

6 Views of other parties

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Government departments

MoD

6.1. The MoD said that (for the reasons set out in paragraph 6.60) it was its current policy that warships (but not their systems) should be procured only from UK companies, so long as adequate competition was available. This policy of limiting warship procurement to a domestic source was adopted by virtually all countries that had a warship-building capability, and in the case of the UK it was sustained by considerations some of which were specific to UK circumstances and some of general application.

6.2. Specific considerations were British history as a naval power, and the political and strategic implications linked to it. There was, too, the particular problem of the Royal Navy's submarines, now exclusively nuclear-powered, and developed originally from nuclear propulsion technology from the USA. The technology was supplied under an agreement negotiated in 1958 which forbade the transfer of the technology to any other party, thereby effectively preventing the UK from contracting abroad (except in the

USA) for any design of nuclear propulsion that depended on that technology. Moreover, the design of much of the submarine was profoundly influenced by the requirements of nuclear-powered propulsion, and this had implications for submarine construction capacity as well as supply.

6.3. The considerations of general application were that integration of equipment in a warship from a huge range of suppliers required the closest working relationship between the Government, which had procured the weapon systems; the weapon systems designers; and the shipbuilders. It was much easier to conduct this relationship within national frontiers, rather than across them, so eliminating problems of language and exchange rate fluctuation. Security was a major problem, particularly in concealing a ship's critically important stealth characteristics. The demands of security would be a particularly difficult aspect of conducting acceptance procedures abroad, because of the risk of revealing the ship's capabilities and vulnerabilities.

6.4. Hitherto the criterion of adequate competition had not presented difficulties for the MoD in pursuing its policy of relying on domestic sources, but the maintenance of competition when there was a single domestic source might lead to the MoD contemplating contracting outside the UK for some classes of vessels, as in an earlier round of minehunter competitions, when bids involving subcontracted French and Belgian hull construction had been obtained before the competition was terminated. But, for the reasons given in paragraphs 6.2, 6.3 and 6.60, it was unlikely that this course would be adopted for the procurement of other than the smaller non-combat vessels. It was not to be ruled out that technology trade-offs might lead to some foreign procurement of warships, but that did not seem likely at present.

6.5. In the case of the CNGF collaborative project the three partners, France, Italy and the UK, would jointly design and develop the ships and the weapon systems, and there would be joint procurement for part of those systems. But it was not envisaged that follow-on vessels to meet the Royal Navy's requirements would be built outside the UK. In part this was a strategic decision, but the MoD did not believe it entailed additional costs. If there were to be only one UK frigate-builder the MoD would not promote competition by seeking foreign bids but would apply its 'sole source' disciplines (see paragraphs 6.20 and 6.25 to 6.27).

6.6. More generally, regardless of who the partners were in a collaborative international venture, the UK would wish to have control over the integrity of the system and of the UK's national operational, maintenance and adaptation requirements.

6.7. The MoD believed the UK warship-building industry, after a decade of fierce competition, compared well with other national builders. The UK industry was at least as good as, and probably better than, the US industry. The cost of the US Navy's nuclear submarines was roughly double that of the Royal Navy's vessels, but they were larger and had different equipment so the 2:1 ratio could not be taken as a true measure of the relative efficiency of the yards. It had to be said, too, that the US Navy was satisfied that it was securing value for money. Some parts of the French and German industries were notably inefficient; and there was no evidence that the commercial shipbuilding efficiency and technology of Japan and Korea had carried across to their warship-building.

6.8. There was no satisfactory evidence on the relative costs of warships built in foreign yards. There were no directly comparable ships, and indirect costs were extremely difficult to ascertain. Subsidies were common, and the prices charged for Spanish and French ships on the export market had little relation to costs. German ships were substantially assisted by Government aid for the purchasing countries.

6.9. The competitive process entailed negotiations between the MoD and the tendering builders that could be brief or extensive, depending on the circumstances of each case. It was not an auction, and the device of seeking 'best and final offers' (as in the LPH competition) was not always adopted. In the OSV case, for example, there had been only two bids; the MoD had been satisfied that both were genuine, and had had no difficulty in deciding which was better. That was the best situation from the MoD's point of view. But where there were several bidders, starting from different states of knowledge (as was expected to be the case with the next Type 23 frigate order-see paragraphs 6.33 and 6.34), the MoD would go through a much more complicated process, attempting to ensure that the terms and conditions of the contract were well understood (without which the price would be meaningless).

6.10. The MoD believed that, despite an actual and prospective reduction of about 30 per cent in total in its Procurement Executive staff numbers in the period 1990 to 1996, it would still possess substantial internal technical expertise in the appraisal of contracts; within its 1995 strength of 7,000 it had some 400 cost assessors; for advice on weapon systems, it could draw on the former MoD naval research establishments, now within the Defence Research Agency; and it could continue to hire expertise from such external sources as Three Quays, YARD (now part of BAe SEMA) or BMT, which had a thorough understanding of warship-building matters.

6.11. But assessing whether or not a bid was predatory (ie pitched at a level that seemed likely to incur a loss) entailed judgments about risk against profit. A bid which carried no risk but yielded only 1 per cent profit would not be regarded by the MoD as predatory. On the other hand, where the risk was not covered, or covered wholly inadequately, a notional 1 per cent profit could well be predatory. However, there could be no general rule, because risk varied so much from one project to another. The attribution of overheads presented particular difficulties. The MoD was not averse in principle to keen bids which risked a loss when there was vigorous competition over a wide product range, and particularly if the cost was borne by a foreign taxpayer. But in the circumstances of VSEL and the Type 23 tender the MoD would look most carefully at the origins of the bid; no outcome could be assumed in advance: there would be a classic competition based on thorough investment appraisal and most careful study of the subcontracting arrangements.

Prime contractors and subcontractors

6.12. The MoD told us that it was now its policy to seek prime contractors wherever possible for naval construction projects. Prime contractorship was of long standing in other defence projects, particularly aircraft, but in naval procurement there had been no full prime contracts for major warships (see paragraphs 6.18 and 6.19). Where 'whole ship procurement' (ie including the weapon system) had been tried, such as for the AOR *Fort Victoria*, built by H&W, problems were encountered in ensuring that those elements of the combat system equipment and its components for which the MoD was responsible were available when required. This largely reflected H&W's lack of recent experience in building to naval standards. Learning from it, the MoD had transferred the financial risk for the LPH to VSEL for most major equipment, but the MoD was still exposed to the risk of delay in the programme.

6.13. Potential prime contractors had to have a financial base large enough to cover the risks involved; their major skills lay in design and project management; material purchasing; and the application of highly-developed CAD/CAM expertise. For submarine projects some knowledge of submarine construction was required, so limiting the field to VSEL and GEC (through the GEC/Rolls-Royce team). Potential prime contractors were invited to bid in conjunction with a recognized warship-builder, but not in isolation: it was essential for the MoD to know who the shipbuilder was before a contract was placed.

6.14. In the case of VSEL, the MoD had noted the strength of its financial reserves (roughly the production cost of one nuclear submarine) but had not been satisfied that it had the skills in place to take on the prime contractor role for the B2TC. Hence the MoD had been pleased when VSEL teamed with Loral ASIC for the project, and thus reinforced would regard it as a potential prime contractor for the B2TC even if it continued as an independent company.

6.15. The MoD said that it would look very carefully at a situation where a prospective prime contractor would not be engaged in any part of the actual construction, but it would not rule out the possibility of prime contractorship on those grounds alone. Loral ASIC, for example, was a highly competent prime contractor for the Merlin helicopter, although it was not building it. Of the warship-builders, GEC (through GEC-Marconi Naval Systems and YSL) was the prospective prime contractor for the UK first-of-class CNGF, and YSL was the prime contractor for the Malaysian frigates currently under construction. BAe (through BAe SEMA) was the prime contractor for the OSV, to be built by ASL, but that was not a classical warship. However, the MoD was quite satisfied that BAe was competent to be a warship prime contractor. VSEL was the prime contractor for the LPH, and coupled with BAe would look much more robust in that role for other projects. VT was the prime contractor for its export projects, and the MoD would have welcomed it in that role for the LPD if it had been prepared to bid.

6.16. In seeking tenders the MoD would require the intending prime contractor to identify the extent of the subcontracted work, and to adopt a transparent subcontracting process, with the MoD having full access to the evaluation. The MoD believed this transparent process had been successful in terms of fairness and even-handedness. The prime contractor's subsidiaries were treated in the same way as any other potential subcontractors. The MoD had the right to nominate candidates if it was not satisfied with those initially selected by the prime contractor. But if competitions were to be run sensibly and equitably great effort was needed in the definition of the interfaces between contracts: it was essential to avoid imposing subcontract requirements that the prime contractor was not prepared to underwrite. The MoD recognized that the prime contractor's assumption of greater risks meant that it must have greater discretion in carrying out its responsibilities.

