

5 Views of main parties

VSEL

Background

5.1. VSEL told us that it welcomed BAe's bid. It believed the future development of its business would be best secured within a large defence-orientated company. This would maximize the value of VSEL to its shareholders, provide a secure future for its employees, and satisfy the requirements of its customers.

5.2. VSEL said that it had developed this view over the years since 1989, when it started to prepare a strategic plan. The view had been much reinforced by the changes in UK defence procurement, reflecting the MoD's exercise known as 'Options for Change'. Within British Shipbuilders the role of VSEL had been restricted to supplying submarines. Having thus been obliged to withdraw from overseas and domestic markets for surface ships VSEL had lost a good deal of its standing, reputation and influence in those markets. VSEL had ceased to be considered as a natural supplier of surface warships. No export sales of ships or submarines had been secured for many years.

5.3. In 1986, when British Shipbuilders was privatized, VSEL's long-term viability appeared secure, because of the Royal Navy's large and continuing requirement for submarines. However, its security was adversely affected by a reduction in the submarine requirement, following the end of the Cold War. The company had conducted a strategic review in 1989/90, in which it identified the need to try to win a share of the surface warship programme, in the light of the MoD's cancellation of plans for further conventionally-powered submarines and deferment of nuclear-powered submarine orders. It also set out to strengthen its balance sheet so as to be able to achieve the prime contractor status that was becoming an increasingly important feature of MoD procurement. VSEL returned to surface ship construction at Barrow with a successful bid (albeit supported from reserves) for the LPH. Since 1990, it had restructured and rationalized its whole business, reducing its Barrow workforce by 9,000 people. In 1990 it had also decided to cease naval shipbuilding at its CL yard, having concluded that UK demand for naval shipbuilding would not sustain the five naval yards then operating. However, VSEL had achieved no success in export markets, and only limited diversification. Under the aegis of BAe it believed it would have greater prospect of obtaining export orders than it would if it remained independent.

5.4. [

Details omitted. See note on page iv.

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5.5. VSEL said that, in the light of changed international defence procurement requirements following the end of the Cold War, the defence industry world-wide was engaged in a process of major structural reorganization. This had been most apparent in the USA, where there had been a series of mergers (such as Northrop/Grumman and Lockheed/Martin Marietta). There was a similar trend in the European defence industry. VSEL believed the proposed merger should be seen in this context.

Public interest issues

5.6. We identified a range of public interest issues which we put to VSEL and discussed with it. VSEL's views on them are set out below.

5.7. On the effects of the proposed merger on the interests of subcontractors VSEL said that it believed a responsible prime contractor would need to maintain and support the subcontract infrastructure which existed in the industry. As a prime contractor VSEL would endeavour to maintain the loyalty of its subcontractors, whichever contract they were currently working on. It expected that whoever owned VSEL would be able to continue, as VSEL would do if it were on its own, the procedure which it currently operated of having an independent office to handle subcontracting matters where it had a potential conflict of interest. Under this procedure, sealed bids by subcontractors for MoD orders were opened in the presence of an MoD representative, who was then involved in the assessment and allocation of the subcontract.

5.8. VSEL understood that subcontractors might be concerned lest a prime contractor favoured its subsidiaries, but believed the problem was manageable by setting up such a subcontract office.

5.9. VSEL said that any company which wanted to maintain credibility within its industry had to be willing to safeguard the interests of its subcontractors, although it might not want to use them on every contract. A prime contractor would find itself isolated if it developed a relationship of distrust in which subcontractors were not willing to provide it with bids or technical information because it might be transferred to their competitors.

5.10. The B2TC design had to meet enhanced requirements, but retain as much as possible of the equipment that had been used in the first batch. In many cases that meant going back to the same suppliers, because only they were able to provide that equipment.

5.11. A most important consideration for a prime contractor was that it carried the risk of the project as a whole. The costs and liability that it could incur because of a subcontractor's defective component were such that he could not afford to take a risk with an untried component merely to achieve a small reduction in its cost.

5.12. VSEL told us that it had been unable to form a partnership with BAe on the B2TC project because BAe insisted that it should be the prime contractor and that VSEL should be a subcontractor. As an independent company VSEL had thought it unacceptable to put its core business at risk in that way. But if VSEL were owned by BAe there would be no problem: the responsibility would lie with BAe.

