

ROLLING STOCK LEASING MARKET INVESTIGATION

Industry background working paper

Introduction

1. This paper is intended to provide a broad factual background to the railway industry. It outlines the roles and responsibilities of the key bodies in the industry. It also provides further background on rolling stock, rolling stock lessors, the leasing arrangements, the rail franchising process and key legal agreements, as well as providing an outline of rolling stock procurement. In addition, a summary of the previous reviews into the rolling stock market is outlined.

Industry structure

2. In July 1992 the Government published proposals for the restructuring and privatization of the railway industry in Great Britain. The Railways Act 1993 provided the legislative backing for the new structure, which separated the provision of passenger train services from the management of the national rail network infrastructure (the track, signalling, stations and depots) and ownership of the rolling stock which operated on that network. British Rail's operations were reorganized into a number of different businesses which were sold into the private sector.

Overview of the railway industry

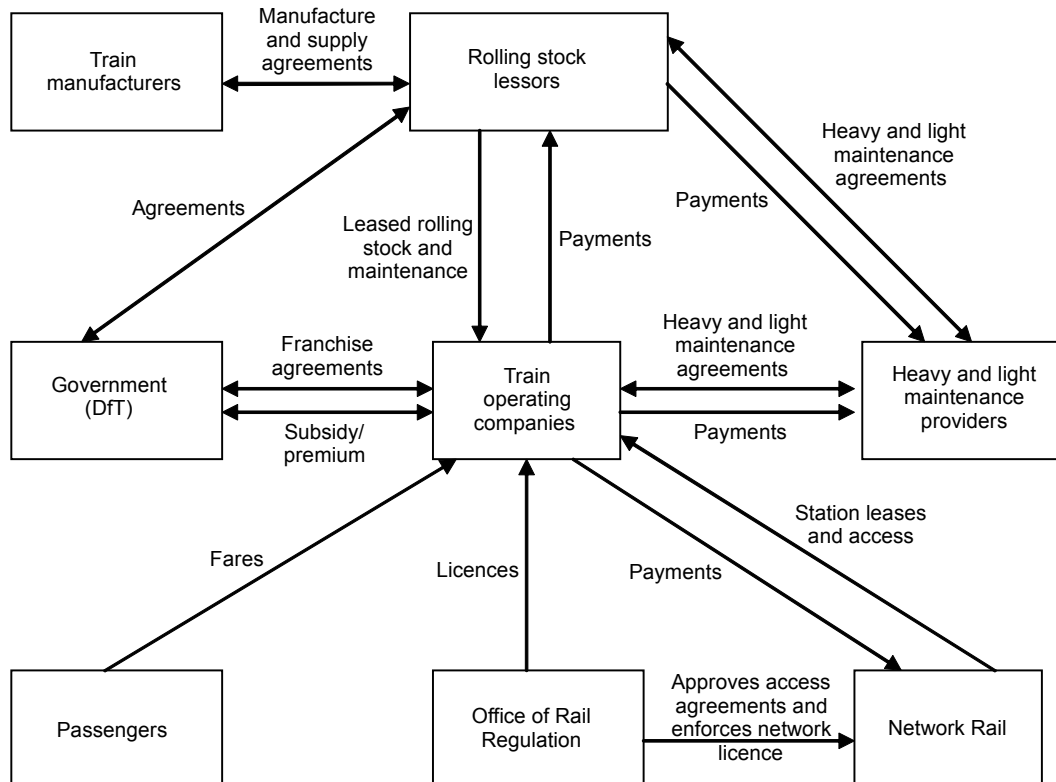
3. Passenger trains are operated mainly by train operating companies (TOCs) under franchise agreements¹ granted by the Department for Transport (DfT). Most trains are leased by the TOCs from rolling stock companies. The railway infrastructure is owned and operated by the network operator Network Rail.

¹Trains are also operated by non-franchised operators that are not subject to the franchising process.

4. In simple regulatory terms, the Office of Rail Regulation (ORR) is responsible for regulating Network Rail, while the DfT is responsible for passenger- and train-related matters, letting franchises and monitoring operator performance. Outlined in Figure 1 is a diagram which illustrates the key participants and their relationship in the railway industry.

FIGURE 1

The current structure of the railway industry



Source: CC

Key participants

Rolling stock lessors

5. Rolling stock lessors own rolling stock and lease this stock to the companies which operate rail services. The majority of passenger rolling stock is owned by three rolling stock leasing companies: Angel, Porterbrook and HSBC (known in the industry as the ROSCOs). The passenger rolling stock owned by the ROSCOs is comprised partly of stock formerly owned by British Rail and transferred to the ROSCOs at

privatization (approximately 60 per cent) and partly of new rolling stock purchased since the ROSCOs were created (40 per cent). A more detailed description of the process by which the rolling stock was transferred at privatization by the creation of the ROSCOs is provided from paragraph 37 as well as a profile of current rolling stock lessors.

6. Rolling stock lessors are not subject to regulatory controls, although they are subject to competition law. They are indirectly affected by the regulatory framework governing other parts of the railway industry. Each ROSCO is also subject to a Code of Practice drafted in similar terms for each ROSCO. The Codes of Practice were negotiated by the ORR as part of the 1998 review of the rolling stock market.

TOCs

7. Passenger railway services in Great Britain are run by TOCs. The majority of TOCs hold franchises which are let by the DfT through a competitive tender process. The franchises allow the TOCs to operate services on certain routes for a specified duration. There are also a small number of operators who provide passenger train services on the national rail network outside the franchising system. The majority of these are open access operators (OAOs), which hold licences to provide supplementary train passenger services on chosen routes. These operators can run services for the duration of the licence. A current list of operators of franchised passenger services and of non-franchised services is outlined in Tables 1 and 2.
8. TOCs generally do not own the rolling stock they use but lease it from rolling stock lessors. TOCs must obtain a licence from the ORR to operate trains and an access agreement with Network Rail to use the infrastructure. The representative body for the passenger TOCs is the Association of Train Operating Companies (ATOC).

9. There were originally 20 TOCs set up as subsidiaries of British Rail in April 1994. They were privatized in stages between February 1996 and March 1997 through a franchising process run by the Government.² As part of this process, bidders competed to be awarded specific franchises. The first franchises were awarded in late 1995 and the rest were awarded between January 1996 and March 1997.
10. On completion of the initial franchising process in 1997, ownership of the TOCs was split between 11 organizations (known as owning groups). The list of current owning groups, their TOCs and the franchises they operate is set out in Table 1.

TABLE 1 **Current operators of franchised train services (as at December 2007)**

<i>Owning group</i>	<i>TOC</i>	<i>Franchise</i>	<i>Start date</i>	<i>End date</i>	<i>End date(s) if extension(s) granted</i>
Arriva	Arriva Trains Wales	Wales & Borders	2003	2018	N/A
	Arriva Cross-Country	Cross Country	2007	2013	2016
First Group	First Capital Connect	Great Northern/Thameslink	2006	2010	2012, 2015
	First Great Western	Greater Western	2006	2013	2016
	First ScotRail	ScotRail	2004	2011	2014
	Trans-Pennine Express (jointly operated with Keolis)	Trans-Pennine	2004	2012	2017
Govia	Southeastern	Integrated Kent	2006	2014	2015, 2016
	Southern	South Central	2000	2009	N/A
	London Midland	West Midlands	2007	2013	2015
Laing Rail	Chiltern Railways	Chiltern	2002	2021	N/A
National Express Group	c2c	Thameside	1996	2011	N/A
	One	Greater Anglia	2004	2011	2014
	National Express East Coast Gatwick Express	Inter-City East Coast Gatwick Express	2007 1996	2013 2008	2015 N/A
Serco Group & Ned Railways	Northern Rail	Northern	2004	2011	2013
Stagecoach	South West Trains	South Western	2007	2014	2017
	East Midlands	East Midlands	2007	2013	2015
Virgin Group	Virgin Trains	Inter-City West Coast	1997	2012	N/A

Source: CC and DfT

²The Office of Passenger Rail Franchising (OPRAF) was formed specifically for this task.