6.17. In the case of the B2TC, the MoD said that it wanted to make sure that competition was both real and effective. Both teams had been asked to supply 'make-or-buy' plans (ie schedules of the activities and equipment proposed, showing items to be procured through subcontractors and those to be produced by the main contractor). The MoD would obtain a deep knowledge of the subcontracting plans of both teams, and would be satisfied about the choices being made, both technically and financially.

6.18. The MoD said that the scope of prime contractorship depended on the circumstances of each contract. It was continually encountering the problem of balancing the interests of the prime and subcontractors. The MoD thought it most unlikely that it would offer complete prime contracts for some time yet, and perhaps not at all if the provision of Government equipment continued indefinitely-as it probably would with some items, such as cryptographic equipment. And, of course, it was to be expected that there would always be Government-supplied weapons on warships.

6.19. That apart, the MoD believed the B2TC contract would be the closest it had yet come to full prime contractorship for a major warship. (The LPH was similarly close, but could not be described as a major warship, being much less complex, and although five times the displacement of a B2TC submarine, was only half the cost.)

6.20. The MoD said that there was no single means of promoting competition in all sets of subcontracting circumstances. In some cases, where there was a sole UK source of expertise, the single tender NAPNOC regime might be applied, coupled with the maximum use of competitive subcontracting. (The LPD was a case in point.) The application of this regime was markedly easier if the prime contractor-as was the case with BAe-was not vertically integrated to any great extent. Creating competition where none existed might be justifiable, as with the B2TC, but-as with jet engines for military aircraft-the costs of creating a competitive structure might far outweigh any likely benefits. The MoD was satisfied that it could deal fairly with subcontractors by drawing on its wide array of techniques. It did not accept that it had too few staff for the purpose: the transfer of responsibility to the prime contractor reduced the demands, and the reduction in numbers had followed, not preceded, this transfer.

6.21. The MoD said that GEC had expressed concern to it about the risk of being put at a subcontracting disadvantage to BAe in the event of BAe acquiring VSEL. The MoD said that its techniques for promoting subcontracting competition would apply in that case.

6.22. The subcontracting arrangements for warship export contracts were outwith the MoD's control: they were a matter solely for the prime contractor and the government of the country concerned, within the terms of any relevant memorandum of understanding.

Competition issues

6.23. The MoD told us that in its view the main competition issue about the future ownership of VSEL was the practical effect it would have on the prospects for genuine competition to meet the MoD's planned future requirements. There were also wider issues relating to the balance of advantage in international terms between competition and the consolidation of the warship-building industry, and to the role of the market in deciding the outcome of the two bids for VSEL.

6.24. There were several reasons why the market for defence goods and services, and the UK warship-building market in particular, was very different from markets for consumer goods, where producers were

in continuous competition to meet a stream of commercial opportunities. Competitions for naval orders were infrequent and, like the UK defence budget, the MoD's naval new construction programme was declining in size. Greater use of prime contractorship and batch ordering of naval vessels meant that, as far as the potential prime contractors were concerned, there would be no work or market share for losing bidders and no similar opportunities recurring in the short to medium term. The MoD, therefore, had been faced increasingly with a situation where the losing bidder in a competition might well go out of business, thus removing or reducing the basis of future competition.

6.25. Previous rationalizations had left the UK with several defence areas where only one source of supply (a 'sole source') could be sustained at a reasonable level of competitiveness: combat aircraft, helicopters, tanks and ordnance were examples.

6.26. But the MoD's purchasing strength, and its rights and obligations as a Government department, provided a degree of protection in situations where competition was imperfect. The MoD could have full knowledge of the cost structure of its suppliers' bids and, for its sole source suppliers, this was a normal step towards the establishment of an agreed price. In the latter case the MoD accepted that it could not entirely recreate the pressures of competition, but it had a series of techniques for applying competitive disciplines to the sole sources, including the NAPNOC regime, and an insistence on transparent competitive subcontracting, which usually covered a majority of the work.

6.27. The MoD said that, in effect, it had taken the view, based on its considerable experience, and refinement of contracting techniques, that there were circumstances where it would achieve better long-term value for money from a well-loaded sole source, with no opportunity for competition, than from two or more underloaded sources precariously sustained in a series of infrequent competitions in each of which success or failure was the only possible outcome. It was this practical view of competition and its context that had been used by the MoD to assess the proposed mergers of VSEL.

B2TC

6.28. In the near term, the B2TC was the most important project in the naval procurement programme; it was expected to cost £[*] billion for five submarines; the initial invitation to tender was for at least three. The closing date for submission of tenders was 29 June 1995, and the order was planned to be placed in 1996.

6.29. The MoD had funded a studies contract involving VSEL, GEC, Rolls-Royce and BAe. The MoD saw these companies as likely prime contractors in any B2TC competition. BAe had withdrawn (because VSEL was not prepared to accept it as the prime contractor in a consortium, with VSEL as the main subcontractor) and there were now two potential prime contractors: VSEL, with Loral ASIC and BAe SEMA as main subcontractors, and a GEC/Rolls-Royce team with BMT and AMEC plc as main subcontractors. The GEC/Rolls-Royce team was exploring the adoption of a different and potentially attractive construction strategy using practice developed by the offshore oil and gas industry.

6.30. With the impetus of competition, both teams could be expected to introduce innovative construction, fitting-out and commissioning techniques, but this would require substantial investment during the bid phase. VSEL, as an established submarine-builder and in accordance with Government accounting conventions, would have the opportunity to recover bid costs against the overhead component of other MoD work (effectively, the Trident programme). The MoD was working on the assumption that it would cost about £[*] million to put the bid together. It had offered VSEL a risk reduction studies contract, worth up to £[*] million, to consider innovative construction techniques to reduce the costs and risks, and thereby ensure an effective competition. However, VSEL had not accepted this offer. The MoD presumed it preferred the flexibility inherent in the overhead recovery approach.

6.31. The MoD said that the direct impact of a BAe take-over of VSEL on the B2TC competition would be minimal.

*Figures omitted. See note on page iv.

6.32. The MoD said that there had been intense pressure from France to take the B2TC forward as a collaborative venture. It had been decided that this would not be sensible for what was essentially the updating of an existing class of submarine. But it was to be expected that French pressure for collaboration in the next new nuclear submarine project would again be intense, and the possibility of such a project being realized could not be ruled out, perhaps in the manner of the CNGF (see paragraphs 6.36 to 6.41).

Type 23 frigate

6.33. The MoD told us that it planned to place an order for the construction of the final batch of up to three Type 23 frigates late in 1995. The estimated value of a contract for three ships was about £[*] million. To facilitate competition the tender submission date had been put back from 21 March to 13 June 1995. Nine ships of this class had been built by YSL and four by SH (now closed) [

Details omitted. See note on page iv.]. VSEL had tendered unsuccessfully for previous batches (although only the last would have been built at VSEL) and was expected to tender for the final batch (in which case the MoD would expect BAe, as the new owner of VSEL, to honour the bid). VT, too, had stated that it intended to bid for the Type 23 order. The MoD rated it highly as a contender in all respects, although the subcontracting task would be a challenge. VT had tendered unsuccessfully for earlier batches, and did not bid for more recent batches. Its last steel ship for the Royal Navy was a Type 42 destroyer in the early 1980s.

6.34. The MoD said that the Type 23 competition was unlikely to produce much in the way of innovative cost reduction. The only possibility of significantly reducing the price of the Type 23 order would be if VSEL in BAe ownership submitted a low bid by accepting the risk of taking a loss. If such a bid won the contract YSL would probably go out of business: there was little prospect of export orders, and no prospect that the Government would meet the cost of preserving unused capacity. The MoD would be under no obligation to accept a VSEL loss-risking bid (though it would have to be ready to defend publicly a decision not to do so).

6.35. The MoD told us that a tender that had been submitted was not binding: it could be withdrawn at any time. A bidder could seek the MoD's agreement to amend its tender. If that agreement was given the tender would be treated as if it had been submitted late and the other tenderers would be invited to re-tender.

CNGF

6.36. The MoD said that in February 1994, after extensive preliminary appraisal of the competition possibilities, a GEC/BAe/VT team led by GMNS had been selected (in competition at that stage only with a VSEL/Hunting team) as the UK partner in IJVC, the joint British/French/Italian group that was designing a 6,000-tonne frigate known as the CNGF or Project Horizon.