5.13. On whether the proposed merger would prevent, restrict or distort competition in the supply of any type of gun or armament system, VSEL said that it was in competition with BAe only in respect of a light howitzer to meet a US requirement and, on the basis of performance trials so far in the USA, it expected to win. If BAe acquired VSEL it would be likely to pursue only one product, which VSEL expected would be based largely on the VSEL design. There would be some benefit in trying to bring the best features of both into the product.

5.14. VSEL said that the 4.5 Inch Mark 8 naval gun had a most uncertain future. Unless it were chosen for the UK CNGF there would be no further business, apart from spares for guns in service. It was likely, however, that the CNGF requirement would be for a 127 mm gun and that the MoD would choose an existing US or Italian design. VSEL did not have a product in that category, and (because of the limited number that could be sold) could not justify the investment that would be required to develop it.

5.15. On the resources likely to be available to develop and support the VSEL shipbuilding and armament facilities, VSEL said that it had gone through its strategic plan with BAe. VSEL had BAe's assurance that it regarded the details of the plan as relevant to ownership under its responsibility and that it would encourage VSEL to achieve its objectives. VSEL's investment plans for its facilities were extremely limited outside the marketing and export field. It had identified a programme of investment of about £8 million that was necessary to support the LPD programme and did not believe there was any risk of BAe denying it that sum. It could be wholly justified on the benefits which VSEL would gain from the LPD and need only be proceeded with if it won the LPD contract. VSEL had not identified any other large expenditures during the next decade on its facilities.

5.16. VSEL agreed that there had been speculation that its substantial cash reserves might be of help to BAe, but it had not discussed that aspect of the bid, nor how the cash might be used. VSEL said that it could not believe BAe would be bidding for VSEL unless it had a firm commitment to continuing shipbuilding at

Barrow, and it drew attention to BAe's undertaking to the MoD (given in relation to rights attaching to the special share) to maintain VSEL's facilities for building nuclear-powered submarines.

5.17. VSEL told us that it had built up its cash reserves by managing the current order book well so that it converted profit into cash. It had an acceptable dividend policy which satisfied its shareholders, but the cover had been very high compared with other companies in the sector. VSEL decided to retain that cash rather than to use it to invest because it would be more apparent to the MoD as a support for VSEL's objective of being a prime contractor. The MoD had never told VSEL what cash reserves would be required for it to be accorded that status, but VSEL had adopted an arbitrary target of 10 per cent of the expected value of the B2TC programme as being necessary before that contract was let. VSEL had guessed that the programme would cost £3.5 billion, so the cash reserve had to reach £350 million.

5.18. VSEL said that to build its reserves up to this level it had forgone opportunities of making acquisitions of other businesses. VSEL had concluded that if diversification by acquisition were to have a significant impact on its business it would have had to be substantial. This would have been a high-risk strategy and might well have damaged VSEL's ability to achieve objectives it thought were more important.

5.19. VSEL said that, irrespective of the structure of ownership, there was overcapacity in the UK warship-building industry. But it could not believe the company that owned VSEL would not recognize that Barrow was the only place where the full range of warships could be built. If the B2TC programme were abandoned the whole scene would change. [*Details omitted. See note on page iv.*] But at present it was the only yard that could build nuclear submarines. VSEL was not aware of what innovative technology might be envisaged by the GEC team, but could not imagine any possible change which would outweigh the benefits of using the Barrow facilities. VSEL was convinced that, whoever owned it, these facilities would remain uniquely important to the building of warships for the Royal Navy.

5.20. VSEL said that its loading projections were based upon the submarine programme, with the LPD superimposed on it in the short term, and the surface ship programme involving frigates thereafter. VSEL believed that as part of a bigger organization it was more likely to be able to achieve additional work on top of the submarine programme, especially export orders, which would be a benefit not only to itself and its employees but also to the MoD, because VSEL would be able to offer its submarines at a more attractive price. For those reasons VSEL believed its future would be more secure as part of a large defence-orientated company than it would be if it remained independent.

