

# 6 Conclusions

## Introduction

6.1. We are concerned in this reference with a proposal for the merger of the guided weapons (GW) businesses of British Aerospace plc (BAe) and Thomson-CSF SA (a French company controlled by the state-owned company Thomson SA), into a joint company to be known as Eurodynamics. The new company is intended to be free-standing under the 50:50 ownership of BAe and Thomson-CSF.

## The merger situation

6.2. Under the terms of reference dated 19 September 1990 (see Appendix 1.1) we are required to investigate and report whether arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation in that enterprises carried on by or under the control of BAe will cease to be distinct from enterprises carried on by or under the control of Thomson-CSF. For this purpose, the terms of reference allow us to consider either the assets test or the market share test laid down in section 64(1) of the Fair Trading Act 1973 (the Act), and require us to exclude one of the tests if we find the other to be satisfied.

6.3. As is apparent from Table 2.4, the value of the assets to be taken over (ie those of the parts of Thomson-CSF to be put into the merged enterprise) exceeds £30 million, and the assets test is thus satisfied. We conclude that arrangements are in progress by BAe and Thomson-CSF for the creation of a joint enterprise, which if carried into effect will result in the creation of a merger situation qualifying for investigation.

## The companies involved

### *BAe*

6.4. BAe is one of the largest aerospace organisations in the Western world. In the United Kingdom, it far outstrips other companies engaged in the business of design, development, and production of military and civil aircraft, GW and space systems, and the provision of defence support services. The segment of BAe with which we are concerned is located within British Aerospace Dynamics Ltd (BADL), a wholly-owned subsidiary which manages BAe's GW business and certain other activities, which are not to be included in Eurodynamics. The GW business to be transferred comprises surface-to-air, anti-armour, air-to-air, air-to-surface, and shipborne missile systems. BADL's turnover in this business in 1989 was almost £600 million, and it has over 9,000 employees (ie about £65,000 per employee). The activities that have been part of BADL and are not to be included in Eurodynamics are the underwater systems business, its defence systems integration/electronic warfare activities, and British Aerospace Systems and Equipment (BASE), comprising optronics, navigation and avionics, information systems, defence components and equipment, security systems, and support for naval fire control systems.

## ***Thomson-CSF***

6.5. Thomson SA has two major components today, one in the business of consumer electronics and the other Thomson-CSF, which is largely in the business of defence systems. Thomson-CSF is organised into a number of operational branches, among which are aerospace, detection systems, missile systems and command and communications systems. It is the Missile Systems Branch which is to be transferred into Eurodynamics. This branch is made up of *Division Systèmes Electroniques* (DSE), *Division Electronique de Missiles* (DEM) and the subsidiary *Société de Maintenance 5e* (SM5). DSE designs and develops missile systems, but does not manufacture missiles. It designs, develops and builds the systems concepts and configurations, together with the software systems. SM5 produces electronic and mechanical sub-assemblies as a subcontractor. DEM designs, develops and installs electronic components of the missiles (electromagnetic and optronic seekers, proximity fuzes, data-link receivers and transponders), acting primarily as a subcontractor. DSE principally designs and develops surface-to-air systems, while DEM also designs and develops components for air-to-air, surface-to-surface and air-to-surface systems as a subcontractor to other missile suppliers. The turnover of the Missiles Systems Branch in 1989 was just over £1 billion, and it had about 2,500 employees (ie about £400,000 per employee).

6.6. The discrepancy in respect of the turnover/employee ratio, between what BAe and Thomson-CSF are each putting into the joint venture, is mainly explained by the fact that, unlike BAe, Thomson-CSF is not itself a manufacturer of missiles. The characteristic is especially marked in the case of DSE, which in 1989 had a ratio of nearly £500,000 turnover per employee.

## **The merger proposals**

6.7. Discussions between BAe and Thomson-CSF about the possibility of a joint venture have been in train since late in 1987. They had their origins in the belief, generally held in the defence industries of the Western world, that amalgamation on an international scale would become progressively more necessary. BAe told us that it was motivated by the expectation that the United Kingdom market for GW was going to decline (an expectation accentuated more recently by political changes in Eastern Europe), and that there would be less government funding of development, together with the certainty that increasing technological sophistication would make each product ever more costly per unit as time went on. Thomson-CSF shared this view; research and development (R&D) costs for systems were greatly increasing, while demand was falling. It pointed out that consortia were already almost the norm, but in many ways they were an inferior substitute for permanent, integrated arrangements.

6.8. Thomson-CSF told us that it had explored the possibility of a merger of its missiles business with that of the French company Aérospatiale, but unsuccessfully. Discussions with BAe were more fruitful, stimulated by the signing at the end of 1987 of Anglo-French reciprocal purchasing arrangements, indicating that the two Governments would no longer insist upon purchasing exclusively from their own national defence industries and were willing to accept some integration of the two markets for defence equipment. BAe considered the two businesses a good fit, in that BADL could offer its manufacturing capability, while Thomson-CSF could add its technical competence in systems design and fire control. Complex negotiations resulted eventually in a draft Memorandum of Agreement (MoA).