6.37. The MoD did not seek build prices from the teams (since these would depend on the French and Italian companies' contributions) but it did ask them for their design services charges, and it carefully appraised the risks to which each team was exposed. The MoD's conclusion was that, because of YSL's relatively recent experience of designing the first-of-class Type 23 frigate, the GEC/BAe/VT team offered the lesser risk. This view was reinforced by the strong endorsement of the French and Italian partners. The MoD thought of aggregating the teams to provide the widest possible UK base, but rejected it as impractical. However, the MoD had required the GEC/BAe/VT team to share its information with VSEL/Hunting to ensure that the latter could participate in the follow-on build competition.

6.38. YSL would build the UK first-of-class ship, although agreement would have to be reached with the MoD on the price. There would be competition between UK yards to build the 11 follow-on UK ships at present planned, probably in batches of three and two. The total project value was about £[*] billion, with the follow-on orders planned from 2000 onwards. Hence it was much the largest and most important Royal Navy surface warship order in prospect. VSEL was expected to be YSL's main competitor for the follow-on ships; and the MoD believed that VT, too, intended to bid.

*Figures omitted. See note on page iv.

6.39. The MoD added, however, that it was a substantial task to redevelop the first-of-class design into a data package that could be used as the basis for follow-on construction in another yard. And the more that design was linked to concurrent engineering practice in one yard the greater the work entailed in transferring to another yard, such as VSEL in this instance.

6.40. The MoD said that if BAe acquired VSEL, and VSEL also secured the order for the final batch of Type 23 frigates, there was no certainty that YSL would survive until CNGF orders were placed.

6.41. Since the CNGF was a collaborative venture it was to be expected that a participant's national workshare would be in rough proportion to its navy's production offtake, although the decision on which equipment to fit would be based on the results of competition rather than predetermined shares of work. However, there could be problems for some small UK potential subcontractors if Rolls-Royce gas turbines were to be selected for the ship, as this could mean that a large proportion of the UK's workshare would be taken up in this way. Much would depend upon the proposals from the various companies for arranging the manufacture of components in a way that balanced workshares within equipment systems.

Other large warships

6.42. The MoD said that VSEL had been invited to tender for the construction of up to two LPDs with a total value of some £[*] million. (There had been no other bidder for this contract.) Two AOs were due to be ordered from 1996 onwards, with a total value of £[*] million. Competition was likely to be at the prime contractor level, possibly involving a commercial yard either bidding on its own or in a teaming arrangement to build the hulls, on the model of the VSEL-KG arrangement for the LPH.

Artillery

6.43. The MoD said that BAe, as the owner of RO, was involved in heavy land weapons, overlapping with VSEL's business in this area. A BAe acquisition of VSEL would affect two forthcoming MoD projects:

(a) *The Extended Range Ordnance/Modular Charge System (ERO/MCS)* would provide a new 52-calibre barrel for the AS90 self-propelled howitzer, together with a new charge system. The MoD expected to issue invitations to tender in 1995; the value of the project was about £[*] million, with an in-service date of 1999. The MoD's procurement strategy was determined partly by intellectual property rights issues and partly by the need to place the development risks as far as possible on a prime contractor. The MoD planned to appoint VSEL as the prime contractor, with overall responsibility for ERO/MCS development and initial production. RO would act as subcontractor for ERO, but VSEL would run a competition on the MoD's behalf for development and first production of the MCS, for which RO would be a potential supplier. If VSEL and RO were in common ownership, arrangements would be necessary to ensure that VSEL as prime contractor conducted the competition so as to give equal consideration to all the potential suppliers.

(b) *The Lightweight Mobile Artillery Weapon System (LIMAWS)*. This was assumed at present to be a competitive off-the-shelf purchase of howitzers to replace current systems, with an in-service date of 2006. The total value of the programme (including ammunition and maintenance) was about £875 million. The two contenders (which were also currently in competition to meet a US requirement) were VSEL's lightweight field howitzer and RO's lightweight towed howitzer. The MoD thought [

Details omitted. See note on page iv.

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*Figures omitted. See note on page iv.

Future of the warship-building industry

6.44. The MoD said that the Royal Navy's forward programme provided barely sufficient work to sustain both VSEL and YSL, and all the vessels in the programme could be built by VSEL. The future of the two yards would depend on the outcome of the competitions for the B2TC and the Type 23. On one outcome, VSEL would win the B2TC and (presumably) the LPD, and YSL would win the Type 23s. VSEL would then have an adequate workload for the next few years, although close to the minimum that the company had indicated was necessary for its longer-term viability. On the other hand, if VSEL lost the B2TC competition, it would not be viable in its present form after completion of the Trident contracts; and if YSL did not win the Type 23 order its workload would be reduced to export orders, so that it might not remain in being for the CNGF (which in that event would have to be built elsewhere).

6.45. The MoD said that it believed it was too simple to measure the viability of a warship-building yard in terms of a specified critical mass of employment. In 1991 VSEL's view had been that 10,000 jobs was the critical mass; then it moved to the view that it was about 6,000; and now it believed it was 4,000. This, in the MoD's view, clearly was much too high-provided VSEL was in the project management/assembly mode, and not in the vertical integration mode. In the MoD's view the minimum size was determined by whether a shipyard could be run efficiently and effectively, and competitively enough to stay in the market.

Ownership of strategically important capabilities

6.46. VSEL's Articles of Association contained provisions that *inter alia* prevented the disposal by the company of the whole or a material part of its assets without the consent of the holder of the special share in the company. The holder was the Secretary of State for Defence. He also had a veto over changes to certain of the Articles of Association which *inter alia* prevented any one party from controlling more than 15 per cent of the equity.

6.47. The MoD said that BAe had consulted the Secretary of State about these provisions before making its bid for VSEL. It was told that the Secretary of State would give his consent to the necessary amendments to VSEL's Articles of Association to facilitate the take-over, provided that the amendments were approved by ordinary shareholders, and subject to the necessary regulatory approvals and to his receiving satisfactory assurances about the protection of his other existing rights as special shareholder. (The MoD, however, did not think the special shareholder's rights offered the most satisfactory means of safeguarding its interests: it had better means at its disposal.)

6.48. The MoD said that by the time the bid was referred to us Extraordinary General Meetings of VSEL had approved the necessary amendments to the Articles of Association. The MoD was discussing with BAe the terms of the assurances to be given to the Secretary of State about his other rights as special shareholder. Because of the continuing importance of the nuclear submarine production facilities, the Secretary of State required a continuing veto on their disposal or closure, and a commitment from VSEL to be consulted about those possibilities. In effect, the MoD was seeking to ensure that VSEL's position would be essentially the same post-acquisition as it was pre-acquisition: the MoD had not had, and would not have, any power to compel BAe to spend its money on keeping the facilities open and, although the provisions in the Articles were useful for their intended purpose of preventing an undesirable change of ownership, they would be of limited value in ensuring that the facilities were kept in operation, employing the necessary skilled labour. If those problems had to be met the MoD was satisfied that it would have been given advance warning and it would have to decide what remedial action to take, if any.

6.49. The MoD believed that concentrating important technological capabilities into fewer, more highly-utilized, facilities could increase their prospects of continuing competitively. A BAe acquisition of VSEL might strengthen it by bringing prime contracting and systems skills into play. The MoD did not believe it would be appropriate to seek to object to BAe on these grounds.

Exports

6.50. Exports were critical to the future of the industry. After carefully considering BAe's claims in this area, and its own extensive experience in assisting in export markets, the MoD thought there were no adverse public interest effects of the bid in this respect.

6.51. The MoD provided us with an extensive DESO appraisal of warship export prospects. It said that the German warship-building industry had been much the most successful exporter in the last decade. In part this reflected the readiness of the Federal German Government to support prospective sales through the provision of aid. In larger measure, however, it reflected the success of the leading German export builders, Blöhm und Voss, with the MEKO frigate, and HDW with submarines. (MEKO was an acronym for a 'general purpose combination' of a standard hull and a 'function unit system'; together these provided a product comparatively low in operational capability and therefore low in cost, speedy to construct, and adaptable to the purchaser's requirements but which has not been purchased by the German Navy.) By comparison YSL and VSEL had been almost entirely concerned over the same period with the construction of sophisticated and highly capable warships to meet the Royal Navy's requirements. The higher capability and cost of such vessels meant few customers needed or could afford them.

6.52. VT had been little more successful than YSL or VSEL in securing export orders for major warships: the Omani order for two corvettes in 1992 was the first for a decade. VT, however, had competed strongly in the export market for minor warships, achieving a large number of sales in the face of French, German, Spanish and US competition, including orders from Saudi Arabia for Sandown class minehunters.