TABLE 2 **Current non-franchised passenger operators (as at December 2007)**

<i>Owning Group</i>	<i>Operator</i>	<i>Status</i>	<i>Start date</i>	<i>End date</i>
BAA	Heathrow Express	Open Access	1998	2023
	Heathrow Connect (jointly operated with First)	Open Access	2005	2013/2016 (to coincide with First Great Western end date)
London & Continental Railway (LCR)	Eurostar (UK)	Open Access	1994	No end date
First Group	Hull Trains (jointly operated with Renaissance Trains)	Open Access	2002	2010
Laing Rail	London Overground (jointly operated with MTR and Transport for London)	TfL Rail Concession	2007	2014
	Wrexham & Shropshire (jointly operated with Renaissance Trains)	Open Access	2007 (services due spring 2008)	2014
Grand Central Railways	Grand Central	Open Access	2007	2012
Serco Group & Ned Railways	Merseyrail	Concession ³	2003	2028

Source: CC and DfT

Department for Transport

11. When the railway was privatized, the Railways Act 1993 established two new bodies to regulate and administer the new structure: the Rail Regulator (now the ORR) and the Franchising Director (head of OPRAF). The role of the ORR is set out in paragraph 22. OPRAF was responsible for negotiating, awarding and monitoring franchises granted to the TOCs and agreeing the maximum level of regulated fares that they could charge. OPRAF was succeeded in 2001 by the Strategic Rail Authority (SRA).

12. As a result of the White Paper *The Future of Rail*, published in July 2004, which reviewed the structure of the rail industry, a number of further changes were made to the role of Government. This review led to the Railways Act 2005, in which the SRA was abolished and the responsibility for strategic planning and franchising was transferred to the DfT (on behalf of the Secretary of State). The DfT is now responsible for specifying and letting franchise contracts to TOCs to run franchised

³The DfT has stated that persons providing rail passenger services on the Merseyrail Electrics network were exempted from designation under section 23(1) of the Railways Act 1993 (designation of passenger services as being subject to franchising) under the Merseyrail Electrics Network Order 2002. The Order came into force on 20 July 2003. On that date a Concession Agreement between Merseyrail PTE and SercoNed came into effect.

passenger services in England and intercity services to and from Scotland and Wales.

13. Responsibility for rail within the DfT now rests with the 'Rail and National Networks Group'. Its objectives are as follows:
 - To develop and deliver a robust, affordable and sustainable development strategy that supports wider transport objectives.
 - To ensure delivery of improved operational and financial performance, and safety.
 - To secure appropriate services at an acceptable price through effective specification, procurement and delivery.

14. The DfT has a statutory responsibility to ensure the continuity of rail passenger services under section 30 of the Railways Act 1993.⁴ In carrying out this duty the Government is often referred to as the 'operator of last resort'. To uphold this responsibility, it enters into direct agreements with rolling stock lessors. The DfT also has a role in rolling stock deployment both strategically in the development of the franchises and through the specification contained in the franchises. The DfT also aims to deliver value for money for the taxpayer.

15. The Secretary of State for Transport is also in charge of setting the strategy and budget for the railways, as part of the changes resulting from the 2005 Act. Once every five years the Secretary of State for Transport must set out the rail improvements he or she wants to secure for the coming five-year period. It also means that the Government must clearly specify what it wishes the railway to deliver and how it expects this to be funded. The improvements the Government wishes to see are outlined in the High Level Output Specification (HLOS), which was published with the budget (Statement of Funds) in July 2007. Alongside these papers the DfT

⁴Under section 30 the Government has a duty 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 in respect of the relevant services.

published a White Paper *Delivering a Sustainable Railway* which set out the long-term strategic direction for the railway with regard to increasing the capacity of the railway, delivering a quality service for passengers, and fulfilling rail's environmental potential.

Scottish Executive and the Welsh Assembly

16. The devolved governments in Scotland and Wales also have a role in planning, specifying, funding and managing services.
17. Under the Railways Act 2005, the Scottish Executive takes greater responsibility for rail in Scotland, including sole responsibility for securing future ScotRail franchises and the power to manage and monitor the performance of ScotRail services. In January 2006, Transport Scotland (TS) became the national transport agency for Scotland, with responsibility for the majority of rail powers in Scotland. Safety and the licensing of railway operators remained reserved to UK Ministers discharged through the ORR.
18. The 2005 Act also made provision for the National Assembly for Wales to be a joint signatory with the Secretary of State for Transport to the Wales and Borders franchise for train services operating within Wales. As co-signatory, the Welsh National Assembly, through Transport Wales (TW), is responsible for the financial and performance management of passenger services covered by the agreement and any enhancements to them.

Passenger Transport Executives

19. There are six PTEs which provide, plan, procure and promote public transport in six of England's largest conurbations: Greater Manchester, Merseyside, South Yorkshire, Tyne and Wear, West Midlands and West Yorkshire. PTEs are

responsible to Passenger Transport Authorities (PTAs), made up of representatives of local councils in the areas they serve. Some PTEs are currently co-signatories to the franchise agreements. However, under the Railways Act 2005 PTEs no longer have an automatic right to be co-signatories to franchise agreements. PTEs can amend the franchise specification by funding additional services, capacity or quality, or can reduce the specification and retain any financial savings. The PTEs are represented by the Passenger Transport Executive Group (PTEG).

Transport for London

20. As of November 2007, TfL assumed responsibility for London Overground services, comprising the North London Railway and the new East London Railway. TfL is responsible for procuring services on these lines, not in the form of a franchise agreement but through an operating concession (known as the 'London Rail Concession'). The Concession has similar features to a franchise, but is akin to a management contract where the specification is fully priced and set out in the contract, and the revenue generated goes directly to TfL.

21. TfL also operates two of its own railways, the London Underground (LU) and the Docklands Light Railway (DLR), neither of which are part of the national rail network or the regulatory environment that is applicable to it.

Office of Rail Regulation

22. The ORR was established on 5 July 2004 under the Railways and Transport Safety Act 2003. It is an independent statutory body led by a board. It has responsibility for providing overall regulation of the UK railway industry to protect the interests of rail users and to promote efficiency and economy in the provision of railway services. Its key roles are to:
 - regulate Network Rail and determine its funding from the Government;

- license operators of railway assets;
- set the terms for access by operators to the network and other railway facilities;
- encourage continuous improvement in health and safety performance and compliance with relevant health and safety law; and
- promote competition in the provision of railway services.

23. From 1 April 2006 the ORR also became the health and safety regulator for the rail industry when responsibility was transferred from the Health and Safety Executive.

Network Rail

24. In April 1994 ownership of the national rail network infrastructure (track, signalling, bridges, depots and stations) was passed from British Rail to Railtrack. In 1996 the company was floated on the Stock Exchange and was acquired by Railtrack Group. In October 2001 Railtrack was placed into 'Railway Administration'⁵ under the provisions of the Railways Act 1993 on the petition of the Secretary of State for Transport. The Administrator remained responsible until October 2002 when the business was sold to Network Rail. Network Rail is a 'not-for-dividend' company limited by guarantee and has taken over responsibility for the rail network infrastructure.

25. Network Rail derives most of its revenue through track access charges paid by TOCs for the use of its network, under conditions approved by the ORR. Grants are also paid directly by the Government under the direction of the ORR. Under the track access agreement train operators are entitled to compensation from Network Rail for train delays caused by the infrastructure or by other train operators and are liable to Network Rail for delays caused by their own train services.

⁵The purpose of the administration order is to transfer, as a going concern, so much of the undertaking of Railtrack as is necessary to ensure that the management of the network is properly carried on (section 59, 1993 Railways Act). Effectively Railtrack was placed under the control of government-appointed administrators, who continued to run the railways until it was sold to Network Rail.

26. Network Rail is responsible for the safety and performance of the infrastructure and is responsible for carrying out all infrastructure maintenance and renewal work. Formerly outsourced to contractors, the infrastructure maintenance work has now been taken largely in-house by Network Rail since 2004.

