

ROLLING STOCK LEASING MARKET INVESTIGATION

Customer behaviour working paper

Summary

1. This working paper provides analysis of the rolling stock negotiations that take place between TOCs and ROSCOs. It attempts to understand the role the DfT plays in the negotiations, the incentives the TOCs face and the relative market power of the TOCs, the ROSCOs and the DfT.

2. In this working paper, we put forward the view that:
 - (a) Using a combination of legal powers, the DfT can specify which rolling stock can be used on a franchise, thus reducing the TOCs' scope for negotiations. The DfT may have public policy reasons for doing so. In particular, it needs to ensure that no franchise is short of rolling stock, that the rail network as a whole can function properly and that railway services meet passenger expectations. However, it remains unclear whether fulfilling these objectives requires the current levels of rolling stock specification.

 - (b) While the DfT has significant legal power to influence what rolling stock is used on which franchise, it seems unlikely that it has monopsony¹ power over the ROSCOs. In most cases, the lack of available alternative rolling stock and the DfT's duty under Section 30 to ensure continuity of rail passenger services are likely to prevent the DfT from obtaining substantial lease rental reductions from the ROSCOs.

¹Monopsony is a market structure whereby there is only one buyer. Monopsony power is an extreme example of buyer power. When monopsony power exists, the sole buyer is able to exert sufficient pressure on the sellers to prevent them from pricing above the competitive level. However, the existence of monopsony may not constrain the seller's behaviour when there is only one seller (ie a monopoly situation) or where the buyer is obliged to purchase.

- (c) TOCs do have incentives to negotiate with ROSCOs. These incentives depend on the stage of negotiations. Prior to franchise award, TOCs have the incentive to produce the best overall bid which will satisfy the DfT's criteria of deliverability and value for money. After the franchise award, the winning TOC will need to ensure that it is capable of delivering the bid. It also has an incentive to reduce its rolling stock costs, as any such reduction will improve its profitability.
- (d) TOCs may not be able to put the incentives to reduce costs into practice, as they may not be able to exert sufficient competitive pressure on the ROSCOs because of a lack of suitable available alternatives to the incumbent rolling stock. This reduces the capacity of the TOCs to negotiate on lease prices and results in price stickiness whereby lease prices remain, in a majority of cases, unchanged or even increase between base case and final price.
- (e) The Codes of Practice ('the Codes') do not seem to make much difference to the negotiation dynamics between the TOCs and ROSCOs, as the key factor giving the ROSCOs considerable negotiating power is the absence of alternatives to the incumbent rolling stock.
- (f) The DfT has increasingly taken a leading role in procurement of new rolling stock by deciding whether, and how, it should be procured. The DfT therefore has attributes of an indirect customer for new rolling stock. New rolling stock also provides an opportunity for TOCs to play ROSCOs off against each other to obtain the best price.
- (g) Self-supply might in principle give TOCs some countervailing buyer power² in their negotiations with ROSCOs. However, only First has acquired more than a negligible amount of rolling stock since privatization. In this case, First gained some negotiation power over ROSCOs. It seems, at present, unlikely that much

²Countervailing buyer power is the capacity of the buyers to constrain the sellers to exercise their market power. In our case, countervailing buyer power would allow TOCs to prevent ROSCOs from pricing leases above the competitive level.

further self-supply will take place for reasons discussed in Annex 1 to the Entry working paper.

Introduction

3. In this working paper we consider the question of whether the DfT or the TOCs are the real customer of the ROSCOs, and whether the DfT or the TOCs have buyer power with respect to the ROSCOs.
4. The paper is organized in two sections. The first section analyses the role of the DfT in TOC/ROSCO negotiations. It analyses both the indirect legal power of the DfT as the architect of the franchise framework (Section 1.1), and the direct legal powers which the DfT can apply to ROSCOs (Section 1.2).
5. The second section analyses the behaviour of the TOCs in TOC/ROSCO negotiations. It analyses both the incentives that TOCs face at different stages of negotiations (Section 2.1) and the factors influencing their ability to negotiate (Section 2.2).
6. This working paper is mostly based on qualitative analysis of various submissions and comments made by the DfT, ROSCOs and TOCs. Whenever possible, we attempt to complement the qualitative analysis with quantitative analysis. In many cases, this quantitative work is still in progress.

1. The role of the DfT

1.1 The DfT's legal powers to set the framework for TOC/ROSCO negotiations

7. The DfT has the power to influence the franchise framework. It will decide (a) the length of the franchises, (b) the degree of franchise cotermination; (c) the degree of

franchise specificity; (d) the general franchise mapping and design; and (e) the franchising process.

8. Setting the franchise framework will influence the availability of rolling stock which TOCs and ROSCOs can bargain over. For instance, at one extreme coterminous and relatively unspecified franchises may, to some extent, allow TOCs to choose from a wider pool of rolling stock.
9. This section analyses how the DfT's setting of the parameters (a) to (d) influences TOC/ROSCO negotiations and whether this leads ROSCOs to consider the DfT to be their real customer and not the TOCs. The franchising process will be discussed in Section 2 when we analyse TOCs' incentives in negotiations with ROSCOs.

1.1.1 ROSCOs' views

Cotermination of franchises

10. HSBC stated that the DfT could instigate more cascades and more competition by ensuring that franchises that use similar rolling stock come up for renewal at the same time, so as to give TOCs more choice, and by ensuring that rolling stock is generic and capable of being easily transferred between each franchise.

Content specification

11. The ROSCOs stated that they did not see the DfT's invitations to tender (ITTs), but were led to believe that ITTs were increasingly prescriptive. For instance, Angel noted that the DfT now displayed an increased willingness to get directly involved in the allocation of rolling stock in situations that might be expected to be left to the operation of the market. Angel concluded that this policy exposed it to the risk that the exercise of the DfT's discretion in such circumstances would reduce its ability to negotiate lease terms with its customers.
12. Angel further argued that the DfT played an increasingly central role in the procurement of new rolling stock. It suggested that in the period after privatization, many bidders chose to include new rolling stock options in their franchise bids and, as a result, numerous new fleets were procured. In more recent times, it stated that the DfT's focus had shifted towards a value-for-money approach. This led to franchise bidders being less committed to new rolling stock.
13. Angel argued that—as mentioned in the ORR's consultation document—in the ITT for the InterCity East Coast franchise, the DfT issued specific instructions for bidders not to include new rolling stock options. Angel added that, based on this, it would seem apparent that the DfT had taken full responsibility for the HST replacement programme (the so-called 'IEP' programme) and removed it from traditional ROSCO/TOC responsibility.
14. HSBC argued that through the ITT, the DfT had a decisive influence on the type of rolling stock that can be used by TOCs, and consequently had considerable monopsonistic power, as the ultimate, albeit indirect, procurer of all rolling stock. HSBC suggested that the DfT was the real purchaser of ROSCOs' services with the TOCs acting as agents.

1.1.2 The DfT's view

Franchise length

15. The DfT specifies the length of the franchise. According to the DfT, the normal length was seven to ten years.³ The DfT argued that longer franchises would increase the risk of franchise renegotiations during the life of the franchise and make it difficult to project revenues. The DfT noted that under longer franchises, it would be very difficult to achieve fixed-price contracts and it was likely that 'cost plus' management contracts would be needed. These contracts would remove the incentive to minimize costs.

16. However, the DfT (or its predecessor, the SRA) had agreed to longer franchises in some cases in the past where major rolling stock replacement was proposed (for example the two initial Virgin franchises and the c2c franchise). According to the DfT, these longer franchises reduced ROSCOs' stranding risk.

17. Moreover, in 2000 the SRA proposed a policy under which all of the existing franchises would be terminated early by agreement, and re-let on a different basis involving franchisees taking delivery risk on long-term investments. Franchisees were to be awarded longer franchises of up to 20 years, subject to various review points. Opportunities for this type of franchise turned out to be limited. The only successfully negotiated franchise was the Chiltern franchise which is 20 years long. The DfT noted that this length was deemed necessary to facilitate a substantial upgrade to train service capacity and route capacity.

³According to our calculations, the average length of the 25 original post-privatization franchises was 8.9 years. The average length of the existing 18 franchises is 11.3 years.