5.21. VSEL said that it had tried to establish what minimum level of work it would need to stay in the warship-building business. The difficulty lay in establishing what the MoD would be prepared to pay for its submarines (which would have to carry a greater share of the overheads if other business were not available to VSEL). In the immediate future, it was important that VSEL won the LPD order, and (since it had been told by the MoD that competition was not feasible) it was now preparing its tender on the basis of a non-competitive bid that would be subject to the normal NAPNOC disciplines. VSEL was not so much worried about the next few years because Trident, LPD and the start of the B2TC would keep it viable until nearly the end of the decade. But VSEL was trying to secure its future for up to ten years ahead, by which time current orders for amphibious ships would have been completed. It was trying to find opportunities to win other work which would then augment its submarine business. That included building up export business.

5.22. VSEL said that it had an agreement with KG on collaboration in warship construction contracts of mixed specification. The two companies had bid successfully for the LPH, and then unsuccessfully for the OSV, which BAe had won as prime contractor. VSEL said that it had encountered some difficulties in the management of the LPH contract. The agreement with KG was of [*] duration and would come up for review [*]. The agreement was [*Details omitted. See note on page iv.*]. However, VSEL would object strongly if KG had bid independently or jointly with another party, because such a bid would inevitably involve use of expertise gained from VSEL.

5.23. VSEL said that, before the proposed merger bids were made, it had been planning to rationalize quite a large part of the Barrow facilities outside DDH.

*Details omitted. See note on page iv.

5.24. On possible employment effects of the merger, VSEL said that, if BAe succeeded in its bid, employment prospects would be improved as a result of export orders.

5.25. VSEL thought the general prospects for the security of employment of the VSEL workforce after the proposed merger would turn on obtaining export orders additional to the MoD work that VSEL was confident of continuing or securing, ie Trident, LPD and B2TC.

5.26. VSEL told us that although its workforce at Barrow had shrunk considerably in recent years (from 14,500 in 1990 to 5,800 in February 1995), it was still by far the largest employer in the town. The next largest industrial firm employed about 350 people. Such was the remoteness of the town and the poor quality of its communication links that VSEL thought there was little prospect of attracting new industry with significant employment opportunities. VSEL believed it made a vital contribution to the wellbeing of Barrow and the adjoining district, and that it was important to consider the future of the company, and the greater security which it believed the proposed merger would bring, in this context.

5.27. On the continued availability of labour, VSEL said that, if the numbers required fell to the level determined by a submarine-only programme, it could well lose skills that it would be difficult to replace: people who had left to make a change in their career or job direction would not reverse that decision, or put themselves at risk of repeated redundancy at a later date. The minimum strength in VSEL's project directorate required to maintain the nuclear submarine capability might be between one-third and one-half of its present level. Much would depend on the mix of skills. But, whatever the level proved to be, the larger question would be what activity would exist at Barrow to support the employment of these people between the Trident and B2TC programmes.

5.28. On warship-building capacity, so far as UK demand was concerned, VSEL said that the size of the industry was independent of ownership. The only potential growth in the industry was through exports, the prospects for which would be enhanced if VSEL were acquired by BAe. If there were insufficient export orders then eventually, whatever their ownership, either VSEL or YSL would have to close. VSEL was confident of its position in that event, since it could construct the whole range of vessels that the MoD might want.

5.29. On exports of warships:

- (a) VSEL developed extensively its view that its export prospects in the absence of a merger would be very limited, but that they would be much enhanced (although not ensured) if VSEL were owned by a much larger company possessing contacts with foreign governments at the highest level. BAe met this requirement. It currently spent over £40 million a year on an infrastructure to market and sell defence products. VSEL believed it could draw on this strength without BAe incurring additional costs. VSEL did not have the weight, resources or influence that larger companies could bring to bear on foreign governments.
- (b) VSEL said that DESO had helped, and continued to help, it greatly in India, the Middle East and North America, particularly in attempting to sell AS90 and the surplus Upholder class submarines (which was a prerequisite if VSEL were to secure any export orders for new non-nuclear submarines). But DESO had been less helpful to VSEL with surface ships, because VSEL was not a recognized builder. DESO, too, was required to be even-handed in representing the merits of rival UK companies to foreign buyers. This put these companies at a disadvantage to foreign competitors that had the exclusive support of their own governments.
- (c) VSEL told us that it was firmly of the view that the enhanced export potential which it believed would flow from BAe acquiring VSEL could not be achieved by collaborative export ventures. This was because of the conflicts VSEL saw between its interests and those of the company responsible for managing the supplies covered by the relevant inter-governmental Memorandum of Understanding, eg BAe for Saudi Arabia. But VSEL thought these difficulties could be resolved satisfactorily if it were under BAe's ownership.
- (d) VSEL contrasted its position with that of VT, which had not been forced to withdraw from surface shipbuilding during the time it was in British Shipbuilders' ownership. Having withdrawn from the

export markets, it was difficult for VSEL to re-enter them. In addition, VT undertook a relatively large number of small contracts at any one time, whereas VSEL had only one or two projects, each very large. The businesses of VT and VSEL were therefore very different.