Rolling stock manufacturers

27. More than 4,500 new vehicles have been ordered since privatization and these orders have been placed with four manufacturers: Bombardier, Alstom, Siemens and Hitachi. The manufacturers are responsible for building rolling stock which is procured by rolling stock lessors, TOCs or the Government.
28. Bombardier is headquartered in Canada. In 2001 it acquired Adtranz (previously British Rail Engineering Limited in the UK market), which manufactured many trains prior to privatization. Bombardier has train-manufacturing facilities in Derby and a number of maintenance, refurbishment and overhaul centres in the UK.
29. Alstom is headquartered in France. It entered the UK market in the 1980s with the acquisition of Metro Cammell, which also manufactured trains for British Rail. Alstom no longer has train manufacturing facilities in the UK but it operates maintenance, refurbishment and overhaul facilities in a number of UK locations. Alstom also provides information solutions, train equipment, signalling and telecommunications equipment to the wider UK rail industry.
30. Siemens is headquartered in Germany. Siemens Transportation Systems (STS) entered the UK market with the supply of the Heathrow Express trains in 1998. In 2001 Siemens won its first major contract with a ROSCO to supply Angel with 785 vehicles for the South West Trains Network. STS maintains 'Traincare' facilities in ten

UK locations. Other services provided include maintenance services, signalling, electrification systems and rail communication, control and information systems.

31. Hitachi is headquartered in Japan and will be delivering the new high-speed trains for use on the Channel Tunnel Rail Link in 2009.
32. The manufacturers Csr Ziyang and Csr Puzhan, headquartered in China and owned by the Government of China, are willing to supply three new trains for use by the OAO Grand Central.

Funding the railway industry

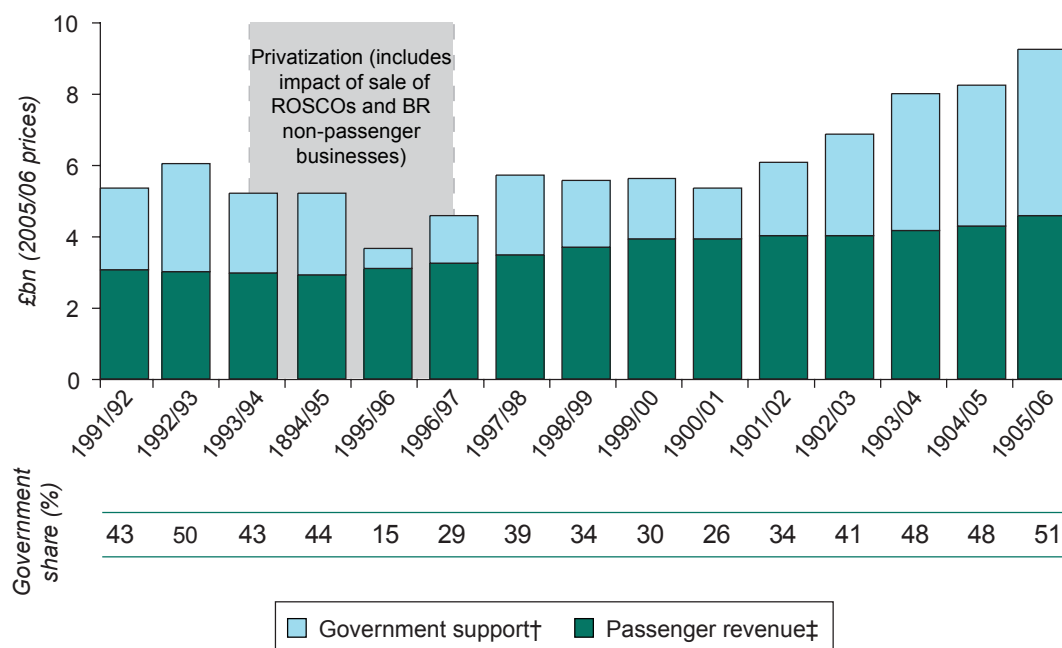
33. The money to fund the railways comes primarily from two sources: rail customers and the Government. Since 1997, the balance between these two sources of funding has changed significantly. Historically there has been considerable (and often year-on-year) variation in levels of public subsidy.⁶ Government support (including PTE grants) to the rail industry was £4.6 billion in 2005/06.⁷

⁶DfT White Paper *Delivering a sustainable railway*, July 2007, p126, 12.16.

⁷*National Rail Trends Yearbook 2006–2007*, ORR, p59.

FIGURE 2

Funding of the passenger railway*



Source: DfT July 2007 White Paper *Delivering a Sustainable Railway*.

*Excludes revenue from property, freight and open access. Also excludes Network Rail debt.

†Includes franchise payments to TOCs, PTE grants, direct grants to Network Rail and CTRL but does not include freight grants.

‡Includes all ticket revenue and miscellaneous charges associated with passenger travel on national railways, eg car parking.

34. In the recent HLOS, the Government has stated that £3,156 million of funding is likely to become available for the railway during the period 2009/10, which is split for illustrative purposes between franchise support (£1,612 million) and network grant (£1,544 million).⁸

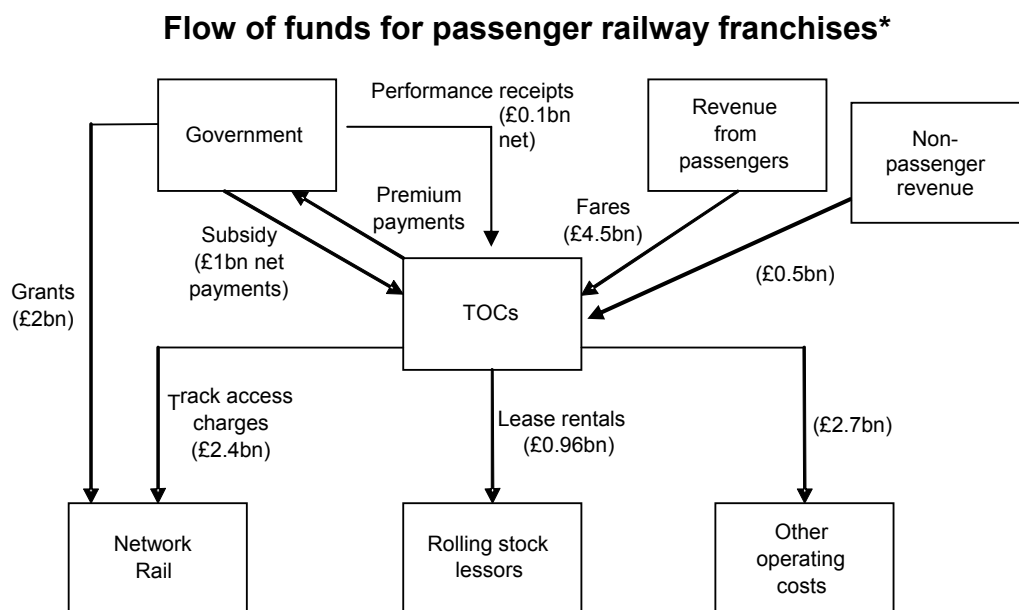
35. The cost of operating, maintaining and renewing the infrastructure (managed by Network Rail) is largely covered by track access charges (paid by TOCs) together with some direct government grants. In addition, the Government also makes franchise payments to franchisees whose total costs exceed revenues generated through passenger fares. In a small number of cases, where revenue exceeds cost, franchise payments are payable by the TOCs to the Government. In the financial

⁸DfT White Paper *Delivering a sustainable railway*, July 2007.

year 2006/07, out of the 19 franchises operating at that time (excluding Merseyrail/MTL Services), three paid a premium to the Government and 16 received a subsidy from the Government in that year.

36. Figure 3 provides a broad illustrative outline of the flow of funds in the passenger railway between the TOCs, rolling stock lessors and the public sector.

FIGURE 3



Source: CC.

*Funding statistics are for illustrative purposes. They are provided for the year 2005/06 and have been sourced from the *National Rail Trends Yearbook 2005–2006 Transport Statistics Great Britain 2006*, and from information provided by the ORR.