6.9. The draft MoA is couched for the most part in general terms. Many details of the arrangements remain to be settled in a shareholder's agreement yet to be agreed, though a number of terms and principles to be included in the agreement have been broadly decided. In general terms it appears that the two national businesses to be merged would become wholly-owned subsidiaries of a holding company registered in the Netherlands, Eurodynamics NL, whose share capital would be owned equally by BAe and Thomson-CSF. The original plan was for a Supervisory and a Management Board. It is now intended that there should be a single Board, on which the shareholders would have equal representation. It has been agreed that the first Chairman should be a Thomson-CSF nominee, and that the position should alternate. Important decisions would require unanimous approval by the Board; a preliminary list of these has been drawn up. A Chief Executive Officer (CEO) would be appointed, responsible to the Board for the management of the company. The first CEO would be a BAe nominee, approved by Thomson-CSF. Eurodynamics' two subsidiaries (that is, the national operating companies) would continue to work out their existing contracts themselves; future contracts would be allocated to them. The new enterprise would have its own research capability, which is to be centralised to avoid duplication.

6.10. The MoA takes account of the need to make equitable arrangements for the letting of subcontracts in relation to Eurodynamics' prime contracts. We considered this issue in some detail, and the matter is further discussed in paragraphs 6.18 to 6.27.

6.11. We also considered the provisions that the parties propose to make for the resolution of a deadlock within Eurodynamics, taking account of its 50:50 ownership. At the time of writing the matter had not been finally resolved. It seems clear that whatever provision is made, the resolution of the deadlock could involve the company coming under the sole control of one party or the other. Public interest considerations would arise if the country's major GW producer passed out of national control—even accepting that under the arrangements in progress it would no longer be exclusively controlled by a United Kingdom enterprise. The Ministry of Defence (MOD) told us that it was content with the proposals as a whole; any change in the 50:50 arrangement would give rise to a new merger situation on which it would wish to be able to comment. If a new situation of this kind was created there would be opportunity for investigation by the appropriate authorities.

### **Increasing concentration in the defence sector**

6.12. The MOD, as much as BAe and Thomson-CSF, clearly sees the proposed merger as a response to developments in the defence sector internationally: falling demand and increasing overcapacity in the GW industry; reduced East/West tension (the consequences of the Gulf crisis being, however, uncertain); increasingly sophisticated and expensive technologies, both in development and purchasing terms; and the gradual internationalisation of national procurement purchasing, as exemplified in the activities of the Independent European Programme Group (IEPG). The same view was put to us by Short Brothers plc (Shorts), the only prime contractor for guided missiles in the United Kingdom other than BAe. These opinions suggest that we cannot sensibly look at the proposed creation of Eurodynamics in isolation: it must be viewed against the background of other recent or forecast moves towards some level of integration in Europe. The trend has caused BAe and Thomson-CSF to conclude that a merger of their respective GW businesses was necessary if they were to compete to best advantage in the coming years.

6.13. Most parties who have given us evidence have agreed that increasing concentration, in one form or another, is inevitable. Governments may be able to frustrate it but that would be to fly in the face of market developments and might rebound on national interests, particularly in terms of value for money and export opportunities. The MOD told us that it wanted to see competition and that international integration was one way of preserving and indeed enhancing it, alongside the opening up of defence contracts to international competition. International consortia for the purpose of individual projects have in the past been a possible alternative. But we have heard plenty of evidence of their disadvantages. They have generally been a means whereby governments, rather than firms, have been able to share the cost of defence R&D. So they have not necessarily been groupings of ideally matched collaborators. Lack of cohesion has often been the consequence, and we would expect such consortia to give way to a considerable extent to more permanent groupings, created by the firms themselves.

### **Competition among prime contractors**

6.14. Competition in the GW industry is possible at prime contract level or at subcontract level. The prime contractor takes responsibility for delivery of the complete GW system, subcontracting various subcomponents where necessary and integrating these into the overall system. We considered whether the proposed establishment of Eurodynamics would reduce either actual or potential competition in the United Kingdom GW market. The case of Shorts is of course an instance of competition at the prime contractor level: actual when BADL was in competition with Shorts for the very short-range air defence (V-SHORAD) contract, today only potential. There have been no other cases of competition at the prime contractor level in the United Kingdom market over the last five years. BAe supplies that market (together with Shorts in a narrow range of weapons), and no French prime contractor has been a competitor for MOD prime contracts in the past. The merger between BADL and Thomson-CSF's guided missile businesses cannot therefore reduce competition in the United Kingdom as it exists today. We have received no evidence that the merger would be likely to have adverse effects on competition in the prime contractor market.