5.30. On exports of other military equipment, VSEL thought BAe would be well placed to help it with land systems, because of its existing involvement with ordnance and ammunition, and its strong representation in the Middle East.

5.31. On competition in the UK for the provision of prime contracting services for the procurement of warships, VSEL believed it was now competent to act as a prime contractor over the whole range of UK warships. It was prime contractor on the LPH, and would bid to be prime contractor on the LPD and B2TC.

5.32. VSEL was confident that it would secure the B2TC contract as prime contractor, and submarine contracts thereafter. It thought it was uniquely and strategically important to the UK, since it was the only yard capable of building nuclear-powered submarines and large warships. Its confidence reflected its track record over the last 30 years of building nuclear-powered submarines of various classes for the Royal Navy, culminating in the Trident programme. It believed it had built up an extraordinarily good reputation for quality, for timeliness and for cost-effectiveness.

5.33. VSEL believed the proposed merger would enhance its competitive position by bringing to bear BAe's experience in managing major defence contracts in other sectors which, although different, would nevertheless be relevant to a prime contractor role for surface warships.

5.34. On operating efficiencies, VSEL said that there would be benefits for it in not having to carry the burden of being an independent company, for example in satisfying the City and other institutions. Being part of a naval systems division, rather than an independent company, would bring some savings. VSEL was not aware of any dramatic effects on the efficiency of its operation that would arise from acquisition by BAe.

BAe

Background

5.35. BAe said that its acquisition of VSEL would enable it to establish itself as a naval prime contractor of a capability that would allow it to compete against GEC for future naval contracts. BAe believed it was the MoD's policy, and in the national interest, to promote competition in this way; that competition was superior to consolidation not only in itself, but because the MoD was not in a position to exercise fully effective countervailing power against a single dominant and vertically integrated supplier; and that we should conclude that the UK's national security, defence capabilities, and economic development generally would be well served by permitting BAe to go ahead with its planned merger with VSEL.

5.36. Developing this view in more detail, BAe told us that a merger between it and VSEL offered the only realistic prospect of ensuring future competition in major warship prime contracting in the UK. It believed that:

- (a) neither BAe nor VSEL separately provided a viable challenge to GEC's potential position as the major UK naval prime contractor and dominant supplier of UK naval equipment and systems;
- (b) a merger between BAe and VSEL would provide major benefits to the UK, in particular in relation to enhanced competition and export potential, as well as benefits to both businesses; and
- (c) no adverse public interest effects were attributable to the proposed merger; in particular, the merger posed no threat to UK national security, to the maintenance of the UK's defence industrial capabilities or to the effectiveness of competition in the defence sector generally.

BAe therefore believed a merger between BAe and VSEL would be positively in the UK public interest.

5.37. BAe had hoped that its joint venture with SEMA, in combination with its systems integration and prime contracting skills, developed in particular in the aircraft sector, could enable it to compete successfully

in naval prime contracting. But that had not been borne out in practice. It was evident that a company with practical experience of shipbuilding commanded much greater credibility with the customer as a prospective naval prime contractor, and it was commercially unattractive to engage in naval prime contracting without being able to spread the risk over the hull construction contract or a substantial proportion of other naval equipment supplied for the project.

5.38. In the case of the B2TC VSEL had not been willing to team with BAe for the prime contract. BAe said that it had not fully understood then, but understood more clearly now, that VSEL's objections lay in the fact that whichever company controlled and applied the prime contractor's skills ultimately controlled the whole product programme and hence, in the B2TC case, would have controlled VSEL. VSEL was content that this should be so if BAe owned it, but not if BAe's status was that of a partner in the B2TC programme.