Rolling stock lessors

Background to privatization and the creation of the ROSCOs

37. As part of the railway privatization, all passenger rolling stock was transferred from British Rail into three rolling stock companies (known in the industry as the ROSCOs) in April 1994. At that time the ROSCOs were still in the public sector as government-owned companies and they were known as Angel Train Contracts Limited, Eversholt

Leasing Limited and Porterbrook Leasing Company Limited. In 1996 the ROSCOs were sold to the private sector with their initial leases in place.

38. At the time of privatization the Government decided that in general TOCs should lease rather than own their rolling stock, because the economic life of rolling stock normally exceeds 30 years and this is much longer than the length of franchises.⁹ Leasing would enable prospective franchise operators to start operations without having to incur major capital expenditure on new or refurbished vehicles. Without the restriction of short franchises, the ROSCOs could also take a longer-term view of the income they would receive from rolling stock.¹⁰ The Government did not, however, prevent TOCs from buying or subleasing rolling stock.
39. The decision was taken to divide British Rail's rolling stock fleet between three new companies, because this was considered to be the minimum number of substantial players deemed necessary to liberalize the market and create competition. The DfT also argued that to create too many ROSCOs might render the new companies unsaleable.¹¹ Hambros was appointed by British Rail to provide advice on how to structure the companies and the leases they would administer, and it was also subsequently appointed to manage the sale of the ROSCOs.

Sale of the ROSCOs and subsequent change in ownership

40. Eight bidders were shortlisted and four bidders went on to produce final bids for the three ROSCOs. The four final bidders were three management employee buyouts (MEBOs) and a consortium GRSH (comprising Babcock and Brown, Nomura International and Prideaux & Associates). In January and February 1996 Porterbrook

⁹NAO Report, *Privatisation of the Rolling Stock Leasing Companies*, paragraph 1.5.

¹⁰ORR Review of the Rolling Stock Market, May 1998, p15, paragraph 2.4.

¹¹*All change; British Railway Privatisation*, Chapter 5, p98.

and Eversholt were sold to MEBOs whilst GRSH bought Angel. The total proceeds from the sale were £1.736 billion.

41. All three of the ROSCOs have changed ownership since their original sale. Porterbrook was first acquired by Stagecoach in August 1996 and then subsequently by Abbey National (Abbey) in April 2000.¹² In February 1997, HSBC Bank bought Eversholt and it was renamed HSBC Rail (UK) (HSBC). In December 1997, Royal Bank of Scotland Group (RBS) bought Angel.
42. The sale of the ROSCOs was assessed by the National Audit Office (NAO) and by the Public Accounts Committee (PAC) in 1998.

Other rolling stock lessors

43. In addition to the three ROSCOs identified above, there has been one other rolling stock lessor in the franchised passenger rail industry: Lombard Leasing Contracts Limited (a NatWest subsidiary), following the success of a marketing venture comprised of NatWest and GATX (which had withdrawn from bidding for the ROSCOs at privatization), funded the new fleet of cross-country trains for Virgin Trains in 1999. This new fleet is called the 'Voyager' trains. The lease to Virgin Trains was undertaken by a NatWest subsidiary (now Voyager Leasing Ltd (Voyager Leasing)), although the owner of the trains and head lessor were other NatWest subsidiaries, GL Trains Ltd and Lombard Leasing Contracts Ltd respectively. Shortly after this transaction, NatWest was taken over by RBS. In order to reduce RBS's exposure to Virgin Trains, the cross-country fleet was evenly split and half the vehicles were sold to Bank of Scotland (now part of HBOS). Bank of Scotland then leased the trains back to Voyager Leasing on similar terms to the lease to Virgin.

¹²Abbey was bought by Grupo Santander in 2004.

44. Voyager Leasing is a limited recourse special purpose vehicle, which is a legal entity created for a limited purpose. Voyager Leasing has remained largely separate from Angel despite having the same parent company, but it has contracted Angel to undertake its regulatory filings and to provide technical support.

Profile of the ROSCOs

Angel Trains

Ownership

45. Formed in March 1994, Angel is now a wholly-owned subsidiary of RBS. In September 1995 it was acquired by the GRSH consortium for £690 million.¹³ In December 1997 Angel was purchased by RBS for approximately £1.1 billion.¹⁴ In September 2007 RBS began a sale process for Angel.

Business overview

46. Angel describes itself as 'a leading lessor of railway rolling stock in the UK'. The company is also active in the freight locomotive market and passenger train leasing markets across Europe through its Angel Trains Cargo and Angel Trains Europa businesses.
47. Angel is headquartered in London, with additional locations comprising an engineering office in Derby and offices in Antwerp, Cologne, Madrid and Rome. It employs approximately 200 staff across all these locations with a variety of both technical and commercial skills. Angel's company goal is 'to become the world's leading investor in trains, by continuing to maintain professional, competitive, long-term and even-handed relationships with leading train operators in a growing number of countries and market segments, and being seen as a dependable partner of

¹³This amount includes £18 million of post-bid interest adjustments.

¹⁴Figures taken from 1998 NAO report *Privatisation of the Rolling Stock Leasing Companies*.

governments and suppliers in the rail industry.’ Angel currently has an A long-term and A2 short-term credit ratings by Standard & Poor’s.

Services/rolling stock

48. Angel leases a diverse range of rolling stock under operating lease arrangements. Its rolling stock includes regional, commuter and high-speed passenger trains, and freight locomotives. It also offers financing and project management services for the procurement of new rolling stock, as well as the management of maintenance, refurbishment and modifications to rolling stock. Angel contracts with rolling stock manufacturers and third party maintainers to carry out maintenance work on Angel’s behalf.

Financial summary

49. Table 3 is intended to provide a broad financial summary of Angel, outlining the revenue, profit before tax and net book value of its rolling stock assets, including its freight assets but excluding its European activities. Angel’s rolling stock is mainly held in the books of Angel Trains Ltd. However, the Pendolino fleet is recorded in the books of an indirect subsidiary of Angel Trains Ltd called Angel Leasing Company Ltd.

TABLE 3 Summary financial information for Angel Trains Ltd (year ended 31 December 2006) and Angel Leasing Company Ltd (year ended 31 March 2006)

	<i>£ million</i>	
	<i>Angel Trains Ltd</i>	<i>Angel Leasing Company Ltd</i>
Revenue	327.3	72.9
Profit before tax	76.1	15.3
Net book value of rolling stock assets at 31/12/2006 or 31/3/2006	1,821.7	657.5

Source: Company accounts.

Porterbrook

Ownership

50. Porterbrook was formed in April 1994. It was acquired by an MEBO in January 1996 for £528 million. It was subsequently sold to Stagecoach in August of the same year for £826 million and then bought by Abbey in April 2000 for £1.4 billion. In February 2003 Abbey announced a new strategic direction to focus solely on personal financial services. Assets and businesses that were not part of those services, including Porterbrook, were placed in a portfolio business unit with the aim of disposing of them.

Business overview

51. Porterbrook has stated that it is 'a leading player in the rail leasing market' and describes itself as an 'asset manager and lessor of rolling stock'. It was the first ROSCO to add freight equipment to its portfolio through a sale and lease-back arrangement with Freightliner in May 1996 and has since expanded into rail freight leasing. Porterbrook is headquartered in Derby, UK and employs approximately 95 personnel, including rail engineers. Porterbrook expanded into the European rolling stock leasing market in September 2001. In November 2004 it sold its European leasing business to the newly-created CB Rail.

Services/rolling stock

52. Porterbrook offers operating leases and a range of other services including the management of new vehicle procurement and the provision of maintenance services. Porterbrook's rolling stock fleet of over 5,500 vehicles includes electric and diesel locomotives, high-speed trains, multiple units and freight wagons. In August 1996 Porterbrook financed the first order for new passenger trains following privatization (Class 168 for Chiltern Railways). Since 1996, Porterbrook has purchased over 2,600 new vehicles with a total value of over £1.5 billion. As well as rolling stock and

maintenance services, Porterbrook also specializes in leasing station equipment: in particular, ticket gates, ticket vending machines and passenger information display systems.

Financial summary

53. Table 4 is intended to provide a broad financial summary of Porterbrook, outlining the revenue, profit before tax and net book value of its rolling stock assets, which may include its freight assets and some other non-passenger rolling stock and railway assets.

