

Hitachi/Thales merger inquiry

ORR's response to the CMA's Remedies Notice

27 June 2023

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Introduction and the purpose of this submission

1. The Office of Rail and Road (**'ORR'**) is the independent economic and safety regulator for the railways in Great Britain (**'GB'**), and the monitor of performance and efficiency for England's motorways and trunk roads. ORR is also a designated national competition authority, with powers held concurrently with the CMA to apply competition law in markets relating to the supply of services relating to railways.
2. A core facet of our role is to hold the primary UK rail infrastructure manager Network Rail to account for the day-to-day running of GB's railways. One of the ways we exercise this function is via periodic reviews (**'PR'**) relating to subsequent five-year control periods (**'CP'**). Our PR process is designed to ensure a sufficient and long-term focus on the core fundamentals of safety; asset sustainability; performance; and efficiency, as well as any other key government priorities including sustainability. The PR process also promotes certainty over what the network needs to deliver and enables effective planning and supply-chain management.¹
3. As we have previously discussed with the CMA, the principal focus of our economic regulatory role is on what we define in this submission GB's 'mainline'² network. The information presented in this submission relates solely to the GB mainline, unless stated otherwise.
4. This submission follows our Phase 1 and Phase 2 written submissions on the anticipated acquisition (the **'Merger'**) by Hitachi Rail, Ltd (**'Hitachi'**) of Thales SA's Ground Transportation Systems Business (**'Thales'**).
5. In this submission we do not respond to or comment on the CMA's Notice of Provisional Findings, which we take as published. Our view of the impact of the Merger on competition remains unchanged since that expressed in our previous submission to, and subsequent dialogue with, the CMA. We believe that the merger will lead to a lessening of competition within this market, but the limited information available to us does not enable us to opine on whether this will amount to a lessening that is 'substantial' under the meaning provided by the Enterprise Act 2002 (**'EA 2002'**). This has been assessed by the CMA and we have prepared this submission in acknowledgement of the CMA's provisional findings that the Merger would result in

¹ ORR manages the periodic review process, but funders and Network Rail also play key roles.

² By this we mean those networks that are interoperable with the UK's principal overground rail network, managed by Network Rail.

the creation of a relevant merger situation, and that the creation of that situation may be expected to result in a substantial lessening of competition ('**SLC**') as a result of horizontal unilateral effects in: (a) the supply of digital mainline signalling systems and related services in Great Britain ('**GB**'); and (b) metro networks, the supply of CBTC signalling systems and related services in the UK.

6. Our aim through this submission is to advise and assist the CMA's deliberations over remedies in the event that its final decision will be to accept appropriate remedies to address the SLC identified in the provisional findings.
7. Our response addresses all of the areas in which CMA's Remedies Notice calls for evidence, namely the scope of the remedies package; suitable purchasers; divestiture process; and impact on TCSF. As will become apparent from the discussion that follows, these areas are to some extent interlinked. In particular, most facets of remedy design have the potential to both impact on and be impacted by the TCSF. Our submission makes observations on certain issues pertaining to remedies design based on the limited information that is available to us at this stage. We note that we have no information on what, if any, remedies might be offered by the Parties but our submission aims to provide the CMA with sector-specific information on what a suitable remedies package for this case might look like. We aim to update our submission, if and when we receive more concrete information on the Parties' remedies offer(s).

Practical considerations and the timing of the TCSF

8. The precise timings and parameters of the Train Control Systems Framework ('**TCSF**') are critical considerations for the CMA at this stage of its Inquiry because through the TCSF, Network Rail aims to balance the potentially conflicting objectives of ensuring effective competition and providing suppliers with certainty over future volumes. The TCSF will pursue this latter objective by, amongst other things, limiting the number of signalling suppliers who are in a position to bid for top-tier mainline signalling projects. Before the conclusion of the CMA's Inquiry, the TCSF process will already have significantly narrowed down the pool of potential players for CP7 and CP8, to a shortlist of (what we anticipate to be) six companies who have been able to demonstrate credentials in this area. Network Rail's final appointment of four suppliers to the TCSF's digital lot will be completed in early 2024. Final bids by candidate suppliers will be submitted around the end of September 2023.
9. It follows from this that, in order to mitigate the SLC which the CMA has identified:
 - (a) Any standalone business that were to be divested as part of a remedies package would need to be shaped in such a way as to retain prequalification for

the TCSF. It would otherwise be unlikely to successfully participate in CP7 or CP8; and