Cotermination of franchises

18. The DfT can ensure that franchises coterminate. Cotermination enables ROSCOs to offer a wider range of options and—to the extent they do so—bidders can choose from a wider pool of available rolling stock. However, the DfT did not consider cotermination to be particularly desirable. According to the DfT, this was for four main reasons: First, the DfT suggested that no more than two or three simultaneous franchise competitions were ‘manageable’ from the perspective of industry resources.
19. Second, the DfT stated that cotermination would make competition ‘meaningless’ as the same rolling stock could be bid on different franchises. This would force the DfT to resolve competing demands for rolling stock, as it has had to do in the re-letting of the West Midlands, East Midlands and New Cross Country franchises (the ‘Midlands Three’).
20. Third, the DfT submitted that cotermination would increase risks and hence risk premia for bidders as they would face a risk of franchise agreement default as they might be unable to secure the rolling stock they bid for.
21. Fourth, the DfT submitted that in the absence of surplus rolling stock, cotermination would only lead to transfers of the rolling stock around different franchises without any reductions in price.

Content specification

22. The ITT will normally specify the number of services, minimum capacity, journey times and stopping patterns. The ITT may also include restrictions on types of alternative rolling stock and, in some instances, it may specify rolling stock to be used. It may also specify whether new rolling stock is to be used.

23. The DfT argued that during the franchise specification process, it liaised with Network Rail and stakeholders, and sought to specify the minimum amount of detail needed to deliver Government objectives.
24. The DfT agreed that it sometimes specified the use of particular rolling stock. It suggested that rolling stock allocation was moving towards the DfT away from the TOCs. For instance, with respect to new rolling stock, the DfT will specify as a minimum what capacity it wants to buy in its High Level Output Specification (HLOS). It will have a leading role negotiating with the TOCs to provide new rolling stock and redeploy existing rolling stock to meet its HLOS commitments. The DfT told us that this allows it to ensure value for money and continuity of services. However, it clarified that it would avoid specifying new rolling stock where fit-for-purpose used rolling stock was available, unless the new rolling stock was required to increase existing capacity.
25. The DfT argued that the current degree of specification was both necessary and not harmful to competition. It argued that specification could only be harmful if the DfT had the ability to be less specific in the ITT as to the particular rolling stock to be used and, chose to be more specific, removing the opportunity for other suitable and available rolling stock to be used. It suggested that the lack of surplus rolling stock and the lack of speculative purchasing by ROSCOs meant that it did not have this ability in practice.
26. The DfT further submitted that a higher degree of specification had been required in the recent franchise lettings because the original franchises tendered between 1995 and 1997, which contained only light specification, proved problematic. In particular, the DfT found bids hard to compare as they did not give a single price for a standardized proposal. It also identified a danger of inconsistent rolling stock

purchases which did not take account of the network as a whole. According to the DfT, this led to 'unstable and unsustainable' outcomes and necessitated intervention.

27. The DfT argued that for the large majority of rolling stock on most franchises, rolling stock substitutability was very low. The DfT submitted that on franchise replacement, a great majority of rolling stock employed by the previous franchisee had been taken on long-term lease by the next franchisee. (See Substitutability working paper.) According to the DfT, this effectively makes the debate about prescriptiveness rather academic.

1.1.3 TOCs' views

Content specification

28. The ORR asked the TOCs whether they considered the most recent rounds of franchise specifications to be prescriptive in relation to rolling stock requirements and whether they noticed any change from earlier practice. All the TOCs seemed to agree that the level of detail in ITTs had increased.
29. The responses varied as to whether this degree of prescription was justified. TOCs made the following comments:
- (a) two TOCs [redacted] considered specification to be very prescriptive; and
 - (b) two other TOCs [redacted] suggested that, whilst the DfT was not fully prescriptive, franchise specifications were provided with the knowledge of what rolling stock was available. This made it extremely difficult for the bidder to do much beyond assume that it would continue leasing the rolling stock already on the franchise.
30. All TOCs agreed that in practice bidders had little alternative but to use the incumbent rolling stock on a franchise at franchise re-let. All TOCs also seemed to

agree that the franchising process itself restricted the choice of lessor and of rolling stock.

31. The TOCs provided the following specific comments:
- (a) GNER recalled that only in two out of the many franchises it competed on was there a realistic option for a change of rolling stock or lessor other than through the procurement of new rolling stock;
 - (b) National Express suggested there were examples where redeployment of spare rolling stock could have been possible if all parties had cooperated and commercial terms been agreed; and
 - (c) Stagecoach argued that, given passenger growth and lack of surplus rolling stock with similar operating characteristics, genuine competition for rolling stock only occurred at the margins.

1.1.4 Our assessment

Franchise length

32. The DfT's setting of franchise length does not seem to have a significant impact on TOC/ROSCO negotiations. It seems understood that the fact that franchise length does not cover the entire asset life will lead to differences in incentives. ROSCOs will have a long-term (whole asset life) view of the rolling stock, while TOCs will have a shorter-term (franchise life) view of the rolling stock.
33. In the past, the DfT has reflected in its franchising policy the fact that shorter leases might increase ROSCOs' stranding risk. This happened, in particular, in the cases of franchises that were based on new rolling stock such as Virgin's winning bid on the Cross Country franchise.

34. We consider that the franchise length will have a significant impact on the extent to which TOCs are able to invest in new rolling stock and self-supply. We consider this issue further in Section 2.2 when we discuss self-supply.

Cotermination of franchises

35. It seems logical that the more franchises coterminate, the wider the pool of rolling stock franchisees may be able to choose from. We do not agree with the DfT that the fact that the same rolling stock can be bid on different franchises necessarily makes competition meaningless. It may, however, lead to the need for different bids to be traded off against one another in order to allocate some rolling stock or to let TOCs submit new bids to take account of some rolling stock ceasing to be available due to its allocation to a different franchise.
36. It is likely that cotermination would make the bidding process more complex. However, it is questionable whether this is unmanageable. While it is possible that the costs of managing the simultaneous letting of more franchises would outweigh the benefits from increased competition between ROSCOs, the DfT did not submit any evidence in support of this other than the statement that more than three franchises would be unmanageable.
37. Cotermination of franchises would have no effect if most of the rolling stock were franchise specific. However, we do not agree with the DfT that moving rolling stock between franchises would necessarily make competition futile. The DfT's view does not take into account that a number of different markets may exist, some of which may have spare capacity while others may not. We have considered the extent of spare capacity in the Capacity working paper.

38. While in theory cotermination may increase availability of rolling stock to TOCs, we consider that the following factors may restrict rolling stock movements in practice: (a) the degree to which surplus rolling stock is available; (b) the degree to which rolling stock is technically and operationally substitutable; and (c) the degree to which substitutes are available at franchise re-let. We discuss these factors in detail in the Substitutability working paper.⁴ We will consider these factors after Emerging Thinking.
39. We consider that the DfT is able to steer the industry over the longer term towards standardization of rolling stock and to facilitate cascades and cotermination. We are, however, unclear at this stage to what extent we can consider a situation with coterminous franchises and standardized rolling stock as a standard for comparison with the current situation, and to what extent this standard is achievable in practice.
40. Therefore, we consider that while cotermination is an important factor that could, in theory, increase the pool of available rolling stock for bidders to negotiate over, it will only have a practical impact on TOC/ROSCO negotiations to the extent that any movements of rolling stock can reasonably be expected. This will depend on rolling stock specificity and substitutability and the comparability of the franchises being simultaneously re-let (eg with respect to services and the rolling stock required).

Content specification

41. All parties (the DfT, ROSCOs and TOCs) appear to agree that the DfT has become more prescriptive over time in the content of the ITTs. The TOCs concluded that content specification reduced the choice of rolling stock for the bidder. We agree with

⁴See working paper on Substitutability for more details.

this conclusion, but only to the extent to which there is a practical possibility for the DfT to be less specific.

42. This raises a question as to whether it would be practicable to specify franchises less and whether this would make a difference to TOC/ROSCO negotiations. The DfT suggested that the fact that a high percentage of rolling stock was leased on the same franchise from one lease to the next made this debate academic. We find this argument to be potentially fallacious. The frequent occurrence of rolling stock being leased on the same franchise (which we calculated to be 78 per cent—see Table 1) is in part a consequence of the current DfT specification policy, and in part a consequence of rolling stock availability (or a lack thereof). We therefore need to understand what standards for comparison could be applied, ie, what rolling stock would have been leased if the DfT had not specified any rolling stock.