6.15. The prime contractor capacity of BADL and Thomson-CSF only overlaps in the surface-to-air sector. The main requirements that the MOD is understood to be likely to have in this sector over the next ten years are set out in paragraphs 3.22 to 3.29. Given the lengthy time-scales involved in this business, discussions are already under way for projects which will only come to completion in the late 1990s. In the majority of cases, at least two alternative options are under consideration, mostly involving international groupings of firms.

6.16. Thomson-CSF told us that it had never tried to compete in the United Kingdom market because it did not believe that it could be successful. However, the scene is changing, and in the United Kingdom at least there is likely to be a much more open market, giving opportunities to foreign competitors in the future. An instance of this is the opening to competition in the last few weeks of the contract for a new advanced short-range air-to-air missile (ASRAAM). It had been expected that BAe would be given the contract without competition. But the MOD has decided to invite competition for it, and it seems most likely that a foreign prime contractor will enter the competition in association with a United Kingdom electronics subcontractor. That is consistent with the MOD's view that the internationalisation of procurement should mean more competition for its GW contracts. That is irrespective of whether or not Eurodynamics goes forward, and it is also of course a practical instance of the MOD's objective of promoting competition for United Kingdom contracts throughout the defence industry. In our view BADL (within Eurodynamics or not) must expect to lose its virtual monopoly position in respect of GW systems for the United Kingdom, and to face competition from overseas at the prime contractor level from foreign contractors linked to United Kingdom firms such as GEC-Marconi and Thorn-EMI Electronics.

6.17. We considered, in the context of potential competition at this level, what the position between BAe and Thomson-CSF would be if the proposed merger did not go ahead. As noted, the only significant overlap today is in the sector of surface-to-air missiles. We understand that the MOD's requirement over the next ten years will largely be met by contracts which are already in place. The only likely new requirements, we were told, relate to sectors in all of which it seems unlikely that the merger would affect competition, in the sense of removing competition that could have developed had BAe and Thomson-CSF remained separate. (For the requirements in question see paragraphs 3.23 and 3.24, the ground-launched short-range air defence system (SHORAD); paragraph 3.26, the ground-launched medium-range surface-to-air missile (MSAM); and paragraph 3.27, the ship-launched V-SHORAD). We base our assessment of potential competition between BAe and Thomson-CSF on their present capacities. It would theoretically be possible for either of them-if their GW business remained separate-to develop competition in systems outside their respective present ranges of expertise. Given the formidable and growing costs of such an undertaking, and the risks of contending with the already established competition in a shrinking market, we do not consider it at all likely that that possibility would be translated into practice.

## **Competition at the subcontractor level**

6.18. Some companies operating in the GW subcontracting market expressed to us their concern that the creation of Eurodynamics would damage their interests by narrowing the market for subcontracted work. They claimed that, in so far as Thomson-CSF had the capacity for a much wider range of subcontracting work than did BADL, it would be natural for Eurodynamics to introduce Thomson-CSF's own practice; this would involve keeping subcontracts within Eurodynamics or within Thomson-CSF's own 'retained businesses' (ie businesses not incorporated into Eurodynamics, such as the branch *Thomson Brandt Armement* which makes munitions). Some subcontractors suspected that Thomson-CSF resorted to juggling of prime and subcontract prices to make sure of winning its own subcontracts by at least matching third party bids.

6.19. Thomson-CSF strongly denied the use of such practices, but was quite frank in telling us that it had always been its policy to secure within the Thomson-CSF organisation as much subcontract work for its prime contracts as possible, and indeed that one of its objectives in the creation of Eurodynamics was to dislodge other subcontractors (British, French or otherwise), specifically by taking a share of the subcontracting business which BAe has hitherto awarded. It was not a subscriber, Thomson-CSF told us, to the French MOD's objective of maintaining some type of separation between prime and subcontractors. It argued, however, as did BAe, that for Eurodynamics, without regard to competition, to place subcontracts in its own organisation or with the retained businesses of Thomson-CSF or BAe would not be commercially viable. Contracts could only be placed in those quarters if they offered the best, or at least an equivalent, product when judged on price and performance criteria. Thomson-CSF claimed that there were two safeguards for this: first, the MOD's policy of monitoring subcontracts; and secondly BAe's concern that profits should not be siphoned out of Eurodynamics and into Thomson-CSF.

6.20. The MOD pointed out that BADL and Thomson-CSF were not at present competitors for defence subcontracts, nor had Thomson-CSF acted as a subcontractor to BADL in the past, although it was currently subcontracted to BADL for development of the air-to-air GW, Active Skyflash, and through BADL to the consortium developing the anti-tank weapon TRIGAT. The creation of Eurodynamics was likely to result in more cases of Thomson-CSF's missile electronics capacity being used in BADL's GW systems, at the expense of United Kingdom electronics manufacturers, if only because of the new openness of the market to outside competition. Effectively Thomson-CSF within Eurodynamics would become an actual rather than simply a potential competitor of other electronics manufacturers in a limited range of specialist products where there were overlapping capacities. Competition would thus be enhanced, not reduced.

