lease rentals. Nevertheless, TOCs generally held the perception that where they had managed to achieve substantial reductions in rentals, this was because of the threat faced by ROSCOs of rolling stock going off lease.

2.39 In relation to the regulatory framework, the CC's findings were mixed. It found that the threat of intervention by DfT, should ROSCOs be seen to be increasing rentals without justification, exerted a significant constraint on ROSCOs' behaviour.

2.40 However, the CC rejected arguments submitted by ROSCOs that the threat of DfT (i) using 'call options';[20] (ii) lengthening franchise terms (e.g. to encourage self-supply by TOCs); or (iii) encouraging the purchase of new rolling stock to displace incumbent rolling stock (e.g. through franchise specifications) acted to control market outcomes.

Changes observed in the market

2.41 The recent procurement of new rolling stock increases the likelihood of existing stock being displaced. As highlighted above, limitations in the ability to store and cascade existing stock could result in it being scrapped when it comes off lease.

2.42 The increased threat of displacement of existing stock could act to constrain lease rentals and shift the balance of negotiating power in favour of the TOCs. ROSCOs told us that the influx of new trains has already led to a reduction in lease rentals, and that they are willing to negotiate on terms and prices, and make tailored offers to TOCs. One ROSCO acknowledged that if lease rates for existing stock are not competitive, the lessor will struggle to re-lease it.

2.43 Some TOCs were of the same opinion, telling us that they are able to negotiate more effectively with rolling stock lessors. However, overall responses were more mixed

[20] Call options give the Government the right to require the Initial ROSCOs to enter into a new lease with Government for up to three years form the end of the current franchise at the same price for the rolling stock as the previous lease between the ROSCO and TOC. These still apply, but only to post-MOLA rolling stock

(as discussed in the next section on TOC incentives); many TOCs felt the situation had not improved and that high lease rentals continued to reflect the lack of choice in certain situations. Meanwhile, DfT was of the view that competition for new rolling stock has allowed franchise bidders to drive value and modernise the rolling stock fleet.

2.44 In terms of the regulatory environment, we note that DfT has intervened in the market a number of times since 2009, including through a number of Direct Awards and the direct public procurement of trains on the East Coast Mainline and Greater Western Mainline (together, the Intercity Express Programme); Thameslink; and Crossrail.[21] One ROSCO told us that the direct public procurement of rolling stock had the effect of shrinking the size of the market available for competition for a significant period of time (with the government guaranteeing stock usage of between 22 and 30 years).

Impact of changes on the original concerns

2.45 It is clear that the threat of rolling stock coming off lease is greater now than at the time of the CC's report. This, at least in the short-term, may be expected to improve competition on price and non-price factors amongst rolling stock lessors. However, we note that it is not clear what the impact of an increase in the supply of new rolling stock is likely to be in the medium to longer term if rolling stock lessors revise the assumptions on which they set their offering to the market.

2.46 We also found that the DfT continues to play a significant role – both directly and indirectly – in the rolling stock leasing market. However, we did not receive any specific representations on how, if at all, ROSCOs' pricing decisions are influenced by DfT policy or the threat of regulatory intervention. It is therefore not possible to comment on what, if any, impact this has on lease rentals and competition in the market more generally.

TOCs' incentives

The original concerns

2.47 The CC found that TOCs' incentives were dampened by the way in which ROSCOs applied the non-discrimination clauses contained within their Codes of Practice. TOCs reported to the CC that, insofar as they managed to negotiate any reductions in rentals with ROSCOs, these would then be offered to rival TOCs such that they were not able to gain any competitive advantage in winning the franchise bid.

21 The Intercity Express Programme contract and Thameslink contract are funded by the private sector with Section 54 guarantees from the DfT, and are akin to Private Finance Initiative type contracts

Changes observed in the market

2.48 The removal of the non-discrimination clauses from Initial ROSCOs' Codes of Practice was intended to increase TOCs' incentives to exercise choice and to negotiate with the ROSCOs. Some TOCs told us that this had happened in practice and that the removal of non-discrimination clauses has enabled operators to differentiate themselves by obtaining better contract terms than their competitors. We received evidence of one TOC successfully negotiating down short-term lease premiums applied by a ROSCO for a direct franchise award.