TABLE 4 Summary financial information for Porterbrook Leasing Company Ltd (year ended 31 December 2006)

	<i>£m</i>
Revenue	302.7
Profit before tax	113.1
Net book value of rolling stock and railway assets at 31/12/2006	1,900

Source: Company accounts.

Note: The profit before tax figures do not take full account of the impact of intercompany funding between members of the Porterbrook group and Porterbrook consider these figures to be potentially misleading.

HSBC Rail

Ownership

54. HSBC was originally established under the name Eversholt Leasing Limited in 1994. It was acquired by an MEBO for £528 million. In February 1997 it was acquired by the HSBC Group, an international banking and financial services organization, for £726 million and in 1999 its name was changed to HSBC Rail (HSBC).
55. [✂]

Business overview

56. HSBC is headquartered in London and employs approximately 100 members of staff. HSBC is involved with passenger rail operating leasing and freight rail leasing. It has also broadened its portfolio to freight vehicles for Continental Europe.

Services/rolling stock

57. HSBC offers investment and financing solutions to the passenger and freight rail industry both in the UK and the rest of the world. Its services range from operating leases to procurement, refurbishment, engineering support and maintenance improvements. The company owns over 4,000 vehicles and has a team of in-house engineers to work on re-engineering projects to deliver improved performance, reliability and passenger environment.

Financial summary

58. Table 5 is intended to provide a broad financial summary of HSBC, outlining the revenue, profit before tax and net book value of its rolling stock assets, which may include its freight assets and some non-passenger rolling stock.

TABLE 5 Summary financial information for HSBC Rail (UK) Ltd (year ended 31 December 2006)

	<i>£m</i>
Revenue	288
Profit before tax	42.5
Net book value of rolling stock assets at 31/12/2006	1,873.6

Source: Company accounts.

Product explanation

Rolling stock

59. The term 'rolling stock' describes all the different types of vehicles which move on a railway. For our purposes, in the provision of transport services to passengers, the

term 'train' is taken to mean the discrete assembly of various rolling stock vehicles that provide the required transport service.

60. Passenger rolling stock is operated in two principal types of train: multiple units ('units') and fixed formation train sets. Multiple unit trains may be formed of a single unit or a number of units coupled together. Each unit is self-powered with a driving cab at each end. There are two types of multiple units: Electric Multiple Units (EMUs), which rely on external electrical energy, and Diesel Multiple Units (DMUs), which derive power from diesel engines. Diesel Electric Multiple Units (DEMUs) are a subset of the DMU type as they have an electrical transmission system on-board. Fixed formation sets are high-speed trains (HST or Intercity 125), Pendolinos, Intercity 225s (IC225), or are semi-permanent formations comprising a locomotive (or power car), a driving trailer vehicle and a number of coaches in between. They have a driving cab at each end so can be driven in either direction. Individual intermediate vehicles can be added or removed to alter the train length.

61. Trains can be powered by diesel engines or are dependent upon electrification infrastructure to provide electrical energy transmitted either through a third rail alongside the track or via an overhead line. Some 13,000km (40 per cent) of the Great Britain rail network is electrified; of this, approximately two-thirds uses overhead line and one-third uses third rail. The rail network south of London is largely electrified with third rail, which is unique to Great Britain. Broadly the intercity routes between London and a number of major cities north of London, as well as some commuter routes, use the overhead line system. Rolling stock typically has an operating life of between 30 and 35 years, but this may be longer or shorter. At privatization, the economic life for leasing of Master Operating Lease Agreement (MOLA—see paragraph 64) stock was assumed to be 35 years for EMUs and

electric locomotives and 30 years for other rolling stock (ie DMUs and coaching stock). [✂]

62. There are a number of technical characteristics of both the infrastructure and the rolling stock which constrain compatibility and limit the routes on which particular stock can operate. For example, electric trains cannot operate on routes which have not been electrified, and rolling stock equipped for third rail electrification cannot operate on overhead line and vice versa—other than a limited number of dual-fitted vehicles. There are also operational characteristics such as line speed, platform length, passenger capacity and door configuration, which can constrain the type of stock which can be used in practice on a particular route or service. For example, suburban commuter trains may not have the speed or facilities required for longer journeys and intercity trains may not have the acceleration to meet a commuter timetable.

63. There are a large number of different types of rolling stock, of which many are not fully interchangeable due to various constraints. A system of classes and sub-classes is used to identify rolling stock having common characteristics. The collective term 'fleet' is used to refer to either (a) a group of one particular class of trains which is operated by a TOC or (b) all the trains of one particular class owned by a rolling stock lessor (which may be leased to more than one TOC). Some generic rolling stock types have family names within which several classes may belong. Table 6 provides an illustrative example of the use of these different terms.

TABLE 6 Example to illustrate terminology

<i>Family name</i>	<i>Class</i>	<i>ROSCO's fleet</i>	<i>TOC's fleet</i>
Turbostar	170	ROSCO A owns 60 vehicles	TOC X leases 20 vehicles TOC Y leases 40 vehicles
Turbostar	170	ROSCO B owns 30 vehicles	
Turbostar	171	ROSCO C owns 50 vehicles	TOC Z leases 80 vehicles

Source: CC.

64. The three ROSCOs were sold with over 11,000 vehicles between them when they were privatized. These included locomotives, loco-hauled coaches, EMUs, DMUs and HSTs. EMUs were the most common type of rolling stock (59 per cent), whilst 24 per cent of rolling stock consisted of HSTs and loco-hauled coaches, and 15 per cent consisted of DMUs. The stock transferred at privatization is known in the industry as MOLA stock, which is a reference to the initial template lease agreement called the Master Operating Lease Agreement.
65. At privatization the Government decided how the ownership of the stock should be divided between the three ROSCOs. Where practicable, comparable fleets were allocated to different ROSCOs. Larger fleets of a single type were divided between two or three ROSCOs and smaller fleets were allocated to a single ROSCO in order to avoid duplication of expertise and to permit efficient maintenance. The structure gave each ROSCO a wide range of customers and gave most TOCs a relationship with at least two ROSCOs.¹⁵

TABLE 7 Vehicles transferred to the ROSCOs as at 1 April 1994

	<i>Angel</i>	<i>Eversholt</i>	<i>Porterbrook</i>	<i>Total number</i>
EMUs	2,099	2,684	1,615	6,398
Locomotives & loco-hauled stock	-	1,366	789	2,155
Diesel multiple units	1,094	-	681	1,775
High speed trains	539	-	370	909
Other	21	-	-	21
Total number of vehicles	3,753	4,050*	3,455	11,258
Average age	16 years	17.6 years	16 years	

Source: National Audit Office.

*Excluding trains still under manufacture.

66. There has been a significant modernization of rolling stock since privatization and a number of classes of rolling stock have been withdrawn. The main legislative change that has affected the withdrawal of rolling stock since privatization has been the

¹⁵*All Change: British Railway Privatisation*, Chapter 5, by John Prideaux, p99.

introduction of safety regulations requiring the replacement of the 'slam door' Mark I rolling stock.

67. The majority of rolling stock continues to be owned by the ROSCOs, which is in turn leased to TOCs. However, TOCs can also directly purchase either used stock or new stock (known as self-supply). The incidence of self-supply among franchised TOCs is low.

Rolling stock leases

68. There are two principal types of leasing: operating and finance leasing. In operating leasing, each period of hire is significantly shorter than the life of the asset, the residual value risk at the end of the lease is borne by the lessor, and the asset appears only on the balance sheet of the lessor. In finance leasing, the period of the lease usually approximates to the remaining economic life of the asset, and the residual value risk is often transferred to the lessee. The value of the asset is recorded in the accounts of the lessee, although the lessor retains legal ownership of the asset. The form of leasing chosen at the time of privatization was operating leasing, as it was intended that train operating franchises would be significantly shorter in duration than the life of the rolling stock assets. The value of the rolling stock asset therefore appears in the books of the ROSCOs and not the TOCs.
69. The first passenger rolling stock leases were substantially agreed by December 1994, before the ROSCOs and TOCs were sold into the private sector. The leases followed a standard form, the MOLA. The MOLA incorporated the terms and conditions applicable to all rolling stock, and lease supplements set out details specific to individual types of vehicles, such as the routes on which they could be used, the maintenance programmes and performance criteria.