TABLE 1 Proportion of incumbent rolling stock leased on franchise re-let

<i>Franchise</i>	<i>Franchisee</i>	<i>Start year of franchise</i>	<i>End year of franchise</i>	<i>Incumbent rolling stock leased by the incoming franchisees %</i>
South West Trains	Stagecoach	2001	2007	46
Chiltern Railways	M40 Trains (John Laing)	2002	2021	97
Southern	Govia	2003	2009	40
Wales & Borders	Arriva Trains Wales	2003	2018	84
Great Western Link	First Great Western Link	2004	2006	92
Scotrail	First	2004	2014	93
Great Anglia (One)	National Express (One)	2004	2011	76
Northern Rail	Serco Ned Railways	2004	2013	70
Trans-Pennine Express	First Group & Keolis	2004	2012	0
InterCity East Coast	GNER (Sea Containers)	2005	2007	90
Thameslink/Great Northern (Capital Connect)	First Capital Connect	2006	2015	100
Great Western	First Great Western	2006	2016	81
Southeastern/Integrated Kent Franchise	Govia	2006	2014	100
East Midlands	Stagecoach Midland	2007	2015	86
West Midlands	Govia (London Midland)	2007	2015	52
New Cross Country	Arriva	2007	2016	100
InterCity East Coast	National Express	2007	2015	100
South West Trains	Stagecoach	2007	2017	91
Weighted average				78

Source: CC analysis based on the DfT's responses to the CC's questionnaire.

43. In order to assess any alternative standard for comparison we need to understand what exactly the DfT's 'prescriptiveness' amounts to in practice and to what extent it could be altered. We identified two types of ITT specification: direct and indirect:
- (a) direct specification occurs when the DfT directly specifies the vehicles to be used (or not to be used) on a given franchise; and
 - (b) by indirect specification we mean other DfT requirements such as minimum capacity or services, journey times or stopping patterns. These requirements influence which vehicles are used.
44. We do not believe that we can at this stage make any assessment of indirect specification.
45. As for direct specification, our analysis suggests that at least 10 per cent of the vehicles used on franchise re-lets were explicitly specified by the DfT or the SRA. We found that out of 13,723 vehicles used on franchise re-lets since privatization (153 fleets), at least 34 per cent of vehicles (or 27 per cent of fleets) were specified in the ITT. This specification clearly restricts the choice bidders have when negotiating with ROSCOs.
46. We found that a majority of the specified vehicles were subject to Section 54 undertakings (72 per cent of all specified vehicles and 52 per cent of all specified fleets).⁵ In a minority of cases (28 per cent of all vehicles and 48 per cent of all fleets), the DfT or the SRA specified vehicles even when these vehicles were not covered by Section 54 undertakings.

⁵The role of Section 54 agreements will be discussed in the following section.

47. We found that in some cases (6 per cent of all vehicles and 7 per cent of all fleets) there were other alternatives available than the vehicles/fleets prescribed by the DfT.

Table 2 explains this in more detail.

TABLE 2 **Directly-specified rolling stock in all franchise re-lets since privatization**

<i>Vehicles/fleets specified</i>	<i>Number of</i>		<i>Per cent</i>	
	<i>Vehicles</i>	<i>Fleets</i>	<i>Of total vehicles</i>	<i>Of total fleets</i>
Yes	4614	42	34	27
No	4841	81	35	53
Information unavailable	4268	30	31	20
Total vehicles/fleets used	13723	153	100	100
<i>Of vehicles/fleets specified</i>	<i>Vehicles</i>	<i>Fleets</i>	<i>Of specified vehicles</i>	<i>Of specified fleets</i>
Section 54	3305	22	72	52
No Section 54	1309	20	28	48
Total specified vehicles/fleets	4614	42	100	100
<i>Of specified vehicles/fleets with no Section 54</i>	<i>Vehicles</i>	<i>Fleets</i>	<i>Of total vehicles</i>	<i>Of total fleets</i>
No other choice was available	457	9	3	6
Other choice was available	852	11	6	7
Total specified without Section 54	1309	20	10	13

Source: CC analysis based on DfT and ROSCO data.

48. The DfT submitted its own analysis of ITT specification. It submitted that specification had taken place in 31 per cent of all cases (see Table 3). In 12 per cent of all cases, vehicles were subject to Section 54 undertakings, and in 18 per cent of all cases, vehicles needed to be leased on the same franchise following a franchise failure or a franchise running into financial difficulties to avoid the payment of early termination fees to ROSCOs. Only in 1 per cent of all cases were there other reasons for specification.⁶

⁶The DfT refers to franchise failure such as occurred in the case of Connex and financial difficulties when the DfT's management contracts were triggered.

TABLE 3 Percentage of incumbent fleet at franchise re-lets

	%
<i>Total percentage of incumbent fleet re-let on a long term basis</i>	81
Section 54 or ITT specified	31
No realistic alternatives to the existing fleet	45
Very limited realistic alternatives to the existing fleet	3
Alternatives available, but incumbent rolling stock chosen	3
<i>Total percentage of incumbent fleet not re-let on a long term basis</i>	19
Life expired	11
Replaced by existing alternatives	2
Replaced by new rolling stock	4
Surplus not retained	1

Source: DfT calculations submitted on 19 November 2007.

49. We believe that in the cases of franchise failure or financial difficulties where the DfT would face very high termination fees, it is possible that the DfT may find it advantageous to avoid those fees by specifying the rolling stock concerned in the ITT.

50. In addition, the DfT also submitted a number of case studies analysing the specification of three franchises: InterCity East Coast 2007, New Cross Country and Integrated Kent. Although the DfT submitted that these three case studies demonstrated that there was very little alternative to leasing the incumbent rolling stock, the case studies raised a number of questions regarding the possible flexibility of the rolling stock supply, the impact of indirect specification and the impact of other DfT rolling stock programmes such as the IEP. We will investigate these issues further.

1.2 The DfT's direct legal powers over the ROSCOs

51. In addition to franchise framework setting, the DfT has legal powers which may directly influence the ROSCOs. These powers relate to (a) Section 30 duty and Direct Agreements, (b) Call Options, (c) Section 54 undertakings and (d) approving leases. The ROSCOs have argued that these powers had a significant impact on their lease negotiations and put the DfT in a strong bargaining position. HSBC and

Porterbrook further argued that the DfT could be considered a monopsonist. This section will analyse each of these powers in turn.

1.2.1 Section 30 duty and Direct Agreements and OPRAF/ROSCO Agreements

52. Section 30 of the Railways Act 1993 obliges the DfT to ensure continuity of rail passenger services when a franchise is terminated or otherwise comes to an end but no further franchise agreement has been entered into. The DfT's duty is commonly referred to as the obligation to act as a 'train operator of last resort'.
53. Under its Section 30 duty, the DfT enters into agreements with ROSCOs. The agreements relate to both the MOLA rolling stock (OPRAF/ROSCO Agreements) and the non-MOLA rolling stock (Direct Agreements). In the case of franchise default, these agreements allow the DfT to step in and take over the control of the rolling stock from the failing TOC.

ROSCOs' views

54. When asked to explain how they understand the DfT's Section 30 duties and the impact of Direct Agreements, the ROSCOs suggested that they were uncertain as to the degree of protection that these duties provided. All ROSCOs argued that Section 30 duties gave the DfT the right to enter into agreement with ROSCOs, but not the obligation.
55. Angel argued that the OPRAF/ROSCO and Direct Agreements gave the DfT various step in and call options that, depending on certain circumstances, can be exercised on an 'all or some' or 'all or nothing' basis.
56. Porterbrook suggested that it was not satisfied that the Section 30 duties and Direct Agreements provided it with any degree of protection. Direct Agreements gave the

DfT in some circumstances the right to enter into lease agreements with ROSCOs on substantially similar terms but not the obligation. Furthermore, the Section 30 duties were weakened by recent legislation and new route utilization strategies. Porterbrook stated that these duties only obliged the DfT to ensure that service continued. It also added that from a credit rating agency perspective, Section 30 might provide an implied level of credit support.