6.53. The MoD said that any country that thought, for perhaps security, or prestige, or economic reasons, that it might have the capability to build warships, attempted to establish a yard. Malaysia, for example, intended to turn an old patrol boat repair yard into a shipbuilding yard, which implied that further frigate orders from them were unlikely. Indonesia had adapted an old naval dockyard at Surabaya for both warship and commercial shipbuilding. Turkey had created a yard for the purpose of building frigates to the MEKO design. Portugal had bought its first MEKO frigate from Germany and now wished to build its own.¹ There were many other examples. However, Korea, surprisingly, had not adapted its highly-developed commercial shipbuilding skills to naval purposes. It was clear, too, that the establishment of a national submarine-building capability was technically much more difficult. India had had a large programme which had been a failure. In consequence there was a tendency for countries to buy submarines rather than attempt to build them with a newly-established capability.

6.54. The MoD told us that in order to assist UK companies in winning defence exports against often aggressive foreign competition, it had announced that, in future, when two or more UK companies were in competition for an overseas contract, and when such competition reduced the chances of UK success, the DESO would lend full support only to the company which it believed stood the best chance of success. (The previous policy had been even-handed in supporting UK companies until the customer had indicated a clear preference.) The new policy would avoid spreading support too thinly, and allow concentration on the UK bidder best placed to succeed. Other countries already did this. The MoD said that it expected the policy of backing winners to result in an increased share of the world market for the UK.

6.55. In summary, the MoD view was that the warship export market was extremely difficult. It was intensely political and invariably carried with it demands for linked local activity of some kind. British ships had usually (although not always) been too advanced for the needs of countries prepared to buy warships (and even Australia had found the Type 23 far too capable for what it required). BAe could add greatly to VSEL's export capability. There was no big market waiting to be exploited, and it would probably be as good an assumption as any that the current relatively low level of UK exports would continue except, perhaps, in non-nuclear submarines, where prospects could be brighter.

¹We noted (from the *Oxford English Dictionary*) that the first recorded reference to a frigate as a warship (as distinct from a light, swift vessel) is in Johnson's *Kingdom and Commonwealth*, published in 1630: 'there are continuall fights with Portugall Frigats'.

Wider issues

6.56. The MoD said that it was the Government's policy to secure the opening of the EC market for warship-building on a fair and equitable basis. But at present the prospects of achieving this appeared fairly remote, and it was commensurately unlikely that the policy of reliance on domestic construction would change. A unilateral decision to accept overseas competition would mean that UK yards could lose work without corresponding access to overseas markets, thus exacerbating problems of underloading and potentially increasing the cost of other UK naval work.

6.57. In this context, the key question was whether the interests of the MoD as customer-and, indeed, the UK national interest-would be better served by attempting to maintain the present degree of competition for UK warship orders or by permitting further consolidation in the warship-building industry.

6.58. The MoD's preference was to sustain competition where practicable. It thought this would not be affected by a BAe acquisition of VSEL. But the UK was already in a position where the reality of warship competition was affected by the fact that if orders were not placed in a certain way a yard would be likely to close. In effect, concentration was a matter of time. Furthermore it was increasingly hard to justify the additional costs and overheads associated with the maintenance of competition, given that for the foreseeable future the small and reducing UK naval programme would not be capable of providing an adequate loading for the capacity that currently existed.

6.59. The MoD said that it had often been content to see its competitions for defence products be the means of resolving issues of industrial restructuring and consolidation. The competition for the LPH between SH and VSEL (which SH lost, and had gone into receivership as a result) was an example. The MoD accepted that the form and timing of consolidation would be likely to depend on whether BAe was successful in its bid for VSEL, but it did not consider that public interest arguments were affected by this.

6.60. The MoD did not expect that conditions for foreign procurement of warships were likely to be met in the near future. It had several considerations in mind:

- (a) *Mutual reliance for support.* The UK had to be able to rely upon the builder's support, and its supply of spares and consumables to keep the ship in operation, particularly during an outbreak of hostilities. There had been cases where foreign partners had not provided support services when they were needed. Reliance on foreign countries was tolerable only if there was mutual reliance that made it likely that support would continue to be provided. National construction expertise was an important-though not always essential-component of providing a secure support service.
- (b) *Reciprocity of access to markets.* It was difficult to permit warship imports from competing countries that denied reciprocal access to their markets. In many European countries warship-building yards were publicly owned and state aided, which could be an impediment to free trade and competition.
- (c) *Intellectual property.* Foreign procurement would entail reliance upon intellectual property that others were willing to sell, and risk the leaking away of UK intellectual property if UK designs were constructed abroad. Foreign procurement was possible when the strategic lead was not a material issue, or when the UK could not afford to generate its own national intellectual property (eg in designing a new front-line fighter aircraft). In the case of nuclear submarines, the UK was bound under treaty to keep certain US-supplied intellectual property within the UK.
- (d) *Management of a uniquely complex system.* The MoD argued that the warship-builder had to integrate an extremely large and varied weapon system, because a warship was a much larger weapons platform than any other military platform (eg a tank or an aircraft). The physical remoteness of the supplier and, in some cases, its language added to costs in proportion to the complexity of the management of the system. These factors could also increase the cost of training the crew to run the ship and its systems.
- (e) *Availability of a suitable product.* International defence procurement normally took the form of using an off-the-shelf design with minimal modification. The Royal Navy had only a small number of ships and these had to be matched carefully with its operational needs and methods. The costs of

modifying a foreign design to the Royal Navy's needs would rarely be different from those of commissioning a new UK design.

- (f) *Short production runs.* Substantial savings could be obtained where long production runs resulted in optimization of production methods for standard items with limited variation. This was rarely achievable for ships, thus reducing the cost advantage of international procurement.

6.61. On the role of the market, the MoD said that its preference was that industrial co-operation and mergers, both within the UK and across national boundaries, should be decided as far as possible by companies and their shareholders. A decision to block the BAe bid for VSEL would frustrate the role of the market on grounds which would do little or nothing to sustain the strength and competitiveness of the UK naval shipbuilding industry in the longer term.

6.62. The MoD had considered carefully whether unconstrained competition to buy VSEL might encourage an excessively high bid in the expectation that its cost could be recovered in the overheads of the MoD's contracts. The scope for doing this was limited by the value of the work in prospect, and the mechanisms for attempting it were limited and well understood. The MoD had already made it clear that it would not permit such a migration of the purchase price for VSEL into product prices.

6.63. The MoD noted our view that, as a possible remedial measure, BAe might be asked to give an undertaking that it 'would not unreasonably refuse to make available VSEL's submarine-building facilities to any prime contractor who sought to use them'. The MoD said that this presented problems of definition: would the undertaking be limited to some, or all, of the physical facilities; would it extend to some, or all, of the workforce; would it mean the engagement of the workforce on a subcontracting basis, or of the whole yard on a comprehensive contract; who would specify the quality of the work to be done, and the price for it? It would be immensely hard to put an undertaking of this sort into practical effect.

Conclusion

6.64. In conclusion, the MoD believed the most significant factor in relation to competition in the warship-building industry was the B2TC programme: there was, for the first time, a prospect of placing a competitive prime contract for nuclear submarine construction.

6.65. No other foreseen project competition was so significant, although the CNGF programme was more substantial: it would be close to double the cost. Competitions for the final batch of three Type 23 frigates and for the AOs were much smaller in value, and competition for the CNGF would be limited to follow-on orders.

6.66. The MoD's preference was to sustain competition where practicable but, given the reducing demand for warships, it saw further concentration as largely a matter of time, as had occurred elsewhere in the defence industry. It also noted that concentration could bring benefits in overseas markets and within the EC.

6.67. The MoD's considered view, therefore, was that, with the assurances mentioned (see paragraph 6.40), it did not expect the acquisition of VSEL by BAe to operate against the public interest, and it saw merit in allowing the market to decide the outcome.

Department of Trade and Industry, Sponsor Command

6.68. DTI's Sponsor Command has sponsorship responsibility for the shipbuilding, aerospace, electronics and engineering industries, which are the main sectors affected by the merger proposal. In submitting its evidence to us Sponsor Command made clear that it did not speak in any way for the DTI's Competition Division and that its views should not be taken to reflect the likely reaction of the Secretary of State for Trade and Industry to the findings of the MMC.