70. The MOLA set out the key rights and responsibilities of the TOC and the ROSCO, such as the delivery of the stock, the term of the lease, rent and payments. Most of the first leases were for a period which matched the TOCs' franchise periods, with an option to extend if the TOCs wished. When the initial lease periods expired in 2002–2004, some significant amendments were made to the original MOLA in the new leases signed. For new build trains, instead of a MOLA and lease supplements, there is generally one separate lease agreement covering similar terms.

71. A large majority of the rolling stock used in franchised passenger services is owned by the ROSCOs and leased out to the TOCs, typically for the length of the franchise, although this can vary and there are shorter-term leases. The division of key responsibilities between the ROSCOs and the TOCs is as follows:

Principal obligations of parties under the rolling stock leases¹⁶

(a) ROSCO obligations:

- delivery of rolling stock to the lessee in an agreed condition, hence allowing the lessee quiet enjoyment of rolling stock;
- procurement from contractors of heavy maintenance and heavy repair and ensuring rolling stock meets prescribed performance criteria following maintenance activities;
- rectification of major faults and design or endemic faults, and paying those costs not met by the lessee;
- procuring and paying for any mandatory modifications required to rolling stock, for instance by the safety regulatory authorities; and
- procurement of property damage insurance.

(b) TOC obligations:

- payment of rent to the lessor;
- performance or contracting of running maintenance and repairs;

¹⁶Source: May 1998, ORR, *Review of the rolling stock market*, report to the Deputy Prime Minister, p20.

- use of rolling stock in accordance with the criteria specified in the lease supplement;
- paying for major faults and design or endemic faults (up to a specified amount and on a shared basis thereafter);
- insurance of rolling stock against third party liabilities and repayment to the lessor of premiums for property damage insurance;
- indemnification of the lessor against losses relating to the leasing, use, and operation of rolling stock in certain circumstances; and
- return of rolling stock to the lessor at the end of the lease period in the condition specified in the lease supplement.

Maintenance

72. At privatization, a characteristic of the rolling stock leases was that the ROSCOs were generally responsible for the provision of heavy maintenance, while light (running) maintenance was to be the responsibility of the TOCs. Lease payments therefore comprised two elements: the capital rent, which pays the ROSCO for the use of its vehicle, and the non-capital rent, which was intended to cover the cost of heavy maintenance and other running costs spread evenly over the vehicle's economic life. This type of maintenance arrangement is known as a 'soggy' lease. These maintenance arrangements replicated British Rail's system and there were a number of reasons put forward at the time to support this.
73. This structure has since been varied to some extent, with ROSCOs now offering a number of maintenance options including:
- TOCs themselves arranging for both the heavy and light maintenance (known as a dry lease); and

- the responsibility for all the maintenance lying with the ROSCO (known as a wet lease).¹⁷

74. Broadly speaking, the distinction between heavy and light maintenance is that light maintenance comprises day-to-day maintenance (including cleaning and inspection), whereas heavy maintenance involves planned overhaul of major components (eg engines).

75. Rolling stock may also need additional capital expenditure during its life, such as refurbishments and technological updates or for mandatory modifications, which are required as a result of legislative changes.

Rail franchising process

76. The following section outlines the background to the introduction of franchising in the passenger railway industry, describes the current process and outlines how the process has changed since its introduction.

Background

77. The DfT stated that 'Rail franchising was designed as a means of bringing competition into passenger rail, notwithstanding the long term requirement for government support as a result of costs exceeding the amount of revenue which could be generated'. The DfT has also stated that most rail services constitute a natural monopoly, as a result of high fixed costs which mean that there is rarely enough revenue to make two routes between the same locations viable. Franchising provides an alternative mechanism for competition by making different train operators compete for the right to operate specified groups of services for a fixed period.

¹⁷In addition, the responsibility for all the maintenance can be contracted back to the manufacturer, which acts as a maintainer. This is often applied to new rolling stock and can be referred to as a dry or wet lease.

78. Section 26 of the Railways Act 1993 provides the legal authority for the process of letting of rail passenger franchises. Under the franchising regime, the DfT lets a franchise by competitive tender. The successful franchisee operates specified passenger services for a specific period of time. The DfT determines the length of the franchises. Franchises typically run for seven years with an option for the DfT to extend it for another two to three years depending on the franchisee meeting performance targets. There is an entitlement to a continuation period, usually for three years, if certain performance standards are attained. However, there are some longer franchises which have been awarded subject to meeting particular performance standards, such as the Chiltern franchise which was awarded on a 20-year basis from 2002 subject to meeting performance standards based on output commitments.
79. A franchisee usually receives franchise payments from the Government to operate the franchise. However, there are some franchises in which the franchisee pays the Government a premium. This is outlined in further detail in paragraph 35.

The franchising process

80. The DfT runs a seven-stage franchise tendering process over a period of up to 74 weeks for each franchise. Table 4 sets out an overview of the DfT's seven-stage franchise replacement process.

TABLE 8 Franchise replacement process

Stage	Typical duration (weeks)	Comments
Stage 1: Completion of pre-qualification questionnaires (PQQs)	4–5	Bidders provided with high-level information about the franchise including standard set of questions.
Stage 2: DfT's evaluation of PQQs	7–8	The DfT receives approx 10 bids, and aims to shortlist 3–5 bidders at the end of this process.
Stage 3: DfT issues ITT	10	Each shortlisted bidder receives an ITT. Issuing of ITTs marks the beginning of the main bidding phase. ITTs contain details of the franchise specification including service and capacity requirements and constraints on rolling stock which can be used on the franchise.
Stage 4: Bidders develop and submit bids	13–16	Each bidder develops its proposed base case solution within the constraints of the franchise specification. Bidders negotiate with ROSCOs and obtain firm prices for the desired rolling stock.
Stage 5: DfT's bid evaluation	8–10	DfT bid evaluation—focuses on the base case bid submission. DfT announces preferred bidder.
Stage 6: DfT negotiation with preferred bidder	4–6	DfT finalizes negotiations with preferred bidder. Preferred bidder finalizes lease terms with ROSCOs.
Stage 7: Mobilization	8–16	Commencement of franchise services by new franchisee.

Source: ORR reasons for making a market investigation reference to the Competition Commission.

81. Following the shortlisting of bidders, the process is started by the issue of an Invitation to Tender (ITT) by the DfT to shortlisted bidders. At this stage TOCs look to secure firm rolling stock agreements when finalizing their franchise bid. This is partly due to the deliverability criteria against which bids are assessed, which leads bidders to strive to make sure that they are able to demonstrate to the DfT that suitable and sufficient rolling stock has been secured for the entire period of the franchise.

82. The ITTs vary in the degree of specificity as to what rolling stock can be used. The DfT has stated that the ITT for the franchise will normally specify the minimum number of services on each route together with the minimum capacity, journey times and stopping patterns. It may also include restrictions on the types of alternative rolling stock and in some instances it may specify individual rolling stock to be used. Historically ITTs were not made public but in future all ITTs will be placed on the DfT's website and will be made available to all bidders (with appropriate redactions).

83. Shortlisted bidders will each approach the ROSCOs or other rolling stock lessors for quotations for rolling stock. At this stage, shortlisted bidders will have signed rolling stock 'heads of terms' rolling stock agreements for inclusion within their business case submission to the DfT.
84. The DfT scrutinizes each bidder's business case to assess deliverability and value for money. A preferred bidder is selected within a ten-week period and the DfT then finalizes contractual terms and conditions in the franchise agreement prior to the start of the franchised services. Once selected as a preferred bidder, the new franchisee will revert to the rolling stock lessor to finalize the rolling stock lease terms and conditions ahead of the franchise start date, which is typically within a 22-week period. The DfT estimated that the complete franchise replacement process, from initiation to franchise commencement, could take up to 24 months.
85. Twenty-six passenger franchises were created at privatization and there are now 18 (outlined in Table 1 above). Changes to the make-up of franchises, which in this case has reduced the number of franchises, can be made by the DfT and this process is referred to as remapping. The DfT aims to stagger its franchise renewals so as to renew one to three franchises per year. It is therefore relatively unusual for franchises to be coterminous. The recent East Midlands, West Midlands and the New Cross Country franchise lettings ended simultaneously. However, in this case the DfT was remapping the franchises.