The DfT's view

57. The DfT argued that given its duty under Section 30, its bargaining position with ROSCOs was weak since, in the end, the DfT had to lease ROSCOs' rolling stock in order to ensure that rail passenger services were maintained. The DfT submitted that its position was further weakened because it faced only one 'seller', as—in the absence of any surplus rolling stock—a ROSCO owns all the available rolling stock required by the 'buyer'. The DfT concluded that the Section 30 duty combined with a lack of surplus rolling stock made it impossible for it to exercise monopsony power.

Our assessment

58. The Section 30 duty does seem to have an impact on the DfT's capacity to influence ROSCOs, especially when juxtaposed with its right to approve leases. We will discuss the interplay of these two powers in Section 1.2.5.
59. Direct Agreements and OPRAF/ROSCO Agreements grant the DfT the option to step in and take over from TOCs if there is a risk that rail passenger services will not be delivered. These agreements will give ROSCOs some comfort that their vehicles will continue to be used in the case of franchise default (although not as much comfort as Section 54 undertakings—see section 1.2.4) and thus may have a positive impact on stranding risk.

60. However, Direct Agreements and OPRAF/ROSCO Agreements do not seem to have any impact on TOC/ROSCO negotiations. In addition, when analysing ROSCOs board papers, these agreements were not mentioned when ROSCOs were considering risk.

1.2.2 Call Options

61. Call Options give the DfT the right to require the ROSCOs to enter into a new lease with the DfT for up to three years from the end of the current franchise at the same price for the rolling stock as the previous lease. Call Options appear in all Direct Agreements entered into since 1995. In addition, in 1999 OPRAF introduced a similar three-year Call Option into the three OPRAF/ROSCO Agreements. This second type of Call Option has now largely fallen away.

62. Call Options can be used only in two circumstances: first when a duty under Section 30 is triggered,⁷ and second when a ROSCO is abusing a dominant position in terms of rolling stock leases offered to TOCs.⁸ The DfT has never exercised its Call Option.

ROSCOs' views

63. Angel argued that if the DfT exercised its Call Options this would oblige a ROSCO to enter into a short-term lease for up to three years. Such a short term lease would increase the risk that some or all of the fleet would be off-lease at the end of the three years.

⁷This can occur in the following three cases: a franchise was due to expire and (a) no new franchise agreement had been entered into; (b) a TOC had been offered unacceptable terms from the ROSCOs and refused to provide rail passenger services; and (c) a new franchise had been entered into but it failed to commence on time.

⁸The DfT believes that it would need to establish infringement of Chapter II of the Competition Act 1998 if it wanted to use a Call Option in these circumstances.

64. Porterbrook challenged the DfT's interpretation of its Call Option powers. It stated that the DfT could use them as a bridging mechanism to bring in new rolling stock. Porterbrook argued that the DfT could use these powers to facilitate the introduction of new rolling stock in accordance with its Section 30 duty to ensure the provision of passenger carriage services. This is because this section applies to all cases where a franchise agreement expires, is terminated, or otherwise comes to an end, and no further franchise agreement is entered into with the incumbent franchisee, irrespective of the reason why.
65. Porterbrook added that the argument that ROSCOs would increase their lease premia if Call Options were to be used more liberally was not necessarily true, as Porterbrook already negotiated lease prices based on the assumption that the Call Option may be exercised. HSBC confirmed this position, suggesting that it has always conducted lease negotiations recognizing that the DfT might have recourse to the Call Option.

The DfT's view

66. The DfT stated that the exercise of Call Options was not appropriate for lease rental disputes with ROSCOs, as any dispute would reflect the DfT's view that current lease rentals were too high and the exercise of the Call Option would merely lock the DfT into paying excessive rentals for a further three years. The DfT also considered that any exercise of the Call Option would require it to take complex assessment under Chapter II of the Competition Act as they considered that the Call Option could not be legally exercised unless the DfT was satisfied that the ROSCO was in breach of its Chapter II obligations.

67. The DfT added that the exercising of Call Options without justification would be undesirable as ROSCOs might 'seek to include a price premium in the first lease period to compensate them for the loss of flexibility in relation to their portfolio'.

Our assessment

68. It seems clear that the DfT is unlikely to use Call Options for either of the two purposes identified. It will not use them to curb excessive lease prices as Call Options would only freeze prices at their current level. It also seems unlikely to use them to perform its Section 30 duty as it already has Direct Agreements and OPRAF/ROSCO Agreements in place for that end. These agreements cover a wider portion of rolling stock than Call Options (crucially, they cover MOLA rolling stock) and are not limited to three years.

69. It also seems unlikely that the DfT would exercise Call Options as a bridging mechanism to bring in new rolling stock in the future as the DfT seems to realize the risks involved in using Call Options.⁹ As for the past, it is possible to envisage circumstances where the DfT might have found it advantageous to use Call Options to bring in new rolling stock even if it meant freezing lease rentals at higher levels than the DfT would have liked. Indeed, the DfT may have preferred accepting these rentals for up to three years as an alternative to accepting them for the duration of the whole franchise.

70. The DfT did not appear to consider that the threat of Call Options could place it at a strategic advantage by enabling it to point ROSCOs to the choice of either negotiating prices or facing the possibility that their fleets would become stranded mid-franchise upon the expiry of the Call Option (by which time new rolling stock would have been procured).

71. There has been a lack of clarity as to when Call Options could be used. The ROSCOs suggested that this has led them to incorporate a premium in their lease prices to hedge for the possibility that Call Options are used. However, upon analysing ROSCOs pricing papers, we did not find Call Options mentioned when ROSCOs were considering risk. In addition, the DfT told us that exercising Call Options was undesirable. We are therefore uncertain whether the risk of Call Options being exercised is one that actually exists. Finally, Call Options do not seem to have had any impact on TOC/ROSCO negotiations.

1.2.3 Section 54 undertakings

72. Under Section 54 of the Railways Act 1993, the DfT may give a ROSCO an undertaking that as long as the performance of the rolling stock remains satisfactory, subsequent operators of that franchise may be required as a franchise condition to use that rolling stock until a specified date on the same terms as the first lessee or predecessor franchisee. According to the DfT, this reduces the residual value risk faced by the ROSCOs and enables them to charge a lower lease rate.

73. Section 54 undertakings are given to encourage investment by ROSCOs in new rolling stock. Section 54 undertakings can also be given for existing rolling stock. This happens mainly in the following two cases: (a) the costs of major refurbishment of used rolling stock are to be recovered over a period in excess of the current franchise (where investment may not occur without a Section 54 undertaking being given; or (b) a franchise is truncated while the lease contract remains in place.¹⁰ See Table 4 for details.

TABLE 4 Section 54 undertakings

[✂]

⁹See paragraph 67.

¹⁰We have given example of these situations by Porterbrook, HSBC and the DfT.

ROSCOs' views

74. ROSCOs in general do not dispute the usefulness of Section 54 in particular with respect to new rolling stock. Porterbrook accepted that Section 54 could, on occasion, restrict competition by discouraging cascades and the building of new rolling stock. However, Porterbrook also suggested that Section 54 undertakings might have a strong public policy rationale.

TOCs' views

75. Two TOCs [REDACTED] stated that Section 54 undertakings could constrain their choice of rolling stock.

76. [REDACTED]

Our assessment

77. Section 54 undertakings have an impact on the choice of rolling stock available to TOCs. They are another way of specifying rolling stock and therefore have a similar impact on TOC/ROSCO negotiations as direct rolling stock specification.

78. As with rolling stock specification, we need to consider the extent to which granting Section 54 undertakings was the only way for the DfT to achieve its objectives, either to facilitate new rolling stock and refurbishment or to address the problem of stranding risk due to franchise failure, and thus to what extent it was necessary to restrict the TOCs' choice of rolling stock. We will consider this issue after the publication of Emerging Thinking.

The right to approve leases

79. The DfT has the right to approve leases. The approval mechanism is contained in its franchise agreement with the TOCs.

ROSCOs' views

80. Porterbrook argued that the fact that the DfT's approval had to be obtained to each rolling stock lease entered into by a TOC, together with the DfT's ability to sponsor the acquisition of new rolling stock, effectively conferred monopsony power on the DfT. Porterbrook further stated that if the DfT did not approve of the terms of a proposed lease, then it had, in the past, required the TOC and the ROSCO to renegotiate the lease. Porterbrook also suggested that the DfT had full knowledge of rolling stock prices across the industry and was therefore very well informed. Porterbrook concluded that this monopsony power had helped to ensure that rolling stock charges were at a competitive level.