- (b) Any remedies, would need to be designed in such a way as to:
 - (i) complement the business models of the shortlisted companies - notably, OEMs with their own set of products would in our view be unlikely to be interested in an access remedy, similarly UK integrators would in our view be unlikely to be interested in buying manufacturing or other assets which require an international presence or cross-country portfolio in order to be efficiently used;
 - (ii) benefit shortlisted companies whose bids would otherwise be relatively weak bids within Network Rail's shortlist of six candidate suppliers. In our view, Siemens and Alstom in particular are already set to be very strong bidders with complete business portfolios so a remedy which improved their ability to bid would be unlikely to mitigate any SLC; and
 - (iii) be concluded in a sufficiently timely fashion in order to be fully reflected in the final bids made by suppliers in September 2023 and in Network Rail's assessment of these bids which will take place in the last months of 2023. These are challenging timescales and an effective remedy should be able to be incorporated or exist as a standalone business in a timely (and probably tight) manner.

Observations on structural remedies

10. As per the CMA's Remedies Guidance, a divestiture, *"seeks to remedy an SLC by either creating a new source of competition, through disposal of a business or set of assets to a new market participant, or by strengthening an existing source of competition, through disposal to an existing market participant independent of the merger parties"*.
11. We understand therefore that the CMA's deliberations on remedies might consider a range of divestment options, ranging from the sale of a viable standalone business to that of a discrete set of assets. In the paragraphs below we primarily consider the former case, i.e. the divestment of a business which, regardless of the identity of the purchaser, would be capable of compensating the market for the loss of a major supplier, subject to the caveats around timings and the TCSF outlined in the previous section.

12. The key principle underlying any structural remedies must be that the divested business will have all capabilities to preserve and maintain the level of competition that existed pre-merger in all impacted geographic and product markets. At this stage we think it is for the Parties rather than for the ORR to provide evidence on what elements of their combined current activities would need to or could viably be divested in order to achieve this, particularly since much of the Parties' technical capability (see below) is not UK based – though we recommend to the CMA to assess such offers with the nature and the potential of the capabilities of the divested firm in mind.

The building blocks of a big four European OEM

13. As recognised by the CMA in its provisional findings report, there is both a domestic and European dimension to competition in mainline signalling markets. Whilst the local delivery presence of the European big four (Siemens, Alstom, Hitachi and Thales) varies significantly across jurisdictions, something that they all have in common is an underlying technical capability which is at least in part pan-European in nature³. With this in mind, we summarise below what we view to be the key elements of the business model currently employed by the big four OEMs. Depending on the severity of the SLC that has been identified, the CMA might consider that this business model would need to be broadly replicated by a new player aspiring to reach a similar level.
14. In our view, based on the advice of our signalling operations experts, it is possible to identify the four key building blocks of an OEM that would be capable of competing with the big four on an even footing.
 - a) **Manufacturing facilities:** During the Siemens-Alstom merger inquiry⁴ we explained to the European Commission the role of key facilities such as Siemens' former Westinghouse facility in Chippenham and Alstom's centre of excellence for signalling in Charleroi. We are not close enough to the operations of either of the Parties in this merger (Hitachi or Thales) to identify specific sites and their purposes but we would recommend the CMA to investigate this further and understand the role of the Parties' key facilities, what they offer and how critical they are to form their pan-European presence. We would then recommend to the CMA to assess whether a divested entity could match such a model.

³ We use "pan-European" here to refer to a technical and service presence across multiple national markets, from which each Party combines its activities so to offer technical solutions which include a bespoke element for individual national markets.