5.39. Against this background BAe had decided during 1992 that it needed a shipbuilding operation, and it had considered a proposal to merge VSEL, BAe's naval interests (including BAeSEMA) and GEC's naval interests (with or without VSEL's and BAe's land defence interests). But this would have reduced competition, which BAe believed would have been unacceptable.

5.40. BAe had therefore investigated the practicability and desirability of buying VSEL. The only overlap between the two companies was in land systems, which BAe believed raised no significant public interest issues. VSEL's limitations, which BAe could redress, were in systems integration expertise and in the scale of prime contracting and project management resources that were necessary for a project such as B2TC. This skill of systems integration was the core of BAe's business; it was of general application, and was central to the whole conduct of a programme.

5.41. BAe said that at present only one UK company-GEC-Marconi Naval Systems-had the potential capability to undertake the naval prime contracting role for major projects. If BAe were to enter the market it needed to acquire a company with shipbuilding capability to complement BAe's prime contractorship skills. VSEL was the only UK company with this capability, GEC apart.

5.42. BAe said that it could not contemplate incurring the risks or the costs-typically £[*] million to £[*] million-entailed in approaching the B2TC prime contractorship by the route adopted by GEC, putting together a team to bid, but without an appropriate hull-building capacity. There was room for more than one view of the credibility of GEC's bid, but it was probably credible enough to have an economic impact on the competition.

5.43. BAe believed competition in naval prime contracting would be advantageous to the customer in promoting improved cost-effectiveness and price performance. In its defence business it had never engaged in predatory pricing and it had no intention of starting to do so if it acquired VSEL. Predatory pricing would be a commercially irrational strategy in view of the speculative, long-term and uncertain nature of any advantage which might be achieved.

5.44. BAe thought, too, that its proposed merger with VSEL would realize important industrial synergies, in addition to the financial synergies deriving from BAe's tax position.

5.45. BAe said that the financial benefits that would accrue to it from the merger were welcome, but in no sense necessary. BAe's balance sheet would be strengthened and its tax losses would cover the whole of VSEL's pre-tax profits.

Public interest issues

5.46. We identified a range of public interest issues which we put to BAe and discussed with it. BAe's views on them are summarized below.

5.47. On the issue of whether the proposed merger, when taken with changes in MoD procurement policy, would prevent, restrict or distort competition between suppliers of defence services, systems or equipment by enabling BAe to favour its subsidiaries or associates in either the purchase or supply of such items, BAe said

*Figures omitted. See note on page iv.

that it would engage in no such favouritism. To do so would damage BAe's reputation as a prime contractor, which was more important to it than any short-term gain from the supply of equipment. Such favouritism would not in any event be possible to any significant extent in view of BAe's lack of equipment interests.

5.48. [*Details omitted. See note on page iv.*

] It should not be supposed that the combat management system would automatically go to BAeSEMA or that BAe would necessarily have any control over the matter. BAe would expect the MoD either to approve BAeSEMA's combat management system, for reasons of commonality with the Trident submarines, or to insist on the subcontract being put out to competition.

5.49. BAe said that VSEL's LPH contract presented no difficulties, because KG's share of the work was largely complete and there would be firm VSEL commitments to the other subcontractors that could not sensibly be changed at this stage.

5.50. BAe said that as a member of the team for the UK first-of-class ship in the CNGF project it would be a major subcontractor and so could reasonably look for subcontract work for the UK follow-on orders. [

Details omitted. See note on page iv.

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5.51. If VSEL secured orders for the last batch of Type 23 frigates there would be no loss of competition at the subcontract level. Such orders were likely to be 'build to print', with the principal items of equipment being approved by the MoD for reasons of commonality with the existing Type 23 frigates. These items would include the vertical-launch Seawolf guided weapon system and BAeSEMA's combat management system. There was little equipment other than this that BAe would be in a position to supply for the Type 23 frigates.

5.52. BAe said that in areas where there were sufficient bidders the MoD competition regime worked effectively. But much depended on the prime contractor and the extent of its vertical integration. It was in the nature of prime contractorship that the prime contractor could adopt specifications that promoted its own interests, but it would be most unwise to do so. An unblemished reputation was essential, not least in export markets. A prime contractor had to be neutral and dispassionate, and avoid any impression of seeking advantage for its own business. BAe said that it conducted tender procedures for subcontracts under strict rules to ensure their integrity and fairness.