2.49 However, other TOCs told us that while they try to negotiate, they have not noticed any real willingness on the part of ROSCOs to engage in negotiations and that their ability in many cases is unchanged and determined primarily by the availability of alternative rolling stock. Some TOCs also held the perception that there is a difference between the Initial and newer ROSCOs – with the latter being more open to negotiations, while Initial ROSCOs tend not to depart from their historic terms and conditions.

2.50 ROSCOs told us that franchise bidders negotiate Indicative Offers more frequently following the removal of non-discrimination requirements, in the knowledge that those terms will not automatically be given to competitors. ROSCOs noted that this has facilitated the development of more bespoke, tailored offers, and provided better value for money to bidders (though not in isolation of other market changes).

Impact of changes on the original concerns

2.51 The evidence points to an increased incentive on the part of TOCs to negotiate with ROSCOs during the procurement process, following the removal of the non-discrimination clauses. However, it appears that this has not necessarily consistently translated into better outcomes (in terms of price and contract terms) for TOCs, and their ability to effectively negotiate with ROSCOs remains largely case-specific.

Future market changes

2.52 It is important to note that the future structure of the railway is uncertain. The Williams Review, which is due to be published this year, is looking at the structure of the whole rail industry and the way in which passenger rail services are delivered. The new government could also affect the commercial structure of the rail sector. Such changes would have a significant impact on the way in which the passenger rolling stock leasing market operates.

Summary conclusion

2.53 There have been significant changes in the market in the last ten years. However, we consider that the original concerns identified by the CC have not been alleviated. In particular, the interaction between the franchising system and leasing of rolling stock continues to determine many aspects of the market and TOCs' choice is still heavily influenced by DfT's franchising policy and ITT specifications.

2.54 The cost of financing new rolling stock, coupled with changes to franchising policy has encouraged the procurement of new rolling stock, which has attracted new entrants to the market. However, as noted above, the impact of these entrants on competitive dynamics, particularly in the longer term, remains uncertain.

2.55 While all TOCs agree there is now a greater choice of new rolling stock, it is uncertain whether the current conditions which favour new rolling stock will prevail. The availability, and therefore, the option of existing stock is still limited by a number of factors, such as limitations on the type of rolling stock which can be used on a franchise, the timing of franchise competitions, and the difficulties with storing rolling stock for long periods.

2.56 It is likely that the recommendations following the Williams Review will lead to more Direct Awards until implementation of the Williams Rail Review and therefore any issue with the lack of choice/ pricing for short term contracts is likely to be particularly relevant, but we are currently unable to assess this.

2.57 The findings on TOCs' incentives and ability to negotiate are mixed; however, there does appear to be some improvement in TOCs' and ROSCOs' willingness to negotiate.

3. Compliance

3.1 This chapter sets out the findings from our review of compliance with the Undertakings (which only applied to the Initial ROSCOs) and, separately, the Transparency Order which may apply to any ROSCO (including new entrant ROSCOs) that makes an Indicative Offer. This included an assessment of whether new entrants in the market are subject to the Transparency Order.

Compliance with the Undertakings

3.2 Prior to the CC's market investigation, the Initial ROSCOs had provisions in their Codes of Practice that prevented ROSCOs from discriminating between TOCs on the terms of their rolling stock leases. Following its market investigation, the CC required that the Initial ROSCOs amend their Codes of Practice to remove non-discrimination requirements. The Initial ROSCOs all gave Undertakings to this effect.[22]

3.3 We reviewed the Initial ROSCOs most recent Codes of Practice, and confirmed that these Codes of Practice are compliant with the requirements of the Undertakings.

Compliance with the Transparency Order

The requirements

3.4 The Transparency Order requires ROSCOs to provide a Potential Lessee[23] with a set list of information when making an offer to lease (set out in Part 2 and the Schedules of the Transparency Order).

