

TO: SECRETARY OF STATE FOR TRADE AND INDUSTRY

FROM: PENNY BOYS
EXECUTIVE DIRECTOR

14 March 2005

ANTICIPATED ACQUISITION BY FINMECCANICA SOCIETA PER AZIONI OF BAE SYSTEMS PLC'S AVIONICS AND COMMUNICATIONS BUSINESS

A REPORT TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY PURSUANT TO ARTICLE 4(2)-(5) OF THE ENTERPRISE ACT 2002 (PROTECTION OF LEGITIMATE INTERESTS) ORDER 2003¹

1. This report is made following the European intervention notice (the Notice) given to the OFT by the Secretary of State for Trade and Industry on 7 February 2005 pursuant to section 67(2) of the Enterprise Act 2002 (the Act).

JURISDICTION

2. This transaction falls for consideration under the EC Merger Regulation (ECMR)². Although the European Commission has sole jurisdiction to investigate the competition aspects of the merger under the ECMR, Member States may exercise their residual power under Article 21(4) of the ECMR to take 'appropriate measures to protect legitimate interests other than those taken into consideration by this Regulation and compatible with the general principles and other provisions of Community law'. The second paragraph of Article 21(4) states that, among other things, public security shall be regarded as a legitimate interest.
3. As a result of this transaction arrangements are in progress by virtue of which a concentration with a Community dimension (within the meaning of Article 1(2) of the ECMR) will arise and in relation to which a reference under section 33 of the Act, which would otherwise have been possible, is prevented from being made by virtue of Article 21(3) of ECMR. The OFT therefore believes that it is or may be the case that arrangements are in progress or in contemplation which if carried into effect will result in the creation of a European relevant merger situation within the meaning of section 68(2) of the Act.
4. You may therefore make a reference to the Competition Commission (the CC) under Article 5 (3) of the Enterprise Act 2002 (Protection of Legitimate Interests) Order 2003 (the Order) to address public security concerns arising from the merger provided that you believe that the conditions set out in Article 5 (3) of the Order are satisfied.

THE PARTIES

5. **Finmeccanica Societa per Azioni (Finmeccanica)** is a holding company incorporated under the laws of Italy, operating through its subsidiaries in aeronautics,

¹ S.I. 2003/1592

² Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings.

aerospace, helicopters, defence electronics, defence systems, energy, transportation and information technology. In the UK, Finmeccanica operates through several subsidiaries, including **Selenia Communications Limited (Selenia)**.

6. **BAE Systems plc (BAES)** is an international manufacturer of advanced systems for the defence and commercial aerospace sectors. The company (either directly or through joint ventures and subsidiary companies) designs, manufactures and supports military aircraft, surface ships, submarines, radar, communications, electronic and guided weaponry and a range of other defence products.
7. BAES' UK avionics activities are carried out by **BAE Systems Avionics Limited (BAES Avionics)** which is a subsidiary of BAES which is active in military avionics, and in particular in airborne radar, Electro Optics and Electronic Warfare.
8. The BAES military communications business is a BAES business which is active in military ground communications systems and military naval information and communication systems.

THE TRANSACTION

9. The transaction is part of the Eurosystems project, under which Finmeccanica intends to acquire the following businesses:
 - a) BAES' Avionics; and
 - b) BAES' military communications business.