81. When asked to recall a situation when the DfT had interfered, HSBC could not recall any occasion when the DfT objected to a deal after the franchise was awarded. However, both Angel and Porterbrook stated that they recalled a number of instances. In many cases, the DfT wanted to keep the rolling stock on its original routes; in other cases, the DfT negotiated rent reductions, or refurbishment or maintenance arrangements. In one case, Angel said that it had been forced by the DfT and Siemens to purchase additional tranche of spare parts.

82. When asked who was the primary negotiator in the ROSCO negotiations, Angel and Porterbrook suggested that negotiations usually took place between TOCs and ROSCOs although the DfT's right to approve leases via the franchise agreement gave it a significant role in the negotiations. Porterbrook specified that the DfT could provide comments and negotiate amendments.

83. Voyager Leasing stated that the DfT was involved in commercial negotiations on franchise re-lets and the termination of the original lease with Virgin.

The DfT's view

84. The DfT argued that the negotiation of the terms on which rolling stock would be leased under new franchises was between TOCs and ROSCOs and that the DfT could not be involved with lease negotiations. The DfT submitted that its interference at this stage would be unlikely to deliver a materially better result than TOC/ROSCO negotiations. This is for the following three reasons: (a) the DfT's Section 30 duty; (b) the lack of alternative existing rolling stock; and (c) the general attitude of the ROSCOs to any challenge to their lease prices.
85. The DfT submitted that it scrutinized lease proposals prior to its approval. The DfT suggested that it would scrutinize clauses regarding any right by the lessor to terminate the lease unilaterally, 'events of default' clauses, information provision clauses, minimum insurance requirements, clauses requiring unnecessary change of livery and branding, etc. The DfT suggested that over the last two to three years, ROSCOs had agreed a 'template' lease agreement which addressed these concerns.
86. The DfT told us that it sometimes adopted a relatively more intrusive approach to approving leases for key strategic reasons. It mentioned the 'Midlands Three' franchises as an example: the DfT needed to allocate rolling stock in the situation when the same rolling stock was being offered by a number of bidders on all three franchises. The DfT also intervened to prevent Angel from offering certain rolling stock currently deployed outside the Midlands Three franchises. The DfT refused to approve the lease for additional Class 158s requested by First for the Greater Western franchise. This was because these vehicles were over and above the original requirements and because these vehicles were needed on the East Midlands franchise which would not have been able to commence without them.

87. The DfT submitted that its power to approve leases did not give it any leverage in the negotiations. It also argued that the Section 30 duty left it vulnerable to ROSCOs' demands. This was because a refusal by the DfT to agree a lease meant that a franchise could not commence. Such refusal would not exert any pressure on the ROSCOs as they know that the DfT's Section 30 duty meant that the DfT would be required to obtain the rolling stock from them anyway.

TOCs' views

88. We asked the TOCs to recall instances when the DfT had used its right to amend or decline approval of lease contracts. GNER, Govia and Laing could not recall any instance where approval was declined. However, GNER reported a couple of minor delays to approval and Govia stated that approval of its leases by the DfT could add a matter of weeks into the contracting process.
89. Two other TOCs (Arriva and National Express) mentioned the case of Porterbrook's Class 150 fleet that was due to come off-lease on the Central franchise. This fleet was offered by Porterbrook to Arriva Wales, however, the DfT refused to permit Arriva Wales to sign the contract. National Express believed that this was because the contract would have left it short of rolling stock the on Central franchise.
90. Two other TOCs (First and SercoNed) mentioned the DfT's intervention on the Midlands Three franchises:
- (a) SercoNed mentioned a delay in approval of 30 additional Class 158 units from Angel. SercoNed believed that the delay was caused by the implications that the deal might have had for the West and East Midlands franchises.
 - (b) First mentioned its attempts to secure rolling stock for its Greater Western franchise from Angel and Porterbrook. The rolling stock was operating on the

Midlands and other franchises. The DfT did not approve the lease. First believed that the DfT may have developed its own strategy for rolling stock.

91. Finally, Quasar Associates¹¹ submitted that the DfT did not try to negotiate instead of TOCs.

Our assessment

92. The DfT's right to approve leases and its Section 30 duty seem to be at the heart of the debate about the extent to which the DfT can or cannot wield its legal power over ROSCOs. On the one hand, the DfT can and has on occasions intervened in lease contracts and used its right to approve leases to prevent a lease agreement from being concluded. On the other hand, the DfT submitted that its duty under Section 30 seriously limited the way it could use this power as—in the end—it had to lease vehicles from ROSCOs, having no other means to fulfil its legal obligations.
93. We note that it is important to distinguish between the situation when the DfT uses its legal powers as the franchise system architect by specifying the franchise details (as discussed in section 1.1), and the situation when the DfT has to fulfil its duties under Section 30 (as discussed in section 1.2). The relative power of the DfT may not be the same in these two situations, with the DfT likely to be in a stronger position in the former case than in the latter. We consider at this stage that it unlikely that the DfT has monopsony power.

2. TOCs' negotiations with ROSCOs

2.1 TOCs' incentives in the negotiations

94. The DfT specifies the franchising process. This process has a number of key stages, which are:

- I. *Prequalification*: The DfT publishes a Prior Information Pack (PIN) which sets out the anticipated programme for procuring a specific franchise. The DfT then publishes an advertisement in domestic, European and international journals and specialized press. Interested parties are then invited to fill in a pre-qualification questionnaire. Finally, the DfT selects three to five bidders for the next stage.¹²
- II. *Invitation to Tender (ITT)*: Each shortlisted bidder receives an ITT. An ITT includes a base service specification. A bid which does not comply with the base service specification will be rejected as non-compliant. The ITT may also invite bidders to submit priced options which will cover specified increases or decreases in service levels and the resulting costs or savings. In addition, bidders can develop their own options. Shortlisted bidders approach ROSCOs to negotiate rolling stock leases that will allow them to fulfil the ITT.¹³ They then develop their bids and submit them to the DfT for evaluation.
- III. *Franchise award*: The DfT selects the preferred bidder. The selection of the winning bidder is based purely on the proposition submitted to operate the base service specification. The DfT will only consider acceptance of priced options and alternative options from the preferred bidder. The award criteria are compliance, deliverability and value for money. After the franchise award, the preferred bidder will have to turn its bid into binding contracts bearing in mind that it will be expected to deliver the service and the price that it has committed to in the bid.
- IV. *Start of franchise*: The DfT will monitor the performance of the franchise. The DfT has an obligation to ensure continuity of rail passenger services and in the case of franchise failure, it has to act as the operator of last resort. The

¹¹Quasar Associates Ltd is a consultancy firm that advises TOCs on preparing bids for rail franchises.

¹²The DfT argues that 'procurement best practice regards three to five bidders as the optimum to provide adequate competition'. The DfT further adds that 'the Department would regard a field of more than five bidders as unlikely because that would add to both suppliers' and the Department's costs, without commensurate benefits in terms of stronger competition'. *A guide to the railway franchise procurement process*, paragraph 5.

DfT has put in place a Revenue Support/Revenue Share Mechanism. This mechanism does not cover changes in costs for which the TOC remains solely responsible.¹⁴

95. The franchising process takes up to two years. In the first year, the DfT publishes its PIN, advertises the tender and issues ITTs. The publication of the PIN and the tender advertisement take place within the first six months. It takes six more months for the DfT to issue ITTs and to select TOCs for the bidding stage. In the second year, selected TOCs submit their bids, the DfT chooses its preferred bidder and the preferred bidder finalizes its contractual arrangements with ROSCOs. The franchises start in about a year from the issue of the ITT and two years from the initiation of the franchising project.

2.1.1 TOCs' incentives—the theory

96. The TOCs' main commercial negotiations with ROSCOs take place at two stages of the franchising process: (a) after an ITT has been issued and before bids are submitted; and (b) between the franchise award and the franchise start date.
97. In theory, the incentives to TOCs at these two stages are different. At the first stage, the TOC endeavours to win the bid with the DfT. This means that it will have to respect the ITT specification if it wants to avoid seeing its bid rejected as non-compliant. It will also have to construct a bid which will weigh value for money against deliverability, as these are the criteria on which the bid will be judged by the DfT.

