

**British Aerospace Public Limited Company
and
VSEL plc**

A report on the proposed merger



MONOPOLIES AND MERGERS COMMISSION

British Aerospace Public Limited Company and VSEL plc

A report on the proposed merger

**Presented to Parliament by the Secretary of State for Trade
and Industry by Command of Her Majesty
May 1995**

Members of the Monopolies and Mergers Commission as at 12 April 1995

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¹These members formed the Group which was responsible for this report under the chairmanship of Mr D G Goyder.

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests. The omissions are indicated by a note in the text.

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Part I

Summary and Conclusions

1 Summary

1.1. We have been asked to investigate and report on the proposed merger of British Aerospace Public Limited Company (BAe) and VSEL plc (VSEL). Our consideration has been limited to those aspects of the proposed merger relating to military activities; over 95 per cent of VSEL's business relates to such activities.

1.2. VSEL, at Barrow-in-Furness, owns the only one of the three warship-building yards currently operational in the UK that can build both submarines and surface warships over 7,000 tonnes. Since its privatization in 1986 it has built only submarines (and currently has two Tridents under construction), but it is keen to secure surface ship orders. VSEL also produces guns, which account for about 10 per cent of its business. Its total turnover from these military activities in 1994 was about £450 million.

1.3. BAe is a major aerospace and defence company with a turnover in 1994 of over £7 billion. It is mainly engaged in the design, development and production of civil and military aircraft, of guided weapon systems and of other defence support services. Its joint venture BAeSEMA provides ship design services and combat management systems. Its subsidiary Royal Ordnance (RO) manufactures ammunition and guns.

1.4. We have examined the effects of the proposed merger on the supply of warships (including submarines) and armaments and other more general effects related to the parties' military activities.

1.5. Since the end of the Cold War there have been substantial reductions in the size of the Royal Navy and in expected new orders for warships. The only yards now supplying warships besides VSEL are Yarrow Shipbuilders Ltd (YSL), owned by The General Electric Company Plc (GEC), and Vosper Thornycroft (UK) Ltd (VT), at Southampton. YSL is currently building three Type 23 frigates for the Royal Navy and two smaller frigates for export, and VT is building smaller warships for export and glass reinforced plastic (GRP) minehunters for the Royal Navy.

1.6. The UK warship market is unusual in several ways. There is only one buyer, the Ministry of Defence (MoD), whose current policy is to use only UK yards. Business is lumpy with large orders placed infrequently, and success or failure in a tender can have a major effect on a supplier's viability. Fifteen years may elapse from the initial concept studies to acceptance of the first ship of a new class.

1.7. The modern warship is a platform on which a range of weapons and support systems, usually provided by subcontractors, have to be integrated. Until recently the MoD has designed the ship, procured some of the main systems and supplied them to the shipbuilder for installation. As part of its overhaul of defence procurement to introduce greater competitiveness and value for money, the MoD now seeks to appoint a prime contractor for its warship orders, responsible for procuring and integrating all systems included in the contract, guaranteeing their performance and providing continuing support. This prime contractor is usually the owner of a shipyard and BAe has stated that a main reason for its proposed acquisition of VSEL is to enable it to secure warship orders, particularly export orders, drawing on its prime contracting experience with aircraft.

1.8. We examined the effects of the proposed merger on orders that are likely to be placed in the period up to 2005. The main warships in the MoD forward programme are a final batch of three Type 23 frigates; up to five nuclear attack submarines (the Batch Two Trafalgar class (B2TC)); and 12 new frigates (the Common New Generation Frigate (CNGF) or Project Horizon, currently being developed as a UK/French/Italian joint venture). Tenders have been invited for the Type 23s and three of the B2TCs; VSEL is expected to bid for both contracts, with competition expected from YSL and VT for the Type 23s, and from a team led by GEC using innovative construction methods for the B2TCs. From 2005 onwards there are prospective replacements for aircraft carriers and nuclear attack submarines.

1.9. We concluded that the merger of VSEL and BAe would not materially affect competition for the warships currently out to tender or for the CNGF. Nor did we expect the merger adversely to affect the tender prices for the Type 23 or other contracts. For the larger warships for which orders may be placed after 2005, VSEL at present has the only proven construction facilities in the UK, but the proposed merger would not bring it into the ownership of a company that also owned another warship yard. We saw no reason, given the many uncertainties about how the market may develop before these orders are placed, including the possibility of new domestic or overseas competition, to expect that the bringing together of BAe's prime contracting skills with VSEL's capabilities would materially affect competition for these contracts. Accordingly we did not expect the proposed merger to lead to adverse consequences for the supply of prime contracting services for warships or of warship-building facilities.

1.10. Except for combat management and missile systems, in the selection of which the MoD is likely to be closely involved, BAe is able to supply little equipment as a subcontractor for warship contracts. We saw no reason, therefore, to expect that the proposed merger of VSEL and BAe would worsen the position of other subcontractors wishing to compete to supply systems or equipment for these warship orders. Nor did we expect the proposed merger materially to affect the prospects for closure of any of the three UK warship yards over the next few years. Closure is likely to be determined by other factors, in particular how the MoD contracts are awarded and whether any yards succeed in winning overseas orders.

1.11. The proposed merger, by giving VSEL access to BAe's marketing and sales skills in the defence area, could put it in a stronger position to compete for export orders. But the export market for warships is difficult and we thought it uncertain how far export orders would be secured.

1.12. VSEL also produces naval guns and artillery, for which RO provides components. The two companies are in direct competition to provide a lightweight howitzer to meet a current US requirement, but which might also be suitable to meet a possible later MoD requirement. [

Details omitted. See note on page iv.

] RO is the sole UK supplier of gun barrels and breeches. The establishment of vertical links with VSEL is unlikely to affect adversely other UK armament suppliers. These suppliers tend to specialize in different areas and were not concerned about the proposed merger. We identified no significant detriment in this area.

1.13. We considered whether BAe had the requisite financial strength and commitment to support VSEL's capability. We reviewed the progress BAe has made in restructuring its business. We did not find any grounds for expecting that VSEL's military activities would be put at risk by the proposed merger.

1.14. Accordingly we conclude that the proposed merger may not be expected to operate against the public interest.