6.69. Sponsor Command said that there was little overlap between the businesses of BAe and VSEL as BAe did not produce ships' hulls and VSEL produced little of the equipment to go into them. There could

be a reduction in market opportunities because of the vertical integration of VSEL and BAeSEMA, the assessment of which would depend on the evidence of competitors to BAeSEMA in the naval business. BAe and VSEL were potential competitors in the supply of artillery to the MoD and other countries. But the product overlap was limited and the market was characterized by vigorous international competition. There appeared to be no other actual or potential reductions in competition threatened by success of the BAe bid.

6.70. In referring the bid the Secretary of State had made clear that he considered it raised public interest concerns. Sponsor Command identified three of them:

- (a) It had been suggested that BAe's bid would be bad financially for VSEL because BAe might divert cash from VSEL to its civil business, and that a BAe take-over could involve VSEL in what was seen as BAe's financially weak position.
- (b) It had also been suggested that if BAe owned VSEL it might launch a predatory bid in the tender for the final batch of Type 23 frigates, thereby probably putting YSL out of business. As well as reducing future competition, this would also raise regional employment considerations.

While expressing no view on whether these concerns were justified, Sponsor Command suggested that they should all be evaluated by the MMC.

6.71. There appeared to be considerable potential benefits in a BAe take-over. BAe had argued that it had wide experience as a prime contractor for the MoD, which it could put to the advantage of the VSEL business; the acquisition of shipbuilding capacity would enable BAe to apply its systems integrations capability across a wider range of defence activities.

6.72. BAe had also argued that it had a strong record as a defence exporter which would enable it to win exports for the VSEL business. Sponsor Command said that the prospects for UK civil shipbuilders were currently uncertain. The expected recovery in demand had not yet materialized and, although by agreement subsidies were to end in December 1995, competition from other suppliers was very strong. The recent involvement of KG in the LPH contract was an innovative development, but warship construction was unlikely to add greatly to the civil yards' workload.

6.73. The MoD was responsible for export promotion of the UK warship industry, but the DTI lent active support. Export markets for warships were extremely competitive and would remain so. VSEL had suffered from specializing in submarines. They had little export potential, but VSEL was now planning to break back into the building of surface ships. The market was difficult with prospects depending on the outcome of a small number of competitions. It was difficult to predict whether substantial export orders would be won by UK yards.

6.74. Sponsor Command concluded that it was for MMC to consider the balance of advantage and whether the seeking of any undertakings from BAe would be desirable.

HM Treasury

6.75. The Treasury said that a merger of VSEL and BAe would not materially affect competition. Indeed, the marketing and management strengths of BAe could enhance the prospects for future competition of ship and submarine purchases. The Treasury therefore had no objections to the merger.

Department of Employment

6.76. The Department of Employment (DE) said that any job cuts at VSEL that resulted from a merger with BAe would clearly have an impact on the local economy. It believed the best way of creating and preserving jobs was for the businesses concerned to do what was best for the business, subject to maintaining a competitive market. It believed the decision should be made on competition grounds alone; therefore maintenance of employment in the short term should not, of itself, be a consideration. Any other course might allow some short-term respite for the shipyard, but possibly at the expense of its long-term future and jobs elsewhere.

Shipbuilders and shiprepairers

GEC

6.77. GEC told us that it did not propose to add to the representations it had made to the OFT about the BAe bid for VSEL (which we had seen, with GEC's approval).

6.78. We noted that GEC had said, in a memorandum of 8 November 1994 to the OFT, that BAe, in press announcements, had claimed that:

- (a) its acquisition of VSEL would strengthen BAe's position as Europe's leading defence company and provide BAe with a similar capability in naval systems to that which it already had in air systems;
- (b) as part of the enlarged group, VSEL's ability to compete successfully for the prime contracting roles for the B2TC programme and forthcoming surface ship requirements should be enhanced;
- (c) BAe's offer for VSEL promoted the MoD's defence procurement policy;
- (d) BAe would develop VSEL's ability to secure export orders by utilizing BAe's export skills and existing international marketing organization; and
- (e) BAe would provide benefits by combining VSEL's leading position in the UK in artillery systems with BAe's strengths in ordnance products.

6.79. Taking these claims in turn, GEC had told the OFT that:

- (a) The extension of BAe's existing monopoly position would be highly undesirable; BAe's record as a prime contractor was undistinguished, and its financial record was deplorable; BAe's published accounts showed that in the 3½ years to June 1994 it had suffered a cash outflow (before rights issues and sales, less purchases of business) of more than £2.5 billion, and a fall in shareholders' funds of more than £1.5 billion; its operating profit margin before exceptional provisions had been less than 1 per cent on sales of £35 billion; one of BAe's principal motives in making its offer for VSEL was to repair its balance sheet and secure VSEL's cash to bolster the declining fortunes of its civil aircraft business.
- (b) BAe's acquisition of VSEL, instead of enhancing VSEL's ability to compete in the naval shipbuilding market, would weaken its financial and longer-term competitive position. VSEL's acquisition by BAe could not alter VSEL's technical competence to undertake the B2TC prime contractorship.
- (c) VSEL had won the LPH order by bidding at a loss and if, in BAe's ownership, it won the contract for the last batch of Type 23 frigates by again bidding at a loss (cross-subsidized by its monopoly activities) there would be no likely alternative to the closure of the YSL yard, although the CNGF design capability might be retained. The MoD had indicated that it was in the national interest that both VSEL and YSL should remain open for the foreseeable future. In this respect, therefore, the BAe bid was adverse to UK defence procurement policy.
- (d) Neither BAe's export skills nor its existing international marketing organization were superior to those of GEC. The GEC network was wider and more developed than BAe's. BAe's acquisition of VSEL might foreclose warship export opportunities for the UK shipbuilding industry in markets where BAe obtained prime contractorships based on the supply of aircraft.
- (e) The combination of VSEL's howitzer business with BAe's RO capabilities would create a UK monopoly in field artillery.

6.80. Subsequently GEC commented on three other matters. First, in discussion with us on possible remedies, GEC said that if an undertaking were required it 'would not unreasonably refuse to make available VSEL's submarine-building facilities to any prime contractor that sought to use them' and (in comparable terms) it would expect that a similar undertaking would be sought from BAe.

6.81. Next, GEC put to us orally and in writing its responses to observations by BAe on its compliance with undertakings required of it in the Plessey case.

6.82. Finally, on its relationships with BAe in 1992 to 1994, GEC told us that in 1992 and 1993 it talked to BAe about a possible merger of their defence businesses. They exchanged confidential information under the terms of a confidentiality agreement, and they entered into a standstill agreement whereby each agreed not to acquire shares in the other for two years ending in June 1995. However, shortly after these agreements became effective the discussions were ended by BAe.

6.83. GEC also told us that in April 1993 it had been approached by a third party, known to BAe, GEC and VSEL, about a proposal to merge the VSEL guns business with that of BAe and subsequently to merge the GEC naval activities with those of VSEL. GEC had said that, if BAe confirmed to it that it was going forward with the proposal, GEC would follow. No such confirmation was received.

6.84. GEC told us that on 29 September 1994 VSEL announced that it had received approaches that might lead to a bid. Shortly afterwards BAe told GEC that it was talking to VSEL, and arranged for meetings between BAe and GEC, between 7 and 18 October. BAe tried to persuade GEC not to intervene, and promised that if GEC complied it would revive the earlier discussions about a merger of GEC's and BAe's defence businesses. At one of the meetings GEC suggested that BAe and GEC should bid jointly for VSEL, but no firm proposals were made. During these discussions BAe continued to negotiate terms with VSEL and at the meeting on 11 October it informed GEC of its intention to bid for VSEL. It announced its bid publicly the following day.

VT

6.85. VT is one of the three remaining warship-builders in the UK. It has a yard at Southampton and another (in intermittent use) at Portchester. It supplies GRP minehunters to the Royal Navy and has recently been successful in securing export orders for smaller steel-hulled surface ships (see paragraphs 4.54 to 4.57). The ships currently on order would be delivered by 2001. VT told us that its core business (80 per cent of turnover) was designing, building, equipping and supporting surface warships. The balance of turnover arose from activities which were related but independent of the uncertain timing of warship contracts.

6.86. VT said that the UK warship-building industry had been characterized by overcapacity for at least 20 years. The end of the 'cold war' had initiated a dramatic decline in warship demand resulting in a reduction in the number of employees for MoD new build work in the UK industry of about 60 per cent in the last five years. Further reductions to about 5,000 employees (25 per cent of 1990 levels) were likely over the next year or two. When actual and possible export work was included a total reduction from 22,000 to about 6,000 employees over the ten-year period was likely. [

Details omitted. See note on page iv.

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6.87. VT believed the proposed merger was not against the public interest. VSEL had had a monopoly in UK submarine-building for many years and this would be unchanged. Should the MoD require VSEL to provide additional prime contractor financial security this could be provided by BAe. The ability of UK yards to export warships would be unaffected.