6.21. At the subcontractors' level, where there is no competition at the prime contractor level, the MOD has procedures to promote it. It has laid down rules which require the prime contractor to identify each subsystem, purchase of components, etc valued at over £50,000 and in each case to make proposals for competition or explain why the contracts should not be competed for. The MOD also seeks to encourage competition at the subcontract level by advertising its requirements in its contracts bulletin (as do an increasing number of other European governments). This would enable the MOD to ensure that subcontractors were not being unreasonably prejudiced by prime contractors who were awarded contracts without competition. Where there is competition for the prime contract (which has been increasingly the MOD's practice in the last six years), the same safeguards could not be applied. The MOD would expect to see subcontractors associate themselves with prime contractors in making bids for competitive tenders and noted that it was in the prime contractor's interest to go for the most cost-effective solution, implying that decisions on subcontracting must be made on economic grounds. Besides, it would still see the larger subcontract bids, and if there was a narrow margin, it might discuss the choice with the prime contractor. Above all, the opening of prime contracts to competition itself widened the market for subcontractors.

6.22. It should be noted that the MOD's contractual rules apply only where it has funded the development of the project and owns or has free use of the intellectual property rights. The MOD could not insist on the rules in a case where, say, the French Government funded the project (though as we have noted in paragraph 6.19, it has similar objectives), or where the company (Eurodynamics in this case) had funded the project itself, without government assistance.

6.23. BAe and Thomson-CSF have agreed on elaborate provisions, designed to ensure that firms competing for subcontracts with Eurodynamics' against one of their (BAe's or Thomson-CSF's) retained businesses or the merged concern itself are not unfairly prejudiced. BAe was certain that the interests of the United Kingdom subcontractors would be safeguarded; any attempt to grant favours or use underhand methods would be firmly stamped on. It did not believe that Thomson-CSF's greater potential for securing subcontracts for itself, simply because of the structure of its business, was significant in this context.

6.24. It is also intended by the two parties that when subcontractors for a new Eurodynamics project are being sought, a competition should be held and suitable retained businesses of the two partners invited to participate in it. The retained businesses should be invited to discuss future anticipated requirements on a regular basis, and if tenders from a retained business and a third party subcontractor are equivalent in all material respects, the retained businesses' tender should be preferred. This provision seemed to us to indicate *prima facie* a certain bias towards the retained businesses of the two companies or the subsidiaries of Eurodynamics itself.

6.25. Commenting on this, BAe told us that it was the intention that the integrated company itself should take major decisions. Thus it could not escape involvement in any problems arising over allocation of subcontracts. The subsidiaries would be operating within centrally determined policies and within a framework of control. BAe also pointed out that its current subcontractors had largely obtained their existing subcontracts with BADL through appointment by the MOD, and not as a result of competition. Existing subcontractors had such a head start on others that they would have to become quite unreliable before it was worthwhile to oust them.

6.26. Thomson-CSF argued that it was taking on a bigger risk than BAe in committing itself to Eurodynamics, in so far as its GW divisions placed 40 per cent of their external procurement with its 'retained businesses', ie other branches of Thomson-CSF not to be transferred into Eurodynamics. (The comparable proportion in BADL's case is only 11 per cent.) Thompson-CSF's divisions, once merged into Eurodynamics, had correspondingly more to lose from competition coming from independent subcontractors. It did not expect the subsidiaries to have any autonomy over decisions about subcontracting.

6.27. We acknowledge the concerns expressed by United Kingdom subcontractors. However, as we have seen, the MOD has an interest in the maintenance of competition. Moreover, we expect that the proposed merger will in itself stimulate competition at the prime contractor and subcontractor level. This will be of potential benefit to all. The companies likely to be concerned are not without muscle: GEC-Marconi, Siemens Plessey Radar Ltd, and Thorn-EMI Electronics have for parents three of the largest participants in the electrical and electronics market, while Cossor Electronics is a subsidiary of Raytheon, a major United States defence contractor. They are well equipped to maintain their subsidiaries in a competitive environment if they wish to. The MOD's interest in their continuance in the market will give some assurance of fair play, and BAe itself will be alert to ensure that it does not suffer disadvantage as a shareholder through contracts being awarded uncompetitively. By the time the issue becomes actual on a large scale-when, that is, the current contracts have mostly run out-it is likely that procurement will be taking place in a framework of increasingly international programmes.