Legal agreements

86. In addition to the lease agreements, there are a number of other key legal agreements which exist between the Government, the TOCs and the ROSCOs. Below is a short description of the Franchise Agreement between the Government

and the TOC, and the Direct Agreement and section 54 undertakings between the Government and the ROSCOs.

The Franchise Agreement

87. The Franchise Agreement is between the DfT¹⁸ (signed by the Secretary of State for Transport) and the TOC which has been successful in winning a franchise. It is a bespoke agreement containing franchise-specific details, including performance benchmarks, target revenue, revenue sharing thresholds and details of the rolling stock to operate on that particular franchise at the start as well as any additional stock to be introduced during the franchise period. The Franchise Agreement also incorporates a standard set of terms that apply to all franchises, called the National Rail Franchise Terms.
88. Over the period 2001/02 the SRA developed a new model franchise agreement, which was a template designed to rectify the perceived faults in earlier agreements and reduce the cost of bidding and negotiation.
89. A profile of subsidy/premium payments is agreed for the duration of the franchise. Franchisees under the first round of franchising had fixed franchise payments (either premium payments or more likely subsidy payments) contractualized into the franchise agreement. However, this changed in March 2004 when the revenue share/ revenue support mechanism (often referred to as ‘cap and collar’) was introduced. In this mechanism the Government takes a share of revenue if it rises above a target level, but also provides support if revenue falls below a specified level. As a general rule, the franchisee is allowed to retain cost savings but also bears any cost increase. However, the franchise agreement does contain a change mechanism which deals

¹⁸With the exception of the ScotRail franchise where responsibility for the franchise now rests with Scottish Ministers, and the Wales and Border franchise, where the National Assembly for Wales is a joint signatory with the Secretary of State for Transport.

with changes to particular cost items such as access charges and could result in any savings being accrued to the DfT.

Direct Agreements

90. In order to ensure that it can fulfill its section 30 duty, the DfT enters into agreements with the ROSCOs which give it, among other rights, various step-in options in the case of franchisee default. These agreements give the Government the option (but not an obligation) to require the ROSCOs to enter into leases in respect of the rolling stock which are substantially similar to those which were previously in force in respect of that rolling stock (ie between the ROSCO and the TOC). This facility is designed to ensure that the Government has access to sufficient railway assets and services to continue to run passenger services in the event of a franchisee default. A copy of the relevant leasing agreement is appended to the Direct Agreement.

91. At the time of privatization, the Government entered into a Direct Agreement with each of the ROSCOs covering the MOLA stock (known as the OPRAF/ROSCO agreements). The Government has also entered into further Direct Agreements with the ROSCOs in relation to stock procured since privatization (non-MOLA stock), and for each new set of rolling stock there is a separate Direct Agreement. These agreements continue to apply throughout the life of the rolling stock.

92. Direct Agreements in respect of stock procured since 1995 contain a call option. This call option gives the Government the right to require the ROSCO to enter into a new lease for rolling stock with the Government (or its nominee) for up to three years upon what would otherwise be the end of the current franchise period. The new lease would be on the same terms as the existing lease and is available only at the expiry of a franchise agreement.

93. After the ORR's 1998 review of the rolling stock market, this call option was also inserted into the three OPRAF/ROSCO agreements relating to MOLA stock. However, it only referred to franchise agreements that existed on 22 June 1999, of which none are now in existence, therefore the call option for MOLA stock has fallen away entirely.

Section 54 undertakings

94. The Government can give an undertaking under section 54 of the Railways Act 1993 in order to encourage investment in the railways. Under section 54 the DfT can undertake 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. Although a section 54 undertaking does not legally commit the DfT to ensuring that rolling stock is re-leased on the same franchise, in such situations the DfT invariably specifies that the bidders for the new franchise must continue to use that stock. Section 54 undertakings have been given by the Government in order to encourage investment in new rolling stock or in refurbishing existing vehicles. Section 54 undertakings only apply at the expiry of a franchise and not in the event of a TOC's default or the early termination of a franchise.

Rolling stock procurement

95. New rolling stock can be specified in the ITT by the Government, introduced by a TOC through a franchise bid or during a franchise, or can be purchased by rolling stock lessors without any commitments to lease. New stock may be introduced in order to provide additional capacity and/or to replace life-expired rolling stock, or as a result of a change to legislative requirements, as was the case with the withdrawal of the Mark 1 'slam door' stock.

96. When new rolling stock is introduced it may lead to rolling stock moving on to different franchises. This is known in the industry as a 'cascade'. Where new stock displaces incumbent stock on to another franchise, we term this a 'first cascade after new build'. Subsequent cascades may occur if the cascaded rolling stock displaces stock on other franchises.
97. The price for new stock has varied widely; however, in general there has been an upward real trend in the price per vehicle. The time taken to build new rolling stock varies depending on the availability of a suitable product, the manufacturer's factory capacity, the number of vehicles ordered and the type of vehicle. Lead time can range from less than one year to nearly five years.

The role of TOCs, ROSCOs and the DfT in procurement

98. Most of the TOCs have engaged in procuring new stock to some degree, and in some cases it has been central to the franchise proposition put forward by the TOC, as was the case with Virgin Train's bids for the West Coast and Cross Country franchises. All the ROSCOs have engaged in the procurement of new stock, although the extent of their individual involvement has varied.
99. The DfT is a key player in the placement of orders for the production of new rolling stock. It can determine when new build is procured by specifying new rolling stock in the franchise ITT. It can also determine how new build is procured, for example in the case of the Intercity Express Programme (IEP), where the DfT is leading a procurement exercise for the replacement of high-speed trains.
100. The DfT is playing an increasing role in developing strategies for optimizing the deployment and growth of capacity in the railway system to meet future demand, such as through the HLOS and through determining rolling stock strategy.

101. The Government published its HLOS on 24 July 2007, which specified increases in passenger capacity. The HLOS outlined the additional capacity which the DfT proposes to buy. The accompanying White Paper suggests that this capacity could be delivered through the purchase of up to 1,300 new vehicles to be progressively deployed from 2009 to 2014. The composition of the vehicles has yet to be decided but the DfT has stated that a Rolling Stock Plan will be published in early 2008, and this will give further details. The DfT is considering options for the structure of the procurement process, [✂].

Methods of procurement

102. The method used to procure new rolling stock (also referred to as 'new build' rolling stock) has varied. Typically TOCs will competitively tender to procure new rolling stock. The TOC can either seek a financier, who will liaise with the manufacturer to build the stock, or it can negotiate directly with a manufacturer to build the rolling stock and seek finance for the stock separately. The new rolling stock will then typically be leased back to the TOC.