6.88. VT told us that the export market for warships was extremely difficult and time was needed to secure sales. Effectively VT's potential export markets were limited to those countries which had no domestic capability, a warship requirement and the means to pay; these were found mainly in the Middle and Far East. VT attributed its recent success to the foresight of those in VT who had set up an export

department over 30 years ago, to an active and knowledgeable sales organization and to the ability as prime contractor to offer a complete support and after-sales service to overseas customers.

6.89. VT was, however, concerned that an acquisition of VSEL by BAe might lead to a dilution of MoD (DESO) support for VT. If VT then failed to win further export contracts its ability to survive as a competitor for MoD warships would be put at risk.

6.90. In the event of a successful bid by BAe for VSEL, VT would wish to see the following safeguards:

- (a) unfettered opportunities for VT to compete for all MoD contracts for the design, build, support and refit of surface warships;
- (b) continued export support for VT by the MoD, Foreign and Commonwealth Office and DTI;
- (c) the ability for VT to compete as an equipment supplier on equal terms with other competitors, including BAe;
- (d) VT being protected against BAe quoting artificially high prices when supplying warship equipment to VT; and
- (e) any future international competition by the MoD (eg 'foreign' hull procurement) to be on a reciprocal basis.

6.91. VT is a prospective prime contractor for CNGF follow-on ships, and a subcontractor to GEC for the first-of-class. It told us that it could build follow-on CNGFs at a maximum rate of one vessel every 16 months, if that were required, using Portchester for subassembly work. On that basis there could be up to three vessels in the yards at any one time (but it would imply that the follow-on programme of 11 ships would take about 18 years to complete). No unusual investment would be required but the workforce would have to be increased. This would still leave some capacity for exports and GRP work.

KG

6.92. KG is a subsidiary of Kvaerner AS, a Norwegian company. It is currently constructing the hull of the LPH for the Royal Navy at its yard on the Clyde under the terms of a subcontract from VSEL; it had also recently been approached by VSEL and other naval yards to participate in bids for forthcoming MoD surface ship projects. KG wished to remain primarily a builder of high-quality merchant ships. It did not regard the possibility of involvement in the present intensive MoD procurement procedures to be compatible with its market strategy, although it was keen to offer its expertise as a merchant builder in the construction of naval ships which could benefit from merchant shipbuilding methods contracted under commercial terms. KG could offer value-for-money subcontract work on further LPH/LPD/AOR and other 'quasi-naval' vessels which could have a high degree of merchant-type construction. KG might not wish to act as a naval prime contractor, for example, in relation to the AOR vessels project.

6.93. Owing to the more bureaucratic procurement procedures involved in MoD contracts, there was a wide difference in the organizational structure which existed between merchant and naval yards. KG was therefore sceptical as to the extent to which UK merchant yards could participate fully in naval programmes without a change to those procurement procedures. With the demise of CL and SH, the number and nature of the remaining naval yards (VSEL, YSL and VT) effectively limit the extent of real competition possible, particularly in relation to larger surface vessels.

6.94. KG thought the integration of VSEL within BAe should not necessarily reduce the prospect of competition in the large surface ship market.

DML

6.95. DML manages the Devonport Royal Dockyard. It had no specific concerns about the BAe bid. Further rationalization of UK shipbuilding capacity was both desirable and inevitable. Capacity exceeded foreseeable demand (including export opportunities), and rationalization should benefit value for money through the reduction of fixed costs.

6.96. DML was in a position to carry out the major refitting of all types of surface warships and submarines with the exception of Vanguard class submarines. It was unlikely to be in a position to bid for future warship build contracts, since demand was unlikely to be sufficient to justify the capital expenditure which would be needed to reinstate DML's build capability. For surface ships, panel lines and module construction facilities would have to be created and the existing building slip reinstated with new cranes; the capital expenditure would be in excess of £50 million. For submarines, the most likely approach would require the subcontract manufacture of the hull pressure vessel sections, with subsequent assembly either in a dry dock or on the building slip. The associated investment would be in excess of £50 million. Neither approach would be likely to offer efficiencies anywhere near those potentially achievable at VSEL.

6.97. DML believed UK commercial shipyards had the potential to expand into the building and refitting of large surface warships, although return on investment and the availability of adequately skilled labour would probably preclude any such move in practice. Foreign shipyards also offered potential competition, subject to issues of national security and hidden foreign subsidies which distorted commercial competition. Export opportunities existed for the building of new warships, and would probably be only marginally affected whatever the outcome of the bids. An acquisition by BAe might strengthen BAe's ability to prime certain types of warship construction contract.

Equipment suppliers

David Brown Group plc

6.98. David Brown Group plc (David Brown) is an engineering company. One of its divisions makes large industrial and marine gears, including naval main propulsion gearing for surface ships and submarines. It told us that it had supplied main propulsion gearboxes for the Royal Navy since the Second World War. Naval gearboxes represented some of the most sophisticated applications for large high-powered gearing and were supplied by only a few companies throughout the world. The high cost of the equipment, together with the technical demands of the application, made new entry difficult.

6.99. David Brown said that it thought the acquisition of VSEL by BAe would make no difference to its position in the market: BAe had no subsidiaries in direct competition with it and was not a company that had been interested in acquiring equipment suppliers.

Racal Electronics plc

6.100. Racal supplies electronic warfare equipment for naval defence. Its main interest is in the supply of electronic support measures equipment and electronic counter-measures equipment to the MoD and overseas navies for both surface ships and submarines. It also supplies display equipment for command and control systems, including the BAeSEMA Type 23 command and control system.

6.101. Racal considered that the acquisition of VSEL by BAe would in no way reduce the scope for effective competition for larger warships in the UK and was confident that BAe could adapt its prime contractorship skills to naval shipbuilding to ensure that value for money was achieved and to strengthen VSEL. Racal believed the BAe acquisition would raise no problems for equipment suppliers such as Racal. BAe had a long record of acting as prime contractor on aircraft and missile programmes, but had limited involvement in the design and manufacture of the major electronic systems which constitute a large part of the value of these programmes. It was consequently accustomed to procuring major electronic systems through fair and open competition.

6.102. It was, therefore, Racal's view that the BAe offer for VSEL did not raise any major issues of competition or public interest.

Siemens Plessey Electronic Systems Ltd

6.103. Siemens Plessey Electronic Systems Ltd (Siemens Plessey) supplies surveillance radar, command systems and on-board communications equipment for naval applications. Siemens Plessey said that it had no concerns about the proposed merger as BAe had no subsidiaries which competed directly with Siemens Plessey.

Thorn EMI Electronics Limited

6.104. Thorn EMI is chiefly engaged in various aspects of the music business. But its electronic and defence systems business supplies electronics equipment for naval applications. Thorn EMI told us that it had no concerns about the proposed acquisition. BAe did not compete with Thorn EMI on an equipment basis. BAe was a configurer of platforms and procured the equipment it considered would ensure the performance of the system. Thorn EMI had found that the BAe competitions it had entered into had been run fairly.

Loral ASIC

6.105. Loral ASIC is a US company which is registered in Delaware. It is setting up a UK company to meet the MoD's security requirements. It told us that it was a wholly-owned subsidiary of the Loral Federal Systems Company, acquired from IBM in March 1994, and now part of the Loral Corporation. It specialized in providing command and control systems for aerospace and defence.

6.106. Loral ASIC had signed a teaming agreement to support VSEL in bidding for the B2TC contract. Its role, based on its experience in providing a combat system for US nuclear submarines and its credentials as prime contractor for the MoD Merlin helicopter programme, was to provide, as subcontractor to VSEL, expertise to manage total weapon system integration, including the combat management system, and to support VSEL in taking overall responsibility for combat systems performance, together with project management support for VSEL's prime contractor function. Loral ASIC's main concern was that the proposed acquisition might affect the arrangements for VSEL's B2TC bid and the Loral ASIC role in that bid.

6.107. Loral ASIC said that BAe's subsidiary, BAeSEMA, was a subcontractor to it for part of the combat systems integration. This aspect of BAe being VSEL's owner and also acting as subcontractor to Loral ASIC would have to be resolved, as would full recognition of Loral ASIC's combat systems integration responsibilities. The most sensitive aspect of Loral ASIC's teaming with VSEL was in the area of prime contractor office support, where Loral ASIC had substantial responsibilities to VSEL to help implement new management processes and to staff the project team with experienced people who had been involved in similar programmes. BAe had prime contractorship skills and might wish to displace Loral ASIC in this role. This could detract from the integrity of the B2TC system schedule and management approach, thereby adding risk to the programmes. Loral ASIC said that it would work with BAe should this be necessary.