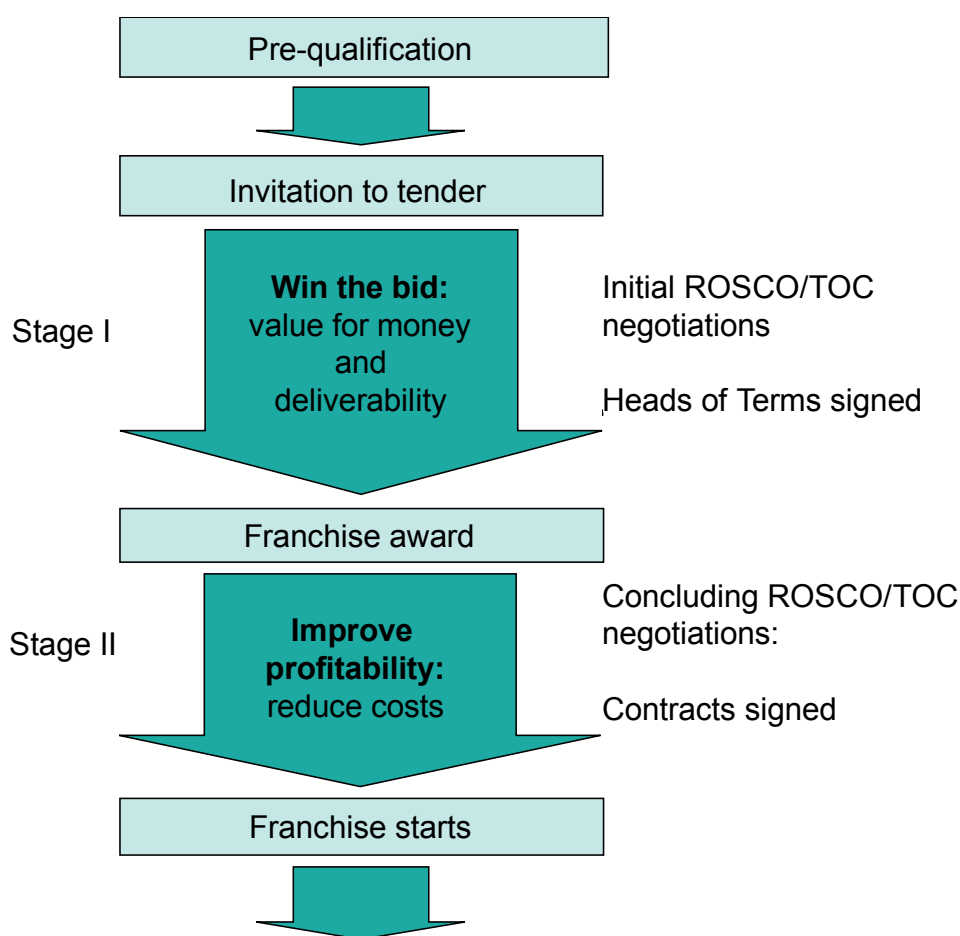
¹³Alternatively, if the ITT specifies new rolling stock, shortlisted bidders would at this stage try to find bids and funding for the new rolling stock.

¹⁴The TOC remains solely responsible for costs unless a change in a particular cost item is a Qualifying Change in terms of Schedule 9 of the franchise agreement.

98. At the second stage, if the TOC is successful, the key parameters of its bid would have been fixed by the DfT's acceptance of the bid. The TOC has to ensure that it is capable of converting the rolling stock offer into a binding contract with ROSCOs. Given that the TOC bears sole responsibility for costs, it is also incentivized to negotiate any further reductions in costs as any such reductions will improve its profitability. See Figure 1.

FIGURE 1

TOCs' incentives at the different stages of franchise negotiations with the ROSCOs



Source: CC

99. Lease rentals constitute a significant proportion of the total franchise costs and about half of the TOCs' variable costs. It would therefore seem logical that the TOCs should wish to negotiate on price. (See Table 5 for details on franchise costs.)

TABLE 5 Breakdown of franchise costs

Type of costs	<i>per cent</i>			Costs negotiable
	Minimum	Maximum	Average	
Leasing charges	8	25	15	Yes
Maintenance costs (on dry leases)	0	16	5	Yes
Staff costs	15	31	23	Yes
Track access charges	25	38	34	No
Other costs	20	33	24	No information

Source: CC analysis of TOC responses to question 18.

2.1.2 ROSCOs' views

Stage I: ITT to bid submission

100. All ROSCOs stated that TOCs had a strong incentive to negotiate at this stage as they needed to obtain the best possible bid to win the franchise. They varied, however, in the emphasis they put on the different elements that TOCs negotiate over.
101. Porterbrook noted that TOCs had a strong incentive to drive a hard bargain on the lease given that rolling stock costs were passed through into subsidy or premium payments. The level of subsidy or premium that the TOC proposes in its bid would be a key factor in winning the franchise.
102. HSBC argued that TOCs had a strong incentive to negotiate the best possible combination of price and other non-price factors such as enhancements, because this would have a strong bearing on their prospects of winning the franchise.
103. Angel stated that bidders had a strong incentive to differentiate themselves. Angel argued that any ability to differentiate their offering by reducing rolling stock costs was likely to be extremely valuable. Whilst lease rental reductions were one obvious way in which the rolling stock cost could be reduced, some bidders also looked to the ways in which they could optimize the composition of their rolling stock fleets, as

improvements in overall fleet availability and passenger carrying capacity might mean that fewer trains were required, so a lower total rolling stock cost was achieved. Angel also disputed that the Codes of Practice would remove the TOCs incentive to negotiate price reductions and other lease terms.

Stage II: Franchise award to franchise start date

104. Angel argued that even after the DfT had selected its preferred bidder, Angel remained under competitive pressure to engage in further negotiations on lease terms as the preferred bidder did not usually contract its rolling stock until just before the franchise commences. As an indication of the extent to which TOCs could negotiate at this stage, Angel gave the example of the [X] franchise where the preferred bidder, [X], exerted considerable pressure on Angel to obtain maximum value from Angel's offer to invest £[X] million in rolling stock. This offer was made at the ITT stage and was conditional on [X] taking Angel's [X].
105. HSBC argued that once the preferred bidder was chosen, the winning TOC would try to obtain further enhancements that reduced the TOC's costs, and minimized its exposure to risks, in order to extract maximum value from the agreed price. HSBC further suggested that the TOCs did not seek to negotiate over price at this stage, as if they did so, the DfT would expect to pay a lower subsidy or receive a higher premium. Instead, TOCs preferred to negotiate on non-price features.
106. Porterbrook said that at this stage, the winning TOC had to ensure that it could deliver the strict financial and performance terms agreed with the DfT. It argued that TOCs had a strong incentive to negotiate as any reduction/betterment in the offer from the ROSCO would influence the TOC's profitability.

2.1.3 The DfT's view

Stage I: ITT to bid submission

107. The DfT acknowledged that in theory, TOCs had an incentive to negotiate with ROSCOs at the bid stage. However, in practice this incentive was removed by the ROSCOs' Codes of Practice which prevented ROSCOs from discriminating between TOCs. The DfT argued that a TOC had virtually no incentive to negotiate improved price terms from a ROSCO at the bid stage, since any price reduction that it secured would automatically be offered to competing bidders. The negotiating TOC would incur search costs without corresponding benefits.
108. ROSCOs did not seem to have a united view as to the features that TOCs negotiated hard over. When asked what TOCs negotiated hardest over, HSBC mentioned three elements, none of them directly related to price: (a) lease terms (better value, longer/shorter leases, change in rolling stock during franchise, etc.), (b) delivery condition, and (c) optional work. Angel suggested that there was no rule to determine what elements were most important for TOCs in negotiations as each TOC adopted its own strategy to differentiate itself to win the bid. In turn, Porterbrook mentioned two elements: (a) lease rentals, and (b) investment in refurbishment.
109. When asked about TOCs' price sensitivity, Angel provided eight case studies. Angel said that the point of the case studies was to demonstrate competitive pressures in action during various re-leasing scenarios. In these cases, TOCs' sensitivity was manifested within the context of a cascade or the threat of new rolling stock rather than in the context of a simple rolling stock re-let negotiation.