SUMMARY OF THIRD PARTY REPRESENTATIONS

10. Following receipt of the Notice, the OFT has consulted and invited comments on the national security public interest consideration identified in the Notice. In response to the consultation, representations on national security issues were received from the Ministry of Defence (MoD) and one other third party. These representations are summarised below.
11. The MoD has made representations that the merger might adversely affect the public interest on national security grounds as a result of both the communications and avionics business transferring to the ownership and control of an overseas company. The MoD has identified two main areas of concern arising from this merger: the maintenance of strategic UK capabilities and the protection of classified information.
12. Regarding the maintenance of strategic UK capabilities, the MoD has stated that BAES is the design authority for the majority of the avionics fitted in UK air platforms and the company houses unique skills and knowledge relating to them. The MoD states that it is essential for the protection of the UK's national security that these capabilities are retained within the UK to design, develop, operate and maintain current and possible future avionics systems. The MoD also states that the BAES communications business houses specialist communications development and production capabilities utilised by the UK Armed Forces. Without these capabilities MoD states that it would be unable to unilaterally update equipment so as to maintain the operational advantage that the UK's armed forces gain from having technologically-advanced and reliable equipment that is capable both of performing alongside our allies and surpassing potential adversaries.
13. The MoD believes that it is essential to obtain an assurance from Finmeccanica that it will continue to make available to the UK the capabilities that currently exist within

BAES' avionics and communications businesses, and that such capabilities will be maintained within the UK and neither run down, nor transferred abroad, following the transaction without prior consultation with the MoD.

14. In relation to the protection of classified information, the MoD has indicated that some of the strategic capabilities described above are dependent on access to highly classified technology and information. Some of the information is available only to UK nationals and may therefore bear a UK Eyes Only caveat. If the avionics and communications business, under the control of Finmeccanica, were to continue their involvement in such work, the MoD considers it is necessary to ensure that such information is retained and protected within the UK. Although the existing UK security regulations are designed to provide such protection, they rely on the integrity of the companies and the individuals concerned. The MoD see the additional mechanism of a legally-binding undertaking combined with an appropriate compliance regime as being necessary to assure the UK government that information and technology is adequately protected.
15. Another third party has made representations relating to the maintenance of strategic capabilities that if, following the merger, Finmeccanica were to hinder other contractors access to BAES avionics products this would have a negative impact on the MOD's ability to choose between alternative prime contractors for UK defence contracts, which would be adverse to be public interest. The MoD, in its representations to the OFT, did not identify this as a national security concern.

Undertakings in lieu

16. The MoD has identified national security concerns arising from the transaction which relate to the maintenance of a strategic capability and the protection of classified information. If you believe that the concerns raised by the MoD may be expected to operate against the public interest, you may either make a reference to the CC under Article 5 (3) of the Order or accept undertakings in lieu of such a reference under paragraph 3(2) of Schedule 2 to the Order.
17. The draft undertakings in the attached appendix are intended to remedy, mitigate or prevent the particular effects adverse to the public interest identified by the MoD which may be expected to result from the creation of the European relevant merger situation. Specifically, the undertakings seek to address the two areas of concern identified above.
18. Finmeccanica, Selenia and BAES Avionics have confirmed that they are willing to sign the undertakings in the form attached in the appendix.

Conclusions on national security considerations

19. The OFT is not expert in national security matters and therefore merely summarises here representations made by the MoD and other third parties.
20. The OFT has no reason to doubt the representations made by the MoD on the appropriateness of the undertakings in order to remedy or prevent the specific effects adverse to the public interest identified by it and which are briefly described above.

CONCLUSIONS

21. The OFT advises you that it is or may be the case that arrangements are in progress or in contemplation which if carried into effect will result in the creation of a European relevant merger situation for the purposes of section 68(2) of the Act.
22. It appears that this transaction raises national security concerns identified by the MoD in its submission to the OFT. If you believe that as a result of this merger a European relevant merger situation will be created; the national security consideration specified in the Notice is relevant to the merger and taking account only of the national security concerns raised the merger may be expected to operate against the public interest, you can make a reference to the CC on such public interest grounds, or accept undertakings in lieu of such a reference. The MoD has prepared undertakings, to be accepted in lieu of reference to the CC, which it believes are the most effective means of remedying the national security concerns it has identified.
23. Following discussions with OFT officials, Finmeccanica, Selenia and BAES Avionics have confirmed that they are prepared to sign the attached draft undertakings. However, this does not fetter your discretion in determining whether to accept the proposed undertakings in their current form, or in a modified version, if found appropriate following public consultation.

Penny Boys
Executive Director