6.108. Loral ASIC was concerned that, as a subcontractor to VSEL providing services which would compete with BAe as a prime contractor, the investment it was making in preparing the tender response could be put at risk by the outcome of the proposed acquisition. Loral ASIC would seek an assurance that any clearance by the MMC to allow a take-over of VSEL by BAe should include a requirement that Loral ASIC's role be preserved. Moreover, Loral ASIC believed its role in the current B2TC programme structure added considerably to the prospects for the ultimate success of the programme. Should the acquisition of VSEL result in any significant change to Loral ASIC's role, the MoD might not secure the

full value which Loral ASIC believed it could add to the VSEL team. As a result, Loral ASIC would recommend safeguards to protect the public interest in maintaining its current arrangements with VSEL.

Rolls-Royce Nuclear Engineering Ltd and Rolls-Royce & Associates Ltd

6.109. Rolls-Royce Nuclear Engineering Ltd (Rolls-Royce) is a subsidiary of Rolls-Royce Plc and, through its subsidiary Rolls-Royce & Associates Ltd, is involved in submarine nuclear propulsion and in the proposed B2TC programme. Rolls-Royce told us that it employed over 2,000 staff mainly in Derby and Dounreay, in the north of Scotland. Since its establishment in 1959 it had designed all the reactor plants for the Royal Navy's submarines. It also managed the Royal Navy Reactor Test Establishment and maintained small support teams at VSEL, the Royal Dockyards, and Faslane.

6.110. Rolls-Royce had been nominated as design authority and supplier of the nuclear steam-raising plant for the B2TC. For the VSEL B2TC bid Rolls-Royce would act as subcontractor to VSEL in providing this plant.

6.111. As designated supplier of the B2TC steam-raising plant Rolls-Royce was ensuring that the full technical capability of the company was available to both bidders. It had established arrangements, familiar to it from earlier projects, including separate project teams, to ensure that commercial and project information relating to the two bids was segregated. The MoD would have access to the price build-up to ensure that equivalent prices were being offered for equivalent work.

Trade unions

Confederation of Shipbuilding and Engineering Unions

6.112. The Confederation of Shipbuilding and Engineering Unions (CSEU) said that the current problems facing VSEL stemmed largely from the crisis in the British defence industry as a whole. The CSEU said that VSEL was over-dependent on military production and had missed opportunities in the commercial sector since the mid-1970s. VSEL had a long history of commercial shipbuilding and could exploit the growing demand for shipbuilding of all kinds in the next ten years. But such opportunities as existed for VSEL, and indeed for other British shipbuilders, would need the support of a strategy to boost investment and to halt closures. The situation at Barrow was of concern to the CSEU because of the many thousands of its members in shipbuilding who were likely to be affected by the outcome of the bid.

6.113. The CSEU said that though VSEL was known for its manufacture of the Trident submarine, it had a long tradition of commercial work in merchant shipping. The nationalisation of VSEL brought about a concentration of defence work and submarine construction. The company employed between 13,000 and 14,000 people throughout the 1970s and 1980s, a period in which the unions had continually raised the question of the company's dependency on military production.

6.114. The limited change in direction by the company in the early part of this decade included a joint agreement with KG to build an auxiliary supply ship. This return to surface warship-building and the company's incursion into the offshore supply industry, power generation and environmental engineering, while welcome, had been too little and too late. VSEL had the skills, experience and commitment to meet the challenges. But it also required investment and a high-quality management with the vision to meet these opportunities.

6.115. The CSEU said that the driving force behind defence company mergers was market share. The ability to manage defence contracts and to compete against other merged companies in the USA and Europe was the strongest argument in favour of the deals. VSEL, because of its geographical position and its overwhelming dependence on military and, in particular, Trident contracts needed to be part of a larger company which could give it access to foreign markets. BAe was clearly better placed to ensure much of this access abroad and could also provide work for VSEL in the lucrative area of fitting weapon systems on warships. Investment was needed to build surface ships, and a new channel at Barrow might have to be

dredged. A crucial aspect of the take-over battle was the need to provide VSEL with financial support to make the conversion. Traditionally VSEL had been the main source of training for apprentices and skilled workers in this area of the UK; it was important that the high-quality training provided was not lost to the local community and to the UK.

6.116. However, the CSEU's main concern was that the best interests of all employees must be protected. The unions would therefore be seeking guarantees that recognition agreements would be protected in full; that all terms and conditions would be maintained, including severance pay; that the apprenticeship system would be preserved; and that the pension fund would be safeguarded. In addition, the CSEU would pursue job protection guarantees, assurances that there would be no asset stripping and no closure of plants or yards.

Barrow and District CSEU

6.117. Barrow and District CSEU comprises the AEEU, GMB, APEX Partnership, MSF, UCATT and EMA, all of which hold recognition agreements within VSEL. Well over 90 per cent of employees in the shipyard have union membership including hourly-paid workers, staff and managers.

6.118. The Barrow and District CSEU said that the decline in the UK defence market coupled with the Government's policy on competitive tendering meant that VSEL's problems had intensified. The unions believed VSEL's survival was dependent on its gaining access to export markets, and having the financial viability to become a prime contractor. In this context a take-over by BAe opened a window of opportunity and offered a unique chance to secure the future of VSEL. BAe had the necessary contacts and sales structure to exploit what could be demonstrated as a viable export market.

6.119. In the last five years there had been a loss of some 9,000 skilled jobs at VSEL, many of which were specialist to the shipbuilding industry. The retention of these skills was essential in the national interest; once the skills were lost they could not easily be replaced.

Other organizations

Lloyds Bank plc

6.120. Lloyds Bank plc (Lloyds) said that it had been a principal banker to BAe (and predecessor companies) for more than 30 years. It was a lead arranger and the agent for the £1,500 million revolving credit facility which was completed for BAe in September 1993. This facility refinanced a number of pre-existing facilities and enabled BAe to implement its corporate strategies. Lloyds had been impressed by the measures taken by BAe's management over the last three years. These had included the disposal of a number of non-core businesses, significant rationalization and efficiency improvement initiatives, and a refocusing of priorities upon the core defence and commercial aerospace businesses. These steps, coupled with a comprehensive reorganization of the group's finances, had resulted in a significantly strengthened balance sheet, enhancement of the group's profitability and thus of its ability to maintain international competitiveness. Lloyds believed BAe's ranking as an investment grade credit provided a useful indication of the support which BAe commanded from the international banking and investment community.

J P Morgan

6.121. J P Morgan said that it had had no significant relationship with BAe prior to 1991, since when BAe had become one of its most important customers in the UK. It was now BAe's lead US bank and a major lender to the group. As such, it regularly discussed BAe's financial and strategic position with the company's senior management. J P Morgan believed BAe's financial position had strengthened significantly over the last three years principally because of fundamental changes effected by BAe's current management team. In its opinion, BAe's current financial position was now strong, a judgment shared by both Moodys and Standard & Poors which both rated BAe as a single A investment grade credit. It believed BAe's current credit standing provided it with consistent access to the domestic and international

bank markets on competitive terms. There was clear evidence to support the proposition that BAe's strategic and financial progress over the past three years had been recognized by the financial markets and reflected in a significant upturn in available credit capacity, and a clear improvement in BAe's access to the financial markets.

Barrow-in-Furness Borough Council

6.122. The Council welcomed BAe's proposed acquisition of VSEL. It was unlikely that VSEL on its own could continue to operate as a major employer and so ensure that shipbuilding remained in Barrow. The Council had felt for some time that diversification should have been pursued by VSEL over the past decade, but there had been little success. The Council said that BAe had not suggested that it could halt the current decline in employment, but had stated that its purpose in acquiring VSEL was that it saw it as a business with an expanding and large market that could be targeted, not just in terms of the UK but also in terms of exports; BAe, too, saw Barrow as having the capacity to construct large surface vessels.

6.123. BAe had given undertakings that it would maintain the existing terms and conditions of the workforce and had said that it would honour the redundancy terms that had already been agreed with the trade unions. However, the Council accepted that any assurances which BAe gave could only be short term.

Furness Enterprise Ltd

6.124. Furness Enterprise Ltd (Furness Enterprise) is an economic development agency set up in 1991 as a partnership between local firms, local authorities and other agencies in response to reductions in the defence industry in the Furness area, in order to encourage the provision of alternative job opportunities.