3.5 The Transparency Order applies to the lease of rolling stock, which, as defined in the Order, "*at the date of an Indicative Offer, has operated or is currently operating on the railway network to enable the carriage of passengers in Great Britain*".

3.6 As set out above, there have been a number of new entrants to the market. We sought information from all companies in the market that were leasing rolling stock to check whether the new entrants' business activities fell within the scope of the Transparency Order, and if so whether they were aware of and compliant with the Order; and whether the Initial ROSCOs were compliant with the Transparency Order.

3.7 We found that the majority of the new entrants to the market were in possession of new rolling stock only, which meant that they were not currently subject to the Transparency Order. We consider that these new entrants will be subject to the requirements of the Transparency Order upon re-lease of their rolling stock. We are

[22] This remedy applies to the Initial ROSCOs only
[23] We note that, in GB, Potential Lessees are franchised TOCs

also aware of at least one entrant since 2009 which leases existing rolling stock and is therefore already captured by the Transparency Order. The ROSCOs which are captured by the Transparency Order are required by the Order to send annual compliance statements to ORR.

3.8 Whilst new entrant ROSCOs had some awareness of the Transparency Order, many of those that leased new rolling stock told us that they believed they did not need to comply with the Transparency Order. The reasoning given by these new entrants was that they were not subject to the Transparency Order because they were formed after it came into force in 2010. We note that the new entrants will be caught by the Transparency Order if they engage in activities, as defined by the Transparency Order, irrespective of when the ROSCO was founded. On that basis, we consider that new entrant ROSCOs would benefit and welcome guidance on the application of the Transparency Order.

3.9 In terms of the three Initial ROSCOs, all TOCs considered that these were compliant with the Transparency Order, and in the ten years we have been monitoring the Order, we have not received any complaints regarding a lack of compliance.

Conclusion on compliance

3.10 Overall our review did not highlight any issues with compliance, however, there are a number of new entrants who were previously unaware of the Transparency Order and are likely to be caught by the Transparency Order now or in the future on re-lease of their rolling stock.

4. Provisional decision on whether to recommend a further CMA review

4.1 As set out in the introductory section of this report, the CMA and not ORR, has the power to revoke or vary the Transparency Order. However any decision to do so will be informed by any recommendation we make, although the CMA is not bound by our findings. This chapter sets out our reasons for provisionally deciding not to recommend to the CMA that it should undertake further work to consider removing or varying the Transparency Order. In making our recommendation, we have considered whether there has been a material change in the market which has led to the alleviation of competition problems identified by the CC, such that the remedies are no longer appropriate, or should be varied to ensure that they remain effective.

Revocation of the Transparency Order

4.2 We do not believe that there is a sufficient basis to consider revoking the Transparency Order at this time. While there have been a number of changes in the market since 2009, these do not appear to have alleviated the original competition concerns identified by the CC. In particular, the availability of alternative rolling stock continues to be limited in certain situations; the interaction between the franchising system and leasing of rolling stock continues to determine many aspects of the market; and, the findings on TOCs' incentives and ability to negotiate are mixed.

4.3 On the basis of these findings, we consider the Transparency Order is still, broadly, appropriate in helping to alleviate the original competition concerns. Whilst the evidence suggests that the Transparency Order has not been the main driver of market changes, it has nevertheless delivered, and continues to deliver, some benefits. TOCs told us that the Transparency Order has improved the transparency of offers and created a standard level of information provided which enables TOCs to compare different ROSCOs' offers consistently. The set list of required information has, according to TOCs, also prevented ROSCOs from withholding key details to their own advantage. Further, we also determined that the costs incurred by ROSCOs in complying with the Transparency Order are minimal, particularly when set against the value of the market for rolling stock leasing.

4.4 Most TOCs agreed that the Transparency Order should remain in place and that its removal would be detrimental; TOCs' ability to negotiate would be reduced and the balance of power would be tipped (back) in favour of the ROSCOs. Of the three Initial ROSCOs, one told us that the Transparency Order creates a level playing field between lessors and across franchise bidders, and its removal would disadvantage new franchise bidders, while two believed that any impact of a revocation of the Order would be negligible.