Stage II: Franchise award to franchise start date

110. The DfT submitted that in theory, the winning TOC might have a strong incentive to negotiate down the lease prices for rolling stock as any cost saving at this stage

represented additional profit for the TOC. The DfT argued that it did not have the ability to reclaim this cost saving via reduced subsidy or increased franchise premium payment.

111. The DfT stated that in practice, the TOCs had little, if any, ability to negotiate rolling stock prices after they became the preferred bidder. According to the DfT, ‘the winning TOC will already have reached commercially binding heads of terms and committed itself to being supplied with rolling stock by one or more ROSCOs’. The winning TOC must also provide the rail services specified in the franchise agreement and was required to reach agreement with ROSCOs in order to do so. The DfT submitted that this would give the ROSCOs strong bargaining power.

2.1.4 TOCs’ views

Stage I: ITT to bid submission

112. All TOCs seemed to agree that at this stage, TOCs were incentivized to produce the most competitive bid. However, there were differences as to what type of incentives existed. The majority of TOCs submitted that non-price differentiation was most important and a minority noted price reduction:

(a) Five TOCs [redacted] suggested that, given that the Codes of Practice obliged ROSCOs to make the same base case offer to all bidders, TOCs were incentivized to differentiate themselves on the basis of non-price features such as fleet composition, refurbishment and maintenance arrangements.

(b) Two TOCs (National Express and Stagecoach) suggested that the success of the franchise bid was primarily determined by the price that bidders offer to the DfT.

113. Quasar Associates, which advises a number of TOCs on rolling stock leasing negotiations, stated that at this stage, TOCs could create uncertainty by suggesting

to a ROSCO that a particular fleet was under threat and thus obtaining improvements to the base case. Quasar further suggested that TOCs generally did not reveal their full rolling stock strategy to the ROSCOs and that this improved their negotiating position.

114. Quasar also argued that at this stage, bidders might be conservative and not propose major changes to the existing fleets since such changes would have operational implications and might make the DfT 'mark the bidder down' on the deliverability of the bid.

Stage II: Franchise award to franchise start date

115. All TOCs seemed to agree that after the franchise award, TOCs were incentivized to reduce the costs of the franchise as any such reductions improved the TOC's profitability. However, most of them did not believe that there was scope for achieving such improvement:

- (a) Govia suggested that at this stage, there was too little time available for negotiations and ROSCOs were in a strong position to determine the lease terms. TOCs and ROSCOs would therefore merely contractualize the heads of terms previously provided by ROSCOs.
- (b) SercoNed submitted that it had never received lower costs from the ROSCOs at this stage and that negotiations focused on the terms and conditions of the franchise with the aim of reducing the overall risks and costs of the franchise.
- (c) Quasar argued that at this stage negotiations were usually just a matter of 'closing out' what had been put forward to the DfT as a rolling stock strategy, although on the minority part of there was still the opportunity to play one ROSCO against the other.

2.1.5 Our assessment

116. All the parties seemed to agree that at least in theory, TOCs do have incentives to negotiate with ROSCOs and that these incentives change depending on the stage of the negotiations.

Stage I: ITT to bid submission

117. All parties agreed that at this stage, TOCs have an incentive to negotiate with ROSCOs the most competitive bid. However, it is unclear whether TOCs have the ability to obtain substantial improvements to the lease prices. The DfT and the TOCs suggested that the Codes of Practice ensured that price offers in relation to the base case are the same to all TOCs. However, this does not preclude exploration of alternative options. We discuss the impact of the Codes in Section 2.2.

Stage II: Franchise award to franchise start date

118. All parties seemed to agree that at this stage, TOCs will focus on improving their profitability whilst ensuring that they can deliver the service they bid to the DfT. Where different parties seem to disagree is the extent to which TOCs are capable of applying these incentives in practice. We tend to agree with the TOCs and the DfT that at this stage, ROSCOs do not have an incentive to offer a better deal as TOCs will need to sign binding contracts to be able to start their franchise.

Concluding remarks

119. We have not been able to collect data on how prices changed between Stage I and Stage II of the TOC/ROSCO negotiations, but we have collected data on price movements from the base case to the contract signature at franchise re-lets.¹⁵ We consider that this information is sufficient, as it allows us to see how prices move as a

¹⁵Our data also shows a very limited number of very limited changes to prices at franchise extensions. For that reason we only focus on franchise re-lets.

result of TOC/ROSCO negotiations. Table 6 shows that in 40 per cent of all cases the prices of vehicles changed. In 28 per cent of all cases prices increased whereas prices fell in 12 per cent of all cases. The extent of price increases suggests that ROCOSOs do not offer additional capital expenditure without corresponding price increases.

120. Put differently, in 88 per cent of cases, prices either remained the same or increased. This might suggest price stickiness. However, these prices may include offers by ROCOSOs to undertake additional capital expenditure. We explain this and the future work we intend to do in the Competitive analysis working paper.

TABLE 6 Changes in lease prices from base case to lease contract

<i>Changes in prices</i>	<i>Number</i>		<i>%</i>	
	<i>Vehicles</i>	<i>Fleets</i>	<i>Of total vehicles</i>	<i>Of total fleets</i>
Yes	4137	74	40	43
price increased	2907	43	28	25
price decreased	1230	31	12	18
No	6162	97	60	57
Total	10299	171	100	100

Source: CC analysis.

2.2 Factors influencing TOCs' ability to negotiate with ROCOSOs

121. ROCOSOs, TOCs and the DfT have argued that there were a number of factors that influenced TOCs' ability to negotiate with ROCOSOs. Depending on the party, the following two factors were claimed to enhance or diminish TOCs' power to negotiate: (a) the ROCOSOs' Codes of Practice; and (b) TOCs' countervailing buyer power.

2.2.1 Codes of Practice

122. ROCOSOs are not directly regulated, but have each signed up to Codes of Practice aimed at preventing the exercise of market power. We understand that all three Codes are identical in wording. The Codes state that ROCOSOs will negotiate prices in good faith and in a non-discriminatory manner. They specify that ROCOSOs will not

discriminate between customers in relation to the price and other non-price terms such as maintenance and modifications, or in relations to a sublease, sale or disposal by other means of [rolling] stock. These 'non discrimination' clauses have led to concerns that they have eliminated competition between ROSCOs and removed TOCs incentives to negotiate.

ROSCOs' views

123. Angel argued that the DfT's belief that the Codes of Practice removed the incentives of TOCs to negotiate on price was unjustified. Angel suggested that the Codes of Practice obliged it to offer the same generic 'base case' to all qualified bidders, but that each bidder was free to negotiate variance of the base cases. The only requirement was that, if two bidders requested exactly the same option, Angel was obliged to offer this option to both bidders at the same price.
124. HSBC provided a similar explanation suggesting that the base case was just a starting point. Once a base case had been made, bidders usually started asking how different factors such as enhancements would affect the price. HSBC argued that while its Code of Practice required it not to respond to the same question from different bidders in different ways, it was permitted to offer different terms to meet individual customers' needs.
125. Porterbrook argued that the Codes did not restrict the scope of each bidder to negotiate competitive terms by focusing on different aspects. This was because the Codes required a ROSCO to treat bidders equally, not identically. Porterbrook gave an example of four offers to bidders for the South Western franchise for Class 458 fleet. In each case, the capital rental offered was different as the four offers each included bespoke elements requested by the bidders.

The DfT's view

126. The DfT noted that a bidding TOC would know that for a given franchise, competing TOCs were in the same position and that they would be unable to gain a competitive advantage in the franchise replacement process through obtaining a lower-cost rolling stock leasing deal. It suggested that this was an unintended consequence of the Codes. It also noted that the Codes removed any incentive bidders might have to seek to drive down rolling stock costs.