5.53. On the issue of whether the proposed merger, when taken with changes in MoD procurement policy, would prevent, restrict or distort competition between suppliers of defence services, systems or equipment by giving BAe access to intellectual property including expertise or to other relevant technical or financial information belonging to the actual or potential competitors of such subsidiaries or associates, BAe said that if a prime contractor was dealing with an equipment supplier which had been selected in preference to a subsidiary of the prime contractor, it was inevitable that the equipment supplier would be wary about the access that it gave the prime contractor, since the prime contractor's subsidiary was a competitor. This was a common problem. It did not mean that a firm that had subsidiaries should never be a prime contractor, although it had to be clear what its objectives were. In BAe's case, this was not an issue, in view of its lack of vertical integration and strict tender procedures.

5.54. On the issue of whether the proposed merger would prevent, restrict or distort competition in the provision of any type of gun or armament system, [*Details omitted. See note on page iv.*

]: its armaments interests lay in the RO business it had acquired from the MoD. When it acquired that business it was aware that extensive rationalization was required. The workforce had now been reduced to about one-quarter of its pre-acquisition level. About 60 per cent of RO's business was with the MoD. The business was now in a satisfactory condition.

5.55. BAe did not believe its acquisition of VSEL would lead to any loss of competition in gun systems technology. RO would remain the only UK producer of gun barrels and breeches. There was no existing MoD requirement for which BAe and VSEL were in competition with each other, and any that arose would probably be subject to competition from other UK or overseas suppliers.

5.56. BAe said that any rationalization that it undertook would not prejudice the existing support arrangements for the Mark 8 4.5 Inch naval gun.

5.57. On the issue of whether the proposed merger between BAe and VSEL would have adverse effects on the actual or potential supply of defence equipment in the UK by reducing the resources available to develop and support the VSEL shipbuilding and armament facilities, BAe said that there would be no such adverse effects. On the contrary, its support for VSEL would come in a multiplicity of ways: exploiting the marketing and selling process; investing in VSEL's surface shipbuilding capabilities, such as slipways; and using BAeSEMA's design skills, through YARD, to ensure that the VSEL business could be positioned to achieve export contracts.

5.58. BAe thought the investment required by VSEL for surface ship business was relatively modest: the provision in the business plan was about £[*] million for plant facilities, although more would be needed in bidding for new programmes. BAe had an extensive existing export infrastructure (reflecting about £3.7 billion of turnover in defence exports in 1994) and any additional expenditure for naval purposes would be slight. There was a wide range of advanced technology in use in BAe (particularly rapid prototyping) that was relevant even in financially difficult times, and could be applied, to the benefit of VSEL. BAe added that it had had a good record of providing funds for investment that it thought necessary.

5.59. On the issue of whether the proposed merger between BAe and VSEL would have adverse effects on the actual or potential supply of defence equipment in the UK by VSEL becoming part of an organization whose financial strength and long-term viability had been questioned, BAe said that its current five-year plan was robust, and without serious balance sheet constraints (reflecting the disposal of the Rover shareholding and the intent to establish the joint venture in regional aircraft). This was reconfirmed by the signing on 24 March 1995 of a new financing for BAe on strong single A credit terms. BAe said that the Defence business continued to strengthen, with the Al Yamamah programme providing a stable base and [Details omitted. See note on page iv.]. The restructuring of the regional aircraft business into a joint venture would entail net expenditure of some £150 million, but was a further significant action towards resolution of the long-term issues inherent in the regional aircraft business.

5.60. [Details omitted. See note on page iv.]

5.61. BAe said, too, that there was scope for annual savings in operating costs at VSEL, accruing from improved performance and cost savings.

5.62. On the issue of whether the proposed merger would have adverse effects on employment, including the continued availability of labour with relevant skills, in the Furness or Clyde areas, BAe said that, based on its analysis of the available MoD and export workload, and taking into account existing rationalization plans, it believed both VSEL and YSL could maintain employment until the end of the decade at about [*] per cent of currently planned levels. Additional employment would result if either yard secured export work. It did not expect that there would be problems in the availability of relevant skills.

5.63. [Details omitted. See note on page iv.]