## **Other considerations**

6.28. We considered the effect of the merger on the export business of prime or subcontractors for GW contracts in the United Kingdom. Thomson-CSF conceded that if a United Kingdom subcontractor were to lose business with Eurodynamics that it had had previously with BADL, it would significantly reduce its export prospects. But, given our opinion in paragraph 6.27, such a loss would be the result of the fair operation of a more competitive market. BAe hoped that subcontractors would actually benefit, in so far as Eurodynamics' enhanced export prospects would bring them greater opportunity for export themselves. These are not areas in which we see a likelihood of adverse effects for the United Kingdom public interest.

6.29. We considered whether the merger could have any adverse effect on the United Kingdom capability for research in the defence sector. The two parties made it plain that the MoA would permit the new enterprise to locate its research facilities wherever the objectives of Eurodynamics would be best served. Potentially, they might be concentrated in one country. The parties stressed that integration of research efforts was an important benefit to efficiency, economy and quality of the research as such. But they discounted the likelihood that either country could lose its capacity to a significant degree. In current conditions, the personal preferences of the key staff could not be ignored, nor could the requirement of the two major domestic customers, the French and United Kingdom MODs. There is plainly no question of the merged enterprise running the risk of depriving itself of the services of a large body of expert technicians and engineers.

## State control: potential issues

6.30. This reference, like three others concurrently under investigation, raises a set of issues beyond the normal competition criteria. These are issues surrounding the concept of state ownership or state control of at least one of the enterprises involved.

6.31. The Department of Trade and Industry (DTI) has suggested to us a number of propositions<sup>1</sup> against which the circumstances of any case involving state ownership or state control might be tested (see Appendix 4.2). These proceed from the basic assumption that state control inevitably distorts the natural condition of the market. State-controlled companies, the argument runs, are likely to behave in a fundamentally different way from other companies because the state as a shareholder is unlike private enterprise shareholders. The state may have objectives distinct from the normal commercial objective of maximising the financial return on a shareholder's investment. State-controlled companies do not face the threat of financial failure, they are not financially accountable in the same way as a quoted company, and they may have access to cheaper forms of finance. Because their objectives (or actions) may not be, or may not be perceived to be, strictly commercial, their behaviour is apt to be unpredictable by the normal standards of the market-place. This creates uncertainty among companies operating in the same area. To the extent that competitors adjust their own behaviour as a result of the involvement of a state-controlled company, there may be a misallocation of resources in the market leading to overall loss of efficiency in the production of the goods or services concerned. In the case of acquisitions by foreign state-owned companies, the state concerned might be seeking to control a sector of the economy in order to pursue some objective inimical to the national interests of the United Kingdom. Furthermore, in addition to the distortion of the product market, the market for corporate control will be adversely affected, because state-controlled companies will usually be immune from take-over and from take-over pressures themselves.

6.32. The DTI further argues that, taken together, these possible consequences lead to a general presumption that acquisitions by state-controlled companies are likely to have adverse effects on the public interest unless there are offsetting benefits.

6.33. We fully appreciate the importance which is attached by DTI to these propositions and the possible consequences suggested. We accept that in some investigations, including the present one, these and other matters arising in connection with state control are among the relevant issues.<sup>2</sup> As regards some merger situations qualifying for investigation, the fact of state control, taken alone or in conjunction with other relevant facts, might indeed be the basis of a conclusion that the creation of the situation operated or might be expected to operate against the public interest.

6.34. Nevertheless, we are unable to accept that we can look at these matters in terms, as has been suggested, of a general presumption. Our approach to the public interest, or to any aspect of it, is governed by section 84(1) of the Act. This provision requires the MMC 'to take into account all matters which appear to them in the particular circumstances to be relevant'. The subsection goes on to require the MMC to have regard to the desirability of five specific matters or objectives. The language of the subsection appears to us to exclude any presumptions, whether of fact or of law.

6.35. It is the MMC's duty to approach each case according to its facts. Whether any particular issue, including as to state control, arises, and the weight to be attached to it for the purpose of section 84(1), will depend on an evaluation of all the relevant evidence against the background of the circumstances of the case in question.

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<sup>1</sup>These propositions, which have been put to the MMC in the three other concurrent references mentioned in paragraph 6.30 (Crédit Lyonnais SA and Woodchester Investments plc, Kemira Oy and ICI PLC, and Sligos SA and Signet Ltd), are addressed in paragraphs 6.33 to 6.35. There has been consultation among the Group Chairmen concerned with a view to approaching the propositions consistently in all cases.

<sup>2</sup>See, for example, the discussion of conclusions-paragraphs 8.111 *et seq*-in the report on the merger situation of *The Government of Kuwait and The British Petroleum Company plc*, Cm 477, October 1988.

## Thomson-CSF and state control

6.36. In a press notice accompanying the reference, DTI said that the Secretary of State considered that concerns arose, among other things, from the implication of the ownership of Thomson-CSF's parent, Thomson SA, by the French Government and from the fact that the French Government controls or influences other companies engaged in this sector.