⁴ M.8677

- b) **A design capability**, for example, again in the Siemens/Alstom transaction the Westinghouse Croydon facility played an important historical role in the design of the family of products which are currently used to supply GB markets. Our recommendation to the CMA would be to assess the offered remedy against this example as it is similar or close in nature and industry concept.
- c) **Installation, logistics, and project management capabilities**, typically with a strong local element. As we have previously described to the CMA, in GB mainline terms the Parties are less strong players in these areas than the two incumbents Siemens and Alstom, hence their past record of partnering with integrators to bid for and deliver projects. Again, a relevant question to be asked is whether a divested entity would be able to follow the same pattern and stand alone or be a good option for integrators to partner with.
- d) **A Research and Development (R&D) capability**: This is essential for the long-term future of a company capable of competing across successive generations of technology and a divested entity should have enough R&D capabilities to compete effectively with incumbent firms.

Diverse portfolio

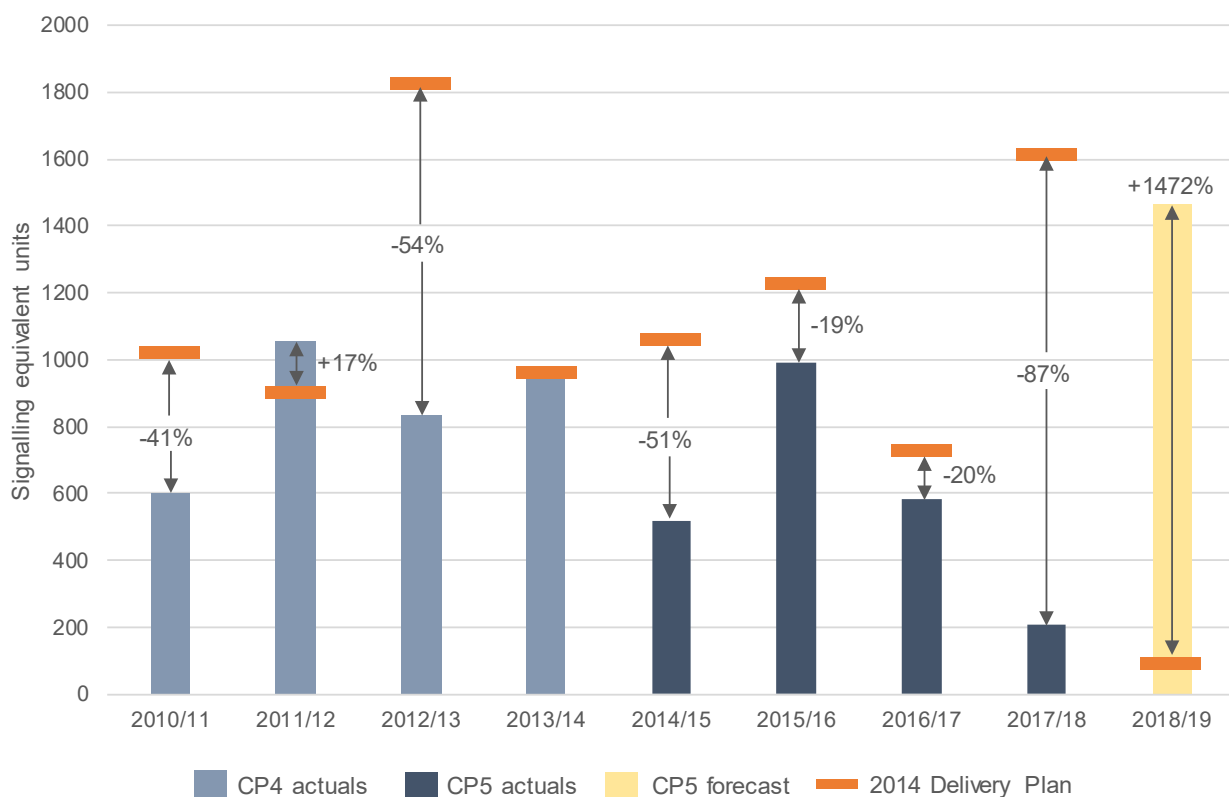
- 15. As the CMA knows, all of the European big four's activities are diversified across a number of European markets. The technical capabilities summarised above give rise to significant fixed costs by way of operational and financial leverage. The smaller the portfolio of contracts controlled by an OEM, the greater will be the potential variability of the cash flows from their signalling business.
- 16. The principal risks against which such 'diversification' offers protection are not of a systematic/ macro-economic nature, but rather relate to individual markets. In the UK, much of this risk has historically arisen from Network Rail's need to manage its capital renewals budget within public sector expenditure constraints. This can result in the need for Network Rail to substantially re-programme work across and within Control Periods.
- 17. Figure 1 below illustrates this demand uncertainty for conventional signalling renewals projects. It shows the variance between Network Rail's planned delivery (represented by the orange bars), as set out in its initial (March 2014) CP5 Delivery Plan⁵, and the outturn (blue)/forecast (gold) renewals volume for that year