TOCs' views

127. When asked about the impact of the Codes on their negotiations with ROSCOs, TOCs provided a wide range of responses:

- (a) First suggested that the Codes meant that ROSCOs had to give the same answer to the same questions asked by different TOCs, but it did not prevent innovation by TOCs through asking different questions.
- (b) Stagecoach added that the non-discrimination clauses encouraged bidders to find bespoke arrangements with ROSCOs in order to maximize their bidding advantage.
- (c) Arriva was very supportive of the Codes suggesting that without it ROSCOs could abuse their market power.
- (d) Govia suggested that the Codes limited the scope for negotiations during the bidding process.
- (e) GNER submitted that the Codes limited the scope for negotiations and added that while the Codes restricted the possibility of negotiations at the bid stage and not after franchise award, TOCs' negotiating power after the franchise award was small.
- (f) Quasar Associates submitted that the Codes protected bidders from being offered different bids by ROSCOs. It suggested that the Codes might make it

harder for Quasar to find bespoke offers for its clients, but they did not prevent it from obtaining them.

Our assessment

128. According to Table 6 (see page 39), prices did not change between base case offers and the final offers in at least 60 per cent of all cases, and in 28 per cent they increased. This would suggest that negotiations have taken place on non-price factors rather than on price.

129. However, we need to understand whether the Codes of Practice are principally responsible for any price stickiness or whether we would be likely to observe the same situation without them. In the absence of suitable alternatives for each type of rolling stock on each given franchise, ROSCOs would have an incentive to offer the highest price TOCs can afford. We consider that the Codes do not change this incentive. We are still considering how much movement can be achieved from base case.

2.2.2 TOCs' countervailing buyer power

130. ROSCOs submitted that TOCs had countervailing buyer power. In general, their arguments focused on four main issues: (a) TOCs have countervailing buyer power because they form a part of larger TOC owning groups; (b) TOCs have significant buyer power with respect to new rolling stock; (c) TOCs are repeat transactors so even with respect to leasing of used rolling stock, ROSCOs' behaviour will be constrained, and (d) TOCs have buyer power because they can supply their own rolling stock. We consider each party's views in turn.

ROSCOs' views

TOCs as part of a larger train operating group

131. Angel stated that TOCs enjoyed a position of strength in negotiations with ROSCOs because they were often a part of a larger TOC owning group. It argued that following the consolidation of franchises and the emergence of a number of transport groups that were multiple franchise owners, the market power of the franchisees and the resulting competitive pressure on ROSCOs had increased.
132. Angel argued that these groups were sophisticated purchasers who were increasingly seeking to utilize synergies between franchises to exert leverage in individual franchise negotiations.

New rolling stock

133. Porterbrook argued that TOCs had buyer power partly because any attempt by a ROSCO to exploit market power in relation to one franchise would damage that ROSCO's future chances of securing business with that TOC and with other TOCs within the same owning group (and indeed unrelated TOCs if the conduct were sufficiently serious).

Leasing of used rolling stock

134. HSBC argued that TOCs were repeat transactors with whom it needed to do business on a long-term basis. HSBC told us that maintaining good relations with TOCs was important. [REDACTED]

Self-supply

135. Porterbrook argued that self-supply on a limited scale was a realistic option for TOCs in some circumstances and that it might give them negotiating power with ROSCOs.

The DfT's view

TOCs as part of a larger train operating group

136. The DfT was not convinced that a TOC was in a position to threaten to penalize a ROSCO with other franchises where the TOC may be bidding. This is for two main reasons. First, at the point of negotiation, a ROSCO cannot be sure what future franchise a particular train operating group will win. And second, any TOC that attempted to penalize a ROSCO would risk harming its own interests where that ROSCO emerged as the ROSCO offering the best lease terms. In addition, the DfT considered that the lack of excess supply and the lack of substitutability of rolling stock on different franchises would make any threat from TOCs not credible.

TOCs' views

TOCs as part of a larger train operating group

137. TOCs provided a variety of views as to whether they hold negotiating power as a result of being part of a larger owning group:
- (a) Three TOCs [redacted] opposed the view that they could have buyer power as a result of bidding on different franchises.
 - (b) National Express stated that ROSCOs needed to keep good relations with TOCs.
 - (c) First stated that where there was a comparable fleet, it was usually locked into another existing franchise that was not due to be re-let at the same time. It added that unless the successful bidder happened to control the second franchise, it was highly unlikely that any commitments could be entered into that would secure such a fleet. Even then, the donating franchisee would have to satisfy its own commitments and might not be able to order replacements within its own franchise.

New rolling stock

138. All TOCs [X] argued that competition between ROSCOs was really only possible on procurement of new rolling stock. TOCs suggested that they were able to play ROSCOs off each other and obtain better prices.

(a) Two TOCs [X] suggested that the market for new rolling stock was competitive.

(b) First agreed that new rolling stock was the only real possibility for creating price competition. First added that it was important that the DfT specified new rolling stock as a possibility, otherwise new rolling stock would be seen as a 'hollow threat'.

Leasing of used rolling stock

139. TOCs submitted that they did not find that there was much scope for negotiation on the leasing of used rolling stock. Three TOCs [X] noted that it was rare that TOCs could choose from more than one alternative class of rolling stock and even when this happened, the choice was only available around the margins, rarely for the core fleet. In addition, ROSCOs usually required the TOC to take the whole incumbent fleet, so TOCs could usually exercise choice on the 'edges' of their requirements.

Self-supply

140. In the Entry working paper, we noted that TOCs had told us that self-supply was not a viable option. The main exception to this was First Group, which owns a fleet of 12 HST power cars and 42 trailer cars which it purchased from Porterbrook. At the time of the purchase, these HSTs were off-lease and Porterbrook was unsure about their longevity. Indeed, the HSTs were almost at the end of their useful economic life and First needed to make significant investment to make them operational for the next ten years.

141. First argued that even though the HST fleet was small, it gave it leverage in its negotiations with Angel and Porterbrook. In particular, Angel agreed to give First a dry lease on the Greater Western franchise. Previously, First had been procuring the maintenance for Angel's HSTs under a soggy lease. First believed that using the threat of deploying its own HSTs in place of some of Angel's fleet, First was able to switch from a soggy to dry lease.

Our assessment

TOCs as part of a larger train operating group

142. Since privatization, franchises have become larger and the number of TOC groups operating them smaller. At privatization there were 25 franchises operated by 13 TOC groups, while now there are 17 franchises operated by eight TOC groups. See Table 7.

TABLE 7 **Changes in numbers of franchises and TOC groups since privatization.**

<i>TOC groups</i>	<i>At privatization</i>	<i>Now*</i>
Arriva	0	2
Serco Ned Railways	0	1
Laing Rail	1	1
Govia	1	3
First	1	4
Stagecoach	2	2
Virgin Rail	2	1
National Express	5	3
Victory Railways (Go Ahead)	1	0
Sea Containers	1	0
GB Railways	1	0
MTL Services	2	0
Connex	2	0
Great Western Holdings	2	0
Prism Rail	4	0
Total of franchises	25	17

Source: CC analysis.

*We excluded Merseyrail from our table as it is a concession.

143. Despite the trend towards concentration of both franchises and franchisees, we do not consider that the TOCs have countervailing buyer power as a result of this process. Both the DfT and First present a credible argument that TOCs will not be able to move rolling stock from one franchise to another as this is likely to leave them

short of rolling stock on the franchise from which the rolling stock has been moved. In addition, franchises do not generally coterminate which means that such a threat will be difficult to implement. Finally, as it is rare that there are several alternatives for incumbent fleet, TOCs are not often in a position to refuse to take ROSCOs' rolling stock.

New rolling stock

144. We consider that new rolling stock gives the TOCs the possibility to play ROSCOs off against each other. This means that TOCs may be in a stronger negotiating position. However, procurement of new rolling stock depends on the DfT's specification.

Leasing of used rolling stock

145. We consider that it is unlikely that the TOCs will have countervailing buyer power as repeat purchasers of used rolling stock. As already discussed, suitable alternatives to incumbent rolling stock for TOCs to choose from are available only to a limited degree. TOCs will only be able to exercise buyer power if there is a credible and available alternative to the incumbent stock. In addition, given the limited amount of vehicles off-lease,¹⁶ it is unlikely in the great majority of cases that TOCs can easily refuse to take ROSCOs' rolling stock.

Self-supply

146. Self-supply might in principle give TOCs some countervailing buyer power in their negotiations with ROSCOs. However, only First has acquired more than a negligible amount of rolling stock since privatization. In this case, First gained some negotiation power over ROSCOs. It seems at present unlikely that much further self-supply will take place, as discussed in Annex 1 in the Entry working paper.

¹⁶See Capacity working paper.