### *Relationship with the state*

6.37. In order to be able to respond to the Secretary of State's concern about the implications of the ownership of Thomson SA by the French Government, we have investigated in some detail and describe below the nature of the relationship between Thomson-CSF and the Government in all material respects. We then consider, in the light of that, what weight should be attached to the general propositions in this particular case.

6.38. Thomson-CSF has responsibilities to three government Ministries: to the Ministry of Defence, which is a major customer; to the Ministry of Industry, which oversees the industrial policy of all state-owned enterprises; and to the Ministry of Economy, Finance and Budget, which acts, through the parent company Thomson SA, as shareholder.

6.39. Thomson SA is almost wholly owned by the state. It holds about 75 per cent of the voting rights in Thomson-CSF, which normally gives it power to pass any resolution in the general assembly. The Chairman of Thomson SA, who is also Chairman of Thomson-CSF, is appointed by the state. Two-thirds of the *Conseil d'Administration* are appointed by Thomson SA and thus effectively by the state. They include representatives of government departments, and of other state-owned industries. Thomson SA annually puts forward and agrees a statement of broad strategic objectives with its sponsoring department, the Ministry of Industry (the *contrat d'objectifs*). This is not an operational plan; as the Chairman told us, its settlement between the two parties enables them to work out their relationship and understand each other better. It includes a section on Thomson-CSF, describing broadly the activities and future prospects of its various components. The Chairman told us that he would expect to have meetings with the Minister of Industry every couple of months, with the Minister of Finance about twice a year, and with the Minister of Defence three or four times a year. The *Conseil d'Administration* meets eight to ten times a year.

6.40. Looked at in that light, Thomson-CSF might seem to be under the strictest state control. However, many factors point the other way. The *Conseil d'Administration*, in line with those in other state-controlled and other private sector companies of this type (*Sociétés Anonymes*), is not an executive body: its duty is to review and advise, and it is the Chairman (*Président*) who wields executive power, assisted by a General Manager and Executive Committee.

6.41. The Chairman of Thomson-CSF gave us a lively and very full description of his relationship with the authorities of the state. In the first place, they were his chief shareholder and he had to satisfy them that their investment was in good hands. As to this, the manner in which the company had been transformed from the parlous loss-making state in which he found it at the time of nationalisation in 1982 suggests that that responsibility has been fulfilled. As for discharging the terms of the *contrat d'objectifs*, the Chairman gave us a wealth of examples illustrating the extent to which he felt independent of government restriction or influence in managing the company to its best advantage. Except where expressly required by law (for instance, in relation to disposals), consultation was kept to a minimum. If the company made profits, the state as shareholder was happy, and did not interfere. Indeed, even the *Conseil d'Administration* tended to be informed after the event rather than consulted beforehand over relatively important matters of policy, such as medium-sized acquisitions.

6.42. In the second place, where the company had a relationship with the Government as customer, that is with the French MOD, Thomson-CSF made it clear that it operated very much as would a similar company in the private sector. Within France, as within the United Kingdom, the respective MOD is the only customer, and Thomson-CSF has to shape its activities according to the needs of the Ministry, but in competition with other prime contractors in the field such as Aérospatiale and Matra. (In that respect, of course, its position is significantly different from that of BAe in the United Kingdom, which until recently has largely lacked direct competition.) A defence company, whether state-owned or not, is also dependent

in other ways on its MOD-for example, for support in export markets, and in having to accept restrictions on where it may sell its goods-and so is unlike a firm selling into a competitive market in the normal commercial fashion.

6.43. Nevertheless, Thomson-CSF added that it was not entirely reliant on orders from the MOD, since it had a flourishing business with customers overseas, making up a large proportion of its total sales. Indeed it is a notable example of its independence from dictation by the state that it did not consult the Government over the development in the mid-1980s of its second generation Crotaie missile, which was funded entirely without state assistance and has since been marketed widely abroad, since it knew that the Government would not be happy about it; moreover, it placed the development of the missile itself with the United States company LTV rather than any of the available French missile manufacturers.

6.44. The evidence that we were given by Ministries in the French Government confirmed this impression of the relationship. They attached great importance to the autonomy of management expressed through the responsibilities attached to the position of *Président*. They told us that it would not be possible for a company like Thomson-CSF to act against the commercial interests of the company, at the instance of the Government, for some wider end. The minority shareholders, who had special rights in this kind of situation, would resist any such policy, as would the company's creditors and employees.

6.45. We acknowledge the force of all this evidence. However, we are not clear that it tells the whole story. For instance, M Pierre Bérégovoy, the Minister of the Economy, Finance and the Budget, suggested in a recent policy speech that state-controlled enterprises might sometimes have to fall in with the wishes of the Government to pursue a social objective or a long-term purpose at variance with the directly economic interest of the company. It may be that this is more relevant to the monopolistic enterprises such as the gas and electric industries and the railways, which are not confronted with the requirements of competition. But it seems possible that the same sort of situation might occur in the areas where the market-oriented enterprises like Thomson-CSF are operating. A similar impression is conveyed by the words of the Minister of Industry, M Roger Fauroux, in a recent press interview, to the effect that as the Chairman and Chief Executive Officer of a holding company that one could call France International Corporation, it was he who gave the green light to the strategic decisions of public sector enterprises. One should perhaps make allowance for a degree of hyperbole here.