6.125. Furness Enterprise told us that the Barrow travel-to-work area had a workforce of about 45,000. Apart from VSEL, the only other significant manufacturing employer was Glaxo, at Ulverston, which provided 1,000 jobs. The area had been hit hard by the reduction in employment at VSEL, following the recent defence cuts, from 14,500 to under 6,000 with the probability of further reductions to 5,000 or even 4,000.

6.126. The Furness area had been granted intermediate assisted area status by HM Government in late 1993 but its remoteness made it extremely difficult to attract new employers. It had been classified by the EC not only as a 'peripheral' area but as one of the most defence-dependent and least adaptable local economies. Furness Enterprise worked with existing firms as well as exploring new prospects, particularly in advising on applications for Regional Selective Assistance grants, encouraging the provisions of business infrastructure, inward investment, technical skills and helping to fund a tourist action programme. However, although over 1,000 jobs have been created and safeguarded, the numbers were small compared with the losses at VSEL.

6.127. Furness Enterprise saw some potentially positive aspects of a take-over of VSEL. New orders, particularly from abroad, might be secured, taking advantage of a larger, broader-based company and sales force, and there might be prospects for diversification, thus securing existing jobs and creating new ones. The new company might also be able to provide even greater support for efforts to encourage inward investment. It knew of no strong local feeling that VSEL should remain independent.

Members of Parliament

6.128. *Mr Julian Brazier MP* saw no objection to a BAe take-over of VSEL. This would leave the UK with two major defence groups each capable of the manufacture of warship hulls, certain types of missiles and, perhaps most important, in the defence context, prime contractorship in a range of areas.

6.129. *Mr Ian Bruce MP* said that VSEL was not in need of BAe to secure its future.

6.130. Mr Bruce could see no logic or sense in allowing a take-over of VSEL by BAe. If BAe wanted to be a prime contractor in whole ship procurement, it would be in a very much better position to buy the hull at the best possible prices, delivery and quality if it did not own its own shipyard. An acquisition of VSEL was likely to dilute BAe's ability to be a competitor to GEC.

6.131. *Sir John Cope MP* said that if BAe were to acquire VSEL it would raise no competition problems and would preserve competition in warship-building.

6.132. *Mr Phil Gallie MP* said that the capabilities of BAe to win export orders should be taken into account. He did not consider a concentration on the home market requirement to be in the best interest of those involved in British shipbuilding or of the UK. In the event of BAe successfully acquiring VSEL, undertakings must be obtained which kept VSEL in the market-place for a minimum of ten years.

6.133. *Mr Thomas Graham MP* felt that a merger between BAe and VSEL offered the best advantages for the industry in general. The headquarters of RO and VSEL were based in the North-West and the safeguarding of jobs was guaranteed through the continued utilization of the Barrow shipyard. BAe and RO had already forged close links in all aspects of business with VSEL over the past two years, and were in a strong position to integrate. VSEL and RO were already targeting the same customer base and thus had a common understanding of the domestic and international markets.

6.134. Within an international context this would greatly enhance UK exports of submarines and warships. BAe had a good track record with around 80 per cent of its turnover derived from exports, and the combination of BAe and VSEL would allow strong competition with the USA, the Middle East and Far East markets.

6.135. *Mr John Hutton MP* (for Barrow and Furness) said that his main concern was to ensure better employment prospects for his constituents. The future of the Furness economy was very much dependent on VSEL and it was critically important therefore that VSEL was able to develop a successful strategy for attracting new business opportunities to its yard. Given the substantial cut-backs in MoD work over the last four years, winning new export orders was essential if the company was to grow and prosper into the next century.

6.136. Mr Hutton believed that across a broad range of areas, including apprentice training and product diversification, VSEL was more likely to succeed in this strategy if it joined forces with a strong and broadly-based engineering company with a proven track record of export success. It was difficult for smaller defence companies like VSEL to compete effectively in an increasingly tough export market. Linked with BAe, VSEL was more likely to succeed in gaining new export business for the UK. This would be a very welcome development for Britain's defence industries as a whole, and for the Furness area in particular. Mr Hutton added that the defence industry was likely to see major reorganization and rationalization as it responded to a rapidly changing security environment. This raised significant questions relating both to the need to retain competition in defence procurement, and skills within the engineering industry.

6.137. *Mr William McKelvey MP* said that if BAe were to acquire VSEL it would not lead to a monopoly in warship-building, and would buoy up the military side of its business to enable the civil aviation side to continue its operations with a secure base.

6.138. *Mr Keith Mans MP* commented that it was unlikely that VSEL could realize its natural potential without a partnership with another company. He believed the partnership should be one where there was a fair degree of synergy and, if possible, the partner should already be involved with other companies in Europe. Mr Mans strongly believed that VSEL's best interest lay in a partnership with BAe.

6.139. *Mr Nicholas Winterton MP* had no concerns about BAe acquiring VSEL as the transaction did not appear to raise any significant competition issues and did not, in his assessment, give rise to national security concerns. The Government's confidence in BAe was amply demonstrated by its active support for BAe's prime contractorship role in the Al Yamamah programme, and by the major military contracts awarded to BAe in the recent past.

6.140. *Mr Timothy Wood MP* believed the proposed merger between BAe and VSEL did not raise significant questions regarding such a merger being against the public interest.

Scottish National Party

6.141. The Scottish National Party (SNP) said that the bid by BAe for VSEL involved issues of supreme importance in relation to restriction of competition and monopolistic practices, which affected vital areas of defence procurement and the survival of industries important to Scotland's industrial base. Clearly, if the bid was allowed to proceed, the creation of a larger group would have an impact on YSL and KG, where employment opportunities were of concern to the SNP.

6.142. SNP was mindful that a transfer of ownership and control of VSEL could result in a diminution in competition which could severely inhibit the choice of ordering and manufacture of equipment and services, particularly in the defence field. This could mean that the monopsonistic power of the MoD would be faced with a more monopolistic supplier, and that this interface of market forces could place a considerable further burden on the resources of the MoD to negotiate, conclude and monitor defence contracts in the public interest. The SNP noted that the MoD had undergone considerable improvement in its capacity to place defence contracts and had, ostensibly, obtained better value for money but, as these contracts have grown in complexity, this ability was far from perfect and the balance overall, in terms of expertise, was on the side of the defence industry. While a merger of interests, such as proposed by BAe, would alter the balance, it was unlikely to tilt it in favour of the MoD and, therefore, it was extremely doubtful if the public interest, in this sphere of public purchasing, could benefit from such a merger, which would reduce the number of individually-owned and -controlled companies bidding for defence contracts.

6.143. The SNP said that with the ending of the Cold War and the reduction in defence procurement, and the increasing costs of R&D to companies like BAe and VSEL, other considerations had to be kept in mind, not least of which were the requirements of scale to enable enterprises to compete for export orders. Notwithstanding such considerations, the SNP urged that particular attention be paid to the effect of the absorption of the activities of VSEL within BAe, on 'maintaining and promoting the balanced distribution of industry and employment in the UK'.

6.144. The SNP believed VSEL's attraction to BAe was directly related to its position in possessing the only site in the UK licensed and equipped to build nuclear-powered submarines. This made VSEL a key player in the survival stakes for naval shipbuilding, and the fact that significant orders would be forthcoming for the next generation of nuclear-powered attack submarines meant that whoever owned VSEL's facility at Barrow would be in a strategic position to determine the survival of other yards competing for naval orders.

6.145. The SNP said that one of the chief fears in Scotland and on the Clyde was that whoever owned and controlled the Barrow facility, underpinned by the stability of the attack nuclear submarine order, would be the survivor in the surface ship stakes as well, unless the MoD took appropriate steps to examine the allocation of costs and overheads between competing facilities.

6.146. The SNP argued that we ought to ensure that our deliberations on the issue of maintaining employment in Scotland came high on the list of priorities. Emphasis on this concern, in the SNP's view, required that no bid for VSEL by BAe should be allowed without the continuance of, and strengthening of, the Government's 'golden share' in any subsequent enterprise. A strengthening of the 'golden share' should include an ability to obtain direct knowledge of decisions which affect the continuance of employment in areas and facilities, as a result of orders placed by the Government with any resultant company, in order to ensure that no curtailment of shipbuilding in Scotland could arise as a result of accounting and costing procedure, which might be designed to place Scottish enterprises in a vulnerable position. Additionally, because of recent experience with the placing and costing of contracts for work at Rosyth Dockyard in opposition to Devonport, such information derived might be subject to a form of agreed independent scrutiny.

D G GOYDER (*Chairman*)

R HALSTEAD

A FORSTER

A P L MINFORD

J F PICKERING

E C TRITTON

A J NIEDUSZYNSKI (*Secretary*)

12 April 1995