



Going off the rails?

The leasing market for passenger trains is under scrutiny, having been referred to the Competition Commission by the Office of Rail Regulation. Heather Greig-Smith takes a look at the market.

In April, the news came that rolling stock leasing companies had dreaded. After months of deliberation, the Office of Rail Regulation (ORR) decided to refer the industry to the Competition Commission, saying elements of the market could prevent, restrict or distort competition.

“This means that train operating companies may be paying higher prices and/or receiving a poorer quality of service than if

competition was more effective,” says ORR chairman Chris Bolt.

The rolling stock leasing companies (Roscos) immediately hit back, with Angel Trains saying they were confident the market was “strong and robust”. But they now face an investigation that could take up to two years to complete, and some are worried this could lead to contracts being re-negotiated.

But does the ORR have a point? The market for leasing passenger

trains in the UK is undeniably a small one, dominated by three Roscos. They were the companies that bought trains from the government when the rail system was privatised in 1994: Angel Trains, HSBC Rail and Porterbrook, owned by the Royal Bank of Scotland, HSBC and Abbey respectively. Last year the DfT claimed they were together making excessive profits of up to £175m a year.

Problems highlighted by the

ORR include a lack of choice when a franchise ends, with little option but to re-lease the stock used previously in that franchise.

But, many argue that the problems in the market are caused by the structure imposed by the Department for Transport, which awards franchises to train operating companies. The ORR concurs that this limits market liquidity because franchises across the country start and stop at different times.

Leasing companies are now faced with a period of uncertainty that some argue is putting a brake on deals. “We’re having to think about it. At some time in the future the DfT may re-open any deals that we do,” says Porterbrook commercial director Keith Howard.

Even the train operators agree: “A lengthy referral process could harm immediate prospects for investment in rolling stock,” says FirstGroup. However, a spokesman for the ORR said this risk was minimal and short-term.



TOCs may be paying higher prices and receiving poorer service”



Chris Bolt: chairman, Office of Rail Regulation (ORR)

Jargon

Rosco: rolling stock leasing company

TOC: train operating company

Dry lease: maintenance is handled by the train operator

Wet lease: maintenance handled by the Rosco for a fixed fee

Soggy lease: a hybrid lease where maintenance is split into day-to-day and heavy maintenance

Cascade: the process whereby train fleets are moved across the country as required

Section 54: the instrument by which the government can require a new operator to take on the previous operator’s rolling stock. This gives guarantees when money is spent on new build

How the system works

Trains have a lifespan of around 30 years but most franchises are seven to ten years. The Department for Transport (DfT) accepts bids from operators and has sign off on the winner’s arrangements for leasing rolling stock.

Howard explains: “In our industry we only do one type of lease, an operating lease. The train operators we deal with don’t have balance sheets strong enough to take it. They tend to be pretty low capitalised businesses.”

In Europe the situation is different. Ed Wilson is head of energy and environmental finance for Bank of Scotland, which has a joint venture with Babcock & Brown for Europe, CB Rail. “You have people buying with cash and new start-up operators who like the operating lease model and a variety of things in between. It’s a much more diverse financing market,” he says.

Leases are either ‘dry’, where the Rosco rents the train and the operator takes care of maintenance, or ‘wet’ – where the maintenance is provided by the Rosco or, as is usually the case with new trains, the manufacturer. There are also ‘soggy’ leases, where the maintenance is split into day-to-day and heavy overhauls.

One of the ORR’s criticisms is that wet lease maintenance is not transparent because of the way payments are bundled together. However, operators such as FirstGroup say Roscos are becoming more amenable to dry and soggy lease options than in the past.

Every December, the industry makes timetable changes that could affect the number of trains needed – so this may have to be



Ed Wilson: head of energy and environmental finance, RBOS



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written into the lease or short-term leases offered in the interim period. Also, most operators will have more trains than they need, as there will be a rolling programme of refreshment and maintenance.

The situation is further complicated by charter services, which might lease extra trains to companies for peak periods, such as routes to the coast in the summer or to take fans to football matches.