] In summary, BAe thought the employment levels currently envisaged at VSEL for the next few years were acceptable.

5.64. BAe said that several trade and technical programmes within VSEL had been suspended or discontinued but BAe attached substantial importance to the continuing recruitment and training of young

*Figure omitted. See note on page iv.

*Details omitted. See note on page iv.

people. BAe would plan to implement its own recruitment and training policy at VSEL because (although the numbers involved were small) it believed it was strategically important to adopt this course, even in the face of financial pressures.

5.65. On the issue of whether the merger might be expected to have any adverse or beneficial effects on UK warship-building capacity, BAe said it did not accept that there was unsustainable overcapacity in UK warship-building or that the MoD's forward programme was insufficient to maintain the VSEL and YSL yards: it thought the programme would suffice for both yards to remain viable at least into the next century, even without further exports.

5.66. The capacity of warship yards was difficult to define; economic viability was a more appropriate concept. BAe believed the VSEL and YSL yards would be capable of remaining viable well into the next century on the basis of a small number of export orders on top of the Royal Navy's forward programme. BAe believed GEC's willingness to keep YSL open for the next seven years indicated that it shared BAe's view that the viability of YSL and VSEL was not a problem during that period. It believed, too, that VT would have ample work until at least the end of the decade.

5.67. In summary, BAe could see a good, firm, base workload for at least the next seven or eight years which, even without export sales, would sustain activity at YSL and VSEL at economically viable levels. A limited amount of export sales could sustain both yards under independent ownership well into the next century.

5.68. BAe said that if VSEL were in its ownership it would expect VSEL's relationship with KG to continue, providing the existing arrangements (which applied to the LPH) were discharged to the satisfaction of both parties. But BAe thought there would be limited scope for the application of civil standards of hull construction to the bulk of the MoD's requirements for major warships, such as aircraft carriers, frigates and submarines.

5.69. On the issue of whether the merger might be expected to have any beneficial or adverse effects on UK exports of warships or other military equipment, BAe said that the merger would have highly beneficial effects. BAe had had for many years direct access to the key decision-makers in defence procurement in many foreign governments. [

Details omitted. See note on page iv.

] This enabled BAe to supply new equipment for new generations of purchasers predisposed in favour of British equipment. In parallel with this, BAe put great effort into promoting political contacts at the most senior levels.

5.70. BAe said that a marketing campaign could take [*] from commencement to closing a sale. Relatively little additional investment would be required to make available the whole of BAe's existing marketing infrastructure and customer base to VSEL. Marketing in this way meant creating opportunities to sell: the sales followed afterwards, but necessarily took years to achieve. Thus, naval export sales by VSEL might not materialize for [*] years or more, although it was possible that the acquisition of VSEL could enable BAe to secure an order quite quickly if it identified a requirement that needed to be met in the near future. More immediate prospects might exist for sales of land systems.

5.71. BAe thought VSEL's important products for export would be non-nuclear submarines and surface warships. The most promising markets were in the Middle and Far East.

5.72. BAe said that a large part of its sales organization was dedicated to making procurement financially possible for the prospective customer, for example through arranging offsetting commodity sales, such as oil or crops. Only a major company, such as BAe, could undertake this task.

5.73. BAe believed foreign customers were seeking flexibility in the warships and equipment they were offered, rather than accepting vessels in the precise form specified by a particular navy for its own requirements.

5.74. BAe said that the core of its business was systems engineering and integration. The skills involved were equally applicable to a range of defence platforms. BAe's existing systems engineering and integration

expertise had been developed principally through its aircraft activities, but its skills were transferable to the naval sector and offered opportunities for the development of BAe's business in this area.

5.75. On the issue of whether the merger might be expected to have any beneficial or adverse effects on competition in the UK for the provision of prime contracting services for the procurement of warships, BAe said that prime contracting for a first-of-class order was more complex than, and of a different nature from, prime contracting for follow-on orders. GEC was at present the only major UK defence group with a potential prime contracting capability for large first-of-class warships and BAe found it difficult to see any UK competitor emerging, other than itself by the acquisition of VSEL. The customer was far more comfortable with a prime contractor that was also a platform constructor. VSEL did not possess the technical or financial resources to act as a prime contractor in relation to a range of major warships: for the B2TC it had to rely heavily on Loral ASIC, drawing on its US staff at substantial expense. For certain follow-on orders, VSEL and VT might be competitors, the technological and commercial demands being less onerous.