6.46. The foregoing discussion leaves unanswered basic questions about the relationship between the state as shareholder and the company. Any assertions about the autonomy of management, the arm's length dealings with the principal customer and so forth are in an important sense wide of the mark. Given mutual confidence between the management and the major shareholder (which clearly exists in the case of Thomson-CSF), the former could happily pursue its independent course, secure in the knowledge that if things went seriously awry the latter would be at hand to bail it out with loans at favourable rates or injections of capital in conditions that ordinary shareholders would not tolerate. In other circumstances, management might be confident that it could afford to secure a valuable contract by quoting uncommercial terms, knowing that it could rely on the state in its dual role of owner-cum-customer to make up the margin on other contracts.

6.47. It is notoriously difficult to establish facts in this area. Matters are especially complex in the defence field, where the dual role of the Government, the needs of advance funding of new projects and so forth all complicate the issue. It would be rash to assert that every defence contract in the United Kingdom was handled on the best commercial basis. Thomson-CSF put it to us that the United States Government gave its entirely private defence industry companies proportionately more for R&D than was available in France through the private or state-owned companies. Thomson-CSF gave us details of its financial management since it was nationalised in a loss-making state in 1982. From the evidence we have received, it was pulled round not by subsidies from the state, but by a combination of large-scale disposals, severe rationalisation and tighter management, which brought improved results and higher turnover in the normal way. Equity was built up largely by that means, and the injection of capital by the state-owned parent company, which represented 25 per cent of the addition since 1982, was made on justifiable terms. We cannot be certain that this is the whole story, but we have no concrete reason for doubting it.

6.48. It is true that the state has made hefty injections of capital into Thomson SA, but these have been for the benefit of the consumer electronics arm of the group. This sector of industry is one which the French Government is confessedly devoted to developing with special assistance in the current decade. We doubt whether there is any intention to siphon that capital off into Thomson-CSF. We can accept that if it became essential to prop up the company to avoid collapse, the state as shareholder would be most likely to step in to do so. It is also difficult for us to accept that the state shareholding would make much difference to the state's behaviour if there was a threat to a major defence company supplying vital products to a national defence market. It would be the importance of the company to national defence interests which would ensure the implicit support of the state, rather than the existence or not of a state shareholding.

6.49. However, even in the foreseeable condition of reduced defence budgets, we do not expect the state to need to step in. Thomson-CSF told us that when earlier this year it took a 50 per cent stake in Ferranti's sonar business, to form Ferranti-Thompson Sonar Systems UK Ltd, it paid proportionately the same price as GEC had paid for its acquisition of Ferranti Defence Systems at that time. As managed today, Thomson-CSF is dedicated to profit-making both to enable it to plan ahead for the longer term and to secure a continued flow of equity capital. As to 40 per cent of its shareholding, it is reliant on the free capital markets.

6.50. We have applied this assessment of Thomson-CSF's relationship with the French Government, since nationalisation in 1982, to DTI's concern that state control could lead to distortion of the market through uncertainty and/or unpredictability. We have also taken account of the fact that the relationship will subsist, if the proposed merger goes ahead, within the framework of an international joint venture of equal participants. Thomson-CSF took the line that there was nothing in the history of its commercial activity in the GW market to suggest that it had been subject to undue influence from the French Government, or that it was likely to be so in the future. It was still less to be expected that the French Government would influence the commercial activities of Eurodynamics, through its 60 per cent indirect holding in Thomson-CSF and the latter's 50 per cent holding in Eurodynamics, in such a way as to affect competition in the GW market of the United Kingdom, let alone in wider defence markets. Thomson-CSF conceded that national governments, as major customers for defence equipment, might potentially influence their domestic defence contractors, whether or not they were state-controlled. Such a circumstance could have an effect on competition in the United Kingdom, but it was not to be expected in the present case. BAe for its part appeared to have no qualms that the position in the United Kingdom market could be adversely affected.

6.51. The MOD believed that any distortion in the defence market arose not from state ownership of suppliers, but because of the tendency toward concentration on the suppliers' side, and its own position as a sole customer who could determine the nature of the market, either by buying nothing or imposing the terms, such as a requirement for competitive tenders, upon the companies active in the market. DTI, when we put this point to it, conceded its force. But it pressed the view that state customer power did not make state ownership any less undesirable: any further distortion superimposed upon the necessary distortion intrinsic to the defence industry was to be avoided. It noted that a private supplier acting in collaboration with a state-controlled one would probably be under less commercial pressure than if it was acting alone. In general, the increasing trend towards collaboration by state-controlled companies such as Thomson-CSF and Aérospatiale on defence contracts at the international level was likely to enhance rather than dilute potential distortion.