New rolling stock tends to be



funded by the Roscos or government. Because an operator might lose its franchise, it is generally uneconomical to buy its own stock and risk being left with trains it cannot use.

Howard says Roscos take the risk in areas such as fleet obsolescence; mandated modifications (for example if government decreed all trains must have seatbelts it would cost a fortune to implement); regulatory change; safety risk and residual value risk. "We also carry the risk that if it's on a dry lease the operator maintained it correctly, as well as the credit risk that they pay us."

As for operators buying their own trains, Howard says it is perfectly possible if they are confident they'll be able to use them in future. "But it does bring in risk that they are not used to handling and we are. If you lose a franchise, your successor may not take [the trains] from you."

Some TOCs do own their own stock. First Great Western has some trains of its own, as it is large enough to be sure it can redeploy them even if it loses a particular franchise.

Arriva is also discussing the possibility with the Welsh Assembly government, which is looking at the long-term options for rolling stock in Wales. An Arriva spokeswoman says one option would be the acquisition of rolling stock by the government or a train operator.

"We have acquired trains in the Netherlands. If we were to look at acquiring trains it would be in partnership with the Welsh Assembly because we have to look at the lifespan of the trains beyond our tenure."

Wilson says this could become more popular. "If there is consolidation and the transportation groups get bigger they can probably conduct their own rolling stock operation." However, he questioned whether trains can be transferred to different routes in the UK that easily. "It's more of a wish list in the UK, but people will start to look at it as a natural progression."

Does the system work?

The Association of Train Operating Companies (ATOC) says the leasing system generally



Bruce Nelson: regional director, Key Equipment Finance



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works well. Spokesman Hassard Stacpoole says: "It has allowed investment to go into rolling stock." Since privatisation some £4.5bn has been spent on new fleets.

Stacpoole adds there is debate in the industry about whether or not the franchises awarded by government should be longer because that would enable TOCs to buy their own stock. But he uses the example of Chiltern Railways, which has a 20-year deal but still leases.

He says freight operators don't have the same restrictions in terms of franchises, but they still lease. "They could quite reasonably buy rolling stock themselves but their preference is to go out to a Rosco. The feeling in the industry is that the current set up does deliver the investment required."

Yet FirstGroup says a judgment needs to be made on whether the market should go down the line of

long term finance-style leases, with section 54 support (where the DfT guarantees the use of stock).

The future

There is the possibility that the market will open out to other players in future. Bruce Nelson is UK and Ireland regional director for Key Equipment Finance. "Never say never. What we all want to do in the industry is watch and see what the outcome of the Competition Commission investigation is. A lot of people are on the periphery. I think the market will open up."

There have already been new entrants, such as HBOS and GL Raillease, a joint venture with Lombard and American company GATX Capital. CB Rail, a joint venture between Bank of Scotland and Babcock & Brown, is offering an operating lease product for rolling stock in Europe.

Ed Wilson of RBS said the bank also does deals in the UK. "We have to compete against the three big Roscos. We're a niche player." While he says the bank will take opportunities in the UK and is watching to see what happens in future, the European market offers more possibilities. "In the UK the three Roscos are quite dominant. Though they are being reviewed by the Competition Commission I suspect they'll continue to be quite powerful."

In its response to the ORR's consultation on competition, HSBC Rail said factors such as access to capital, or industry and technical expertise, do not constitute material barriers to entry into the market. "We consider that the barriers to entry are low enough to mean there is a real prospect of further entry." **CTI**

Juggling the stock

As the life of a train is longer than a franchise, the Roscos have to juggle their assets, making sure they are in use as much of the time as possible to get the best returns.

In May, train operator Southern signed a £58m contract for 48 new Electrostar carriages from Porterbrook. As part of the plan, Southern will release its fleet of 48 class 319 carriages and make these available on the Thameslink route to help deal with overcrowding.

The contract is part of the industry's challenge to provide 1,000 new carriages over the next seven years, as decreed by the Department for Transport.