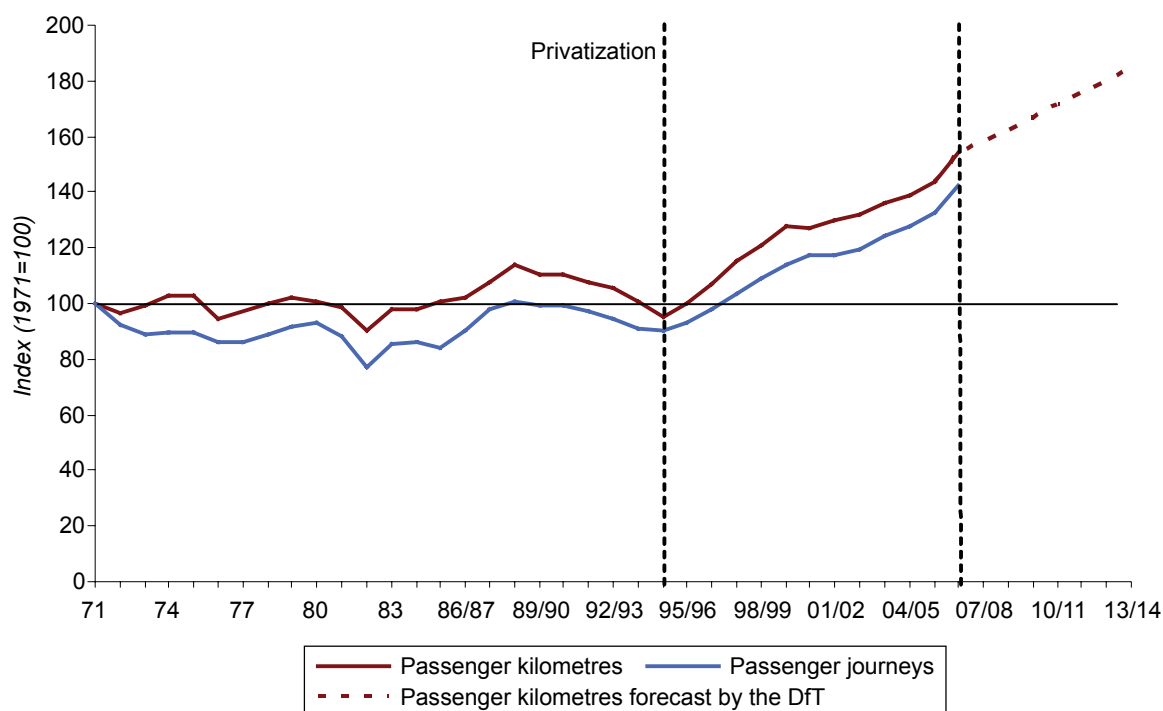
103. There are, however, other alternative methods of procurement, for example the IEP. In this case it is proposed that there will be a single procurement process for a manufacturer, maintainer and financier 'bundled' together. It is envisaged that leasing will be replaced by long-term asset financing based on a 30- to 35-year payment stream and there will be significant Government support. The DfT issued an ITT for the IEP trains on 16 November 2007; tenders are due to be submitted in spring 2008 with the contract awarded in the first quarter of 2009. The aim is to produce a pre-series batch of trains on the East Coast Main Line from 2013 with trains entering full services in 2015.

Railway market size and growth

104. The privatization of the rail industry in the early 1990s occurred against a backdrop of falling demand.¹⁹ However, from 1995/96 rail patronage began to rise and it has continued to grow. 1,164 million journeys were made on the national rail network in the year 2006/07, compared with 735 million in 1994/95. Demand measured in passenger kilometres has also increased. Between April 1996 and March 2007 passenger kilometres in Great Britain grew by approximately 45 per cent, from 32.1 billion to 46.5 billion passenger kilometres (Compound Annual Growth Rate approximately 3.4 per cent).

FIGURE 4

National rail patronage, 1955 to 2006/07



Source: *Transport Statistics Great Britain 2006* edition and figures.

Note: From 1986/87 figures include an element of double counting as a journey involving more than one operator is scored against each operator.

105. Growth in passenger kilometres in Great Britain from 2006 to 2014 is forecast by the DfT at approximately 23 per cent (Compound Annual Growth Rate approximately

¹⁹DfT July 2004 White Paper *The future of rail*, p13, 1.2.1.

2.6 per cent). The DfT has stated that the anticipated growth in passenger demand is a major reason for the capacity increases which the Government specified in its HLOS published in July 2007.

Previous reviews of the rolling stock market

106. The rolling stock market has been scrutinized on a number of previous occasions:

- by the ORR in 1998, following a request from the Deputy Prime Minister;
- by the SRA as part of its rolling stock strategy in 2003;
- by the Secretary of State for Transport as part of the July 2004 White Paper; and
- by the ORR in April 2007, following which the leasing of rolling stock for franchised passenger services was referred to the CC for further investigation.

Below is a short description of each of these reviews and the key outcomes.

ORR Review of the Rolling Stock Market, May 1998

107. In January 1998 the ORR was asked by the Deputy Prime Minister to review and make recommendations on the operation of the rolling stock market, and in particular to assess the scope for ROSCOs to abuse market power through excessive pricing, through inadequate investment in new or refurbished stock or more generally through their response to the requirements of TOCs to secure improvements in performance.

108. The ORR review reported in May 1998. It concluded that new entry was expected to occur in the market and that this would create a more liquid and competitive market.

The key recommendations were that:

- regulation of the rolling stock market should be introduced only as a last resort, if problems of dominance and potential abuse could not be successfully addressed through encouragement of further competition combined with continuing vigilance and speedy action against anti-competitive behaviour;

- the ORR should adopt a firm and proactive approach to the use of its Competition Act powers to identify, monitor and police potential abuse of dominant positions;
- the three ROSCOs should be asked to produce Codes of Practice setting out their approach to the rolling stock market and the terms on which they will do business with TOCs;
- the Government should identify means of reducing current uncertainties over the future strategic direction of the passenger railway and the rolling stock requirements; and
- the ORR should monitor the rolling stock market to identify departures from the Codes or other matters which warrant further investigation as potential abuses of the prohibitions in the Competition Act.

109. In 2001, the ORR reviewed the functioning of the Codes of Practice. It determined that although the market appeared to be working well, it should pursue issues raised by TOCs in relation to mandatory modifications and existing leases.

SRA Rolling Stock Strategy, December 2003

110. In December 2003 the SRA published a Rolling Stock Strategy document, which set out the framework for its involvement with rolling stock markets and identified the actions the SRA wished the industry to take. The strategy proposed a way forward intended to increase the choice available to TOCs at the time of lease renewals. It advocated a number of principles including:

- avoiding the specification of highly bespoke stock;
- facilitating cascades (instances of rolling stock that is switched from use on one franchise to use on another); and
- extending the timescales available to TOCs and franchise bidders when making and implementing their rolling stock decisions.

111. The SRA also recommended strengthening the measures to prevent potential exploitation of market power by: increasing awareness of the Codes of Practice; increasing transparency about the breakdown of charges, including capital and non-capital elements; and benchmarking of lease prices and terms in order to better inform TOCs of what constitutes value for money.

DfT White Paper, The Future of Rail, July 2004

112. In January 2004, the Secretary of State for Transport announced that his Department would undertake a fundamental review of the rail industry. This review considered structural and organizational changes needed to enable the rail industry to deliver for its customers, as well as the regulation of safety and the progress being made to improve performance and control costs.²⁰

113. The White Paper outlined a number of key changes to the structure of the industry, including abolishing the SRA and the Government taking charge of setting the strategy for the railways. With regard to rolling stock, the paper found that a number of predictions made at the time of privatization concerning the development of competition had not been realized. In addition, the paper also identified continuing concerns in the industry about how maintenance responsibility was allocated and suggested that there was a case for looking at how the operation of the markets could be improved. The Railways Act 2005 implemented the institutional changes published in the White Paper.

Negotiations between the Government and the ROSCOs

114. In the period following the publication of the 2004 White Paper, the DfT embarked on a series of negotiations with the three ROSCOs, which focused mainly on lease prices for the ex-British-Rail passenger MOLA rolling stock, but also on other areas

²⁰DfT, *The Future of Rail White Paper*, July 2004, p6.

such as information provision, maintenance packages and a redistribution of risks within the market.

115. The DfT undertook further work to analyse lease prices and on the basis of this work it sought to engage with each of the ROSCOs and their parent companies. The negotiations were ultimately unsuccessful, leading the DfT to ask the ORR to undertake a market study with a view to making a reference to the CC.

ORR referral to the CC, April 2007

116. After conducting a short initial review of the DfT's submission request, the ORR decided to undertake a market study with a view to deciding whether or not to make a market reference to the CC. On the 29 November 2006, the ORR announced that it was *minded* to make a reference to the CC for a market investigation.
117. Taking into account the evidence gathered during the course of its market study (gathered by way of written exchanges, including responses to questionnaires, and by way of meetings with all the key industry parties), on 26 April 2007 the ORR referred the leasing of rolling stock for franchised passenger services to the CC for further investigation under section 131 EA 2002.