⁵ At the start of a price control, Network Rail will set out how it plans to deliver the outputs it has agreed with ORR in its Delivery Plan. The Delivery Plan sets the baseline against which ORR holds Network Rail to account. It also acts a source by which Network Rail's stakeholders can obtain clarity on Network Rail's activities, enabling its supply chain to plan their activities accordingly. The Delivery Plan is updated on an annual basis to reflect changes to programmes.

(represented by the columns). The newest data in Figure 1 is not very recent; it was prepared for a submission which we made to the Siemens/Alstom inquiry in 2019. We understand that the CMA has itself obtained more recent data on which to reach a view on this issue of predictability. If this is not the case we would be happy to discuss the collection of more recent information.

18. Figure 1 also shows frequent, double figure historic variance between planned and actual delivery. The amount of uncertainty faced by *individual suppliers*, particularly suppliers outside of the two GB mainline incumbents Siemens and Alstom by definition has the potential to be greater than is apparent at a total market level, since the former also includes the risk associated with fluctuations in market share as well as total demand.
19. Such demand uncertainty is costly to signalling suppliers since, following a build-up of resource to meet anticipated demand, a large reduction in that demand means that the firm will have to bear the cost of unneeded resource.
20. In conclusion, a firm with a diverse portfolio and a number of customers will be better placed to manage this risk, by potentially deploying that resource on other projects.

Figure 1 - GB mainline signalling (conventional) renewal volumes, CP4 and CP5



21. It follows from the above that the CMA's work on remedies should consider the importance of portfolio effects.

Observations on behavioural remedies

22. Our view is that behavioural remedies would face significant challenges as a means of addressing effectively and with long-term perspective the competition concerns created by the Merger. Recent evidence from signalling markets points towards specific issues with behavioural remedies, such as those which mandate access to technology.
23. As previously discussed with the CMA, access to technology, interlocking in particular, has historically formed a key barrier to entry in the supply of signalling projects. This at first sight suggests access to (interlocking) technology as a remedy with potential to mitigate the SLC that the CMA has identified. However, we do not believe that a remedy mandating access by another entity to one or more of the Parties' interlocking technologies would be adequate (or realistic) as a means of addressing horizontal effects in these markets in the long run. The access/integrator based model is one that has already been trialled in GB signalling, with evidence from this experience pointing towards some important challenges – these are the following:
- As previously discussed with the CMA, for top tier projects we have historically observed an increasing preference for the OEM over integrator model amongst both suppliers and customers. Atkins' use of the integrator model to deliver top tier projects has been to date unique to it in GB. As far as we are aware, the integrator model is not widely seen in the other major European signalling markets, where the OEM-only model predominates.
 - As the CMA is aware, the current technology of both Parties will require significant development costs in order to be ready to deliver digital projects on the UK mainline. It is not clear where the cost of this development would lie for an access remedy. [X].

Next steps

24. We hope this submission will assist the CMA Panel in its understanding and assessment of prospective remedies offers or own CMA proposals and we are happy to discuss any aspects of this submission with the case team and/or the Panel as needed.



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