6.52. A 50:50 joint venture between two major participants is very different from a merger in which one company is taken under the control of another, eg where, hypothetically, BADL might have been acquired by Thomson-CSF to make one GW business under the latter's control. In the present case, a private sector group plans to put its GW business into equal partnership with the complementary business of a group which is under indirect state control. If BAe's independence is being to an extent diminished, the French Government's control over Thomson-CSF is to the same extent being diluted. Given the degree of management autonomy that Thomson-CSF seems already to have, we do not consider it likely that Eurodynamics' position in the market will be seriously distorted by interference by the French authorities. That essentially is also the answer to the suggestion that state control of Thomson-CSF and other companies in the defence industry could distort the market: the requirements of the state in an industrial sector dominated by national procurement necessitate a co-ordinated approach by the MOD as customer to public and privatised enterprise alike. But, perhaps more important than that: not only does Thomson-CSF preserve some independence from the control of the state, it also shows every sign of dealing with other

French defence companies, including state-owned ones, in a highly entrepreneurial and competitive spirit. We have heard no evidence that its relationship with those other companies is anything other than arm's length.

## Conclusions

6.53. We believe that the merger will introduce a new competitive element into the market. Competition will be stimulated. Two issues have, however, concerned us in this inquiry: the competitive position of United Kingdom subcontractors in relation to the joint enterprise, Eurodynamics, if the merger is completed; and the possible impact on Eurodynamics' business of the ownership by the French Government of Thomson-CSF's parent company, Thomson SA.

6.54. As regards the first issue, subcontracting in the defence industry is an important sector of the industry in itself. A drastic reduction of the amount of such work being done in the United Kingdom might raise issues of national security, technological development and employment. It is entirely possible that existing subcontractors to BAe will in the future see some similar contracts with Eurodynamics go to Thomson-CSF's retained businesses. On the other hand, large United Kingdom firms, even in a probably diminishing world market, could well make profitable joint arrangements with other European contractors in competition with Eurodynamics. It is not in the interest of either party to the merger to allow the impression to gain currency that subcontracts with Eurodynamics are impossible for third parties to obtain; and BAe will be alert to ensure that it does not suffer disadvantage as a shareholder through contracts being awarded uncompetitively. Finally, the combination of the two parties' respective strengths should enable Eurodynamics to compete more effectively in the markets, and so win more contracts than they would as separate businesses, thus offering more opportunities to the subcontractors to work with them in the new enterprise. We conclude, on balance, that the proposed merger would not give rise to adverse effects so far as subcontracting in the United Kingdom is concerned.

6.55. Turning to Thomson-CSF's ownership status, we are impressed with the company's commercial approach, and independent management. It sees itself as in competition with other French companies in the defence sector, publicly and privately owned, as well as with those in the international arena. We do not question that. Thomson-CSF has been in the public sector for the past eight years, and in that period we have seen no evidence suggesting that the state has used its shareholder's influence to intervene in the management of the company. Its *contrat d'objectifs* does not give the impression that the Government uses the company's public sector status to manipulate its operations as part of some overall state plan, nor have we received any evidence of such manipulation.

6.56. Powers exist for the Government to intervene in the management of Thomson-CSF, should it see the need. We acknowledge that circumstances could arise-as, for instance, they might if Thomson-CSF's financial situation changed dramatically for the worse-in which the Government could and would intervene. We do not foresee such circumstances today.

6.57. Moreover, in the present case there are several respects in which the influence of French state control would be attenuated, should there be a will to exercise it in some manner potentially detrimental to the public interest. First, it is indirect (ie through the parent company). Secondly, Thomson-CSF's equity capital is 40 per cent privately owned, and quoted on international stock exchanges. Thirdly, the state has a close interest in the survival of its major defence companies generally, not merely those publicly owned. Fourthly, we are not dealing with a take-over, but a joint venture between equals. Lastly, like the French market, the United Kingdom market would to a large extent be dictated after the merger by a sole customer.

6.58. Taking these considerations together we consider it unlikely that, if the merger goes ahead, the ownership of Thomson-CSF's parent, Thomson SA, by the French state will lead to distortion of the GW market in the United Kingdom, or have any other adverse effect.

6.59. We can see benefits arising from the merger. In a shrinking market, Eurodynamics should be able to compete more effectively than either party to the merger on its own. Efficiency should be enhanced; duplication of effort, especially in the field of research, should be reduced.

6.60. In conclusion, therefore, we consider that the proposed arrangements may be expected not to operate against the public interest.

P H DEAN (*Chairman*)

M E BEESLEY

J EVANS

L A MILLS

S N BURBRIDGE (*Secretary*)

28 December 1990