Variation of the Transparency Order

4.5 We also do not consider it appropriate to recommend that the CMA considers varying the Transparency Order. While a minority of TOCs and ROSCOs suggested changes to the Transparency Order which, in their view, would increase its efficacy, we do not believe that the potential benefits such changes could deliver outweigh the costs of undertaking this work.

4.6 The suggested improvements focused on increasing the transparency of the calculation of maintenance charges and short-term lease premiums. These concerns are not novel, and were considered by the CC in its original investigation.

4.7 Following a detailed review of ROSCOs' pricing arrangements and contracts, the CC concluded that TOCs were provided with sufficient information to enable them to evaluate the relative costs of different maintenance arrangements. It also found that short-term lease premiums were not the decisive factor in many switching decisions, albeit they were a relevant consideration and it was important that there was availability of a suitable short-term lease.

4.8 We have also reviewed a number of indicative offers made by ROSCOs and found that, in some cases, the information requested by TOCs to be included in the Transparency Order is already being provided. In a competitive market, we would expect this to enable TOCs to use the provision of this information by some ROSCOs as a bargaining tool in negotiations with alternative lessors.

4.9 Further, in relation to the maintenance charge in particular, we were told that responsibility for the maintenance of new trains is likely to sit with the manufacturers rather than the TOC (in part due to their employment of latest technology) which may render the maintenance charge less relevant in future.

Conclusion on provisional decision not to recommend a further review by CMA

4.10 We consider that there is insufficient justification for recommending that the CMA undertake a review to assess the merits of revoking the Transparency Order. Most TOCs that we spoke to believed that the Transparency Order had provided some non-negligible benefits and that its removal would be unjustified and detrimental.

4.11 Additionally, in view of the limited, incremental nature of changes suggested by some TOCs, we consider that recommending the CMA undertake a review to consider varying the Transparency Order would be disproportionate. Any potential benefits of additional requirements under the Transparency Order in relation to the maintenance charge and short-term lease premiums are expected to be limited when set against the resource required to implement them.

4.12 The uncertainties surrounding the future of the rolling stock leasing market, including the potential impact of the Williams Review and the introduction of a significant number of new rolling stock fleets, further reduces our confidence in the potential benefits of pursuing a recommendation to revoke or amend the Transparency Order.

4.13 In light of these uncertainties, we will continue to monitor the market for passenger rolling stock. If we were to identify or receive evidence to suggest that the market had been significantly affected, we will consider whether a further review of the Transparency Order and Undertakings is required in future. In any event, we would expect to undertake a review within five years if the need does not arise before this.

5. Invitation to comment

5.1 ORR welcomes comment from interested parties on the provisional findings and proposed recommendation of our review by no later than **6 February 2020**. In addition to general submissions, we particularly welcome responses on the following questions:

(a) Do you agree that the changes in the market since 2009 have not alleviated the competition problems identified by the CC?

(b) Do you agree with our decision not to recommend that the CMA undertake a further review of the Transparency Order?

5.2 To respond to this invitation to comment, please email or post your submission to:

Email: beth.tasker@orr.gov.uk and lisa.thurston@orr.gov.uk

Address: ORR Competition Team
2 Rivergate
Temple Quay
Bristol
BS1 6EH

Please also note that our London office has moved to: 25 Cabot Square, London, E14 4QZ.

5.3 We may publish responses to this statement of scope in full or in summary as appropriate. In providing responses:

- please supply a brief summary of the interests or organisations you represent, where appropriate;
- please indicate whether you are providing any material that you consider to be confidential, and explain why this is the case. Please provide both a confidential and non-confidential redacted version of your response; and
- if you are responding in an individual capacity (i.e. you are not representing a business), please indicate whether you wish for your response to be attributed to you by name or published anonymously.

5.4 Following consideration of the consultation responses we receive, we expect to publish a final decision in spring 2020.