5.76. BAe thought it was essential to increase the UK's naval prime contracting capability to ensure the existence of competition. It believed its merger with VSEL should be allowed to proceed to enable it to take up this role.

5.77. BAe said that there was room for two competing naval prime contractors owning major warship yards at least for the next seven years. Whether this was sustainable thereafter would depend upon the volume of MoD demand for major warships, and the extent to which either or both of the two prime contractors were successful in the export market. It was too early to make predictions about the longer term.

5.78. On the issue of whether the merger might be expected to have any beneficial or adverse effects on operating efficiencies of either party, BAe said that it believed there would be highly beneficial effects resulting from the application to VSEL of the prime contracting and business management disciplines it had applied to itself over the last five or six years. For example, the business planning process was not limited to strategic issues: it extended to all levels of BAe. Application of these disciplines had resulted in BAe reducing its cost base by £[*] million.

5.79. [*Details omitted. See note on page iv.*]

5.80. On the land systems side, BAe said that it had no preconceived ideas of what operating efficiencies might be secured. If there had been immediately obvious ways of securing savings they would have been identified in preparing the financial case, but there had been none.

Possible remedies

5.81. We identified five possible remedies which we put to BAe and discussed with it on a hypothetical basis. BAe's views on them are set out below.

5.82. On a measure under which BAe would not reduce (except in negotiations initiated by the MoD) the tender price prepared by VSEL for the order for the last batch of Type 23 frigates, BAe said that it would have no difficulty in providing an undertaking to that effect. Indeed, if the VSEL price were uneconomic, BAe might wish to raise it, since it would seek a return on the capital employed. This was not because it wished to acquire VSEL: it was the course it would follow in any event in accordance with its normal contracting procedures. BAe emphasized, however, that there was no evidence to suggest that it would engage in predatory pricing and that a recommendation that such an undertaking be sought would be entirely unnecessary.

5.83. On measures under which BAe would divest all or part of BAe's armaments business, BAe said that if its ownership of VSEL's armaments business was seen as an obstacle to its acquiring VSEL it would be willing to make an immediate commitment to the Government to sell the business within a specified time.

*Figures omitted. See note on page iv.

5.84. BAe said that its discussions with GIAT, the French armaments group, about heavy artillery, small arms and ammunition, would be unlikely to reach a conclusion before [*], and quite possibly later. It followed that these discussions would not have any early effect on what happened to BAe's armaments business if it acquired VSEL.

5.85. On measures under which BAe would maintain all or part of VSEL's armament capability at Barrow, BAe said that it had no preconceived ideas on whether VSEL's current armaments activity should be moved away but, if an assurance that it would stay was required, BAe would have no difficulty in giving it, provided the activity was economically viable.

5.86. On measures under which BAe as a warship prime contractor would maintain specified procedures to ensure competitive tendering by subcontractors for systems and subsystems, BAe said that it had well-established, and well-documented, procedures, applying to all its procurement activities, that ensured they were carried out on a competitive basis and in a manner yielding the best value for money consistent with the risks entailed. BAe saw no reason why this regime should be changed, and believed the MoD was satisfied with it.

5.87. BAe said that its subsidiaries' equipment was not given preference over that of other manufacturers: suitability and value for money, determined by competition, were the criteria. It was in BAe's own interests as a prime contractor that this should be so.

5.88. BAe did not believe it would be feasible for the MoD to monitor effectively an undertaking requiring BAe to maintain specified competitive tendering procedures: the best safeguard lay in BAe's compelling need to apply them, coupled with the fact that its skills lay in prime contracting, not in the production of equipment for which it had to find an outlet.

5.89. On a measure under which BAe would not unreasonably refuse to make VSEL's submarine-building facilities available to any prime contractor that sought to use them, BAe said that if it owned VSEL, and the GEC team had been awarded the B2TC contract, it would want to maximize the utilization of the VSEL submarine facilities. So, far from obstructing the GEC team, BAe would welcome the work being placed with VSEL. The same would be true of any proposal to use VSEL facilities that otherwise would be under-utilized or not used at all. It followed that BAe would have no difficulty in principle in giving an appropriate undertaking, providing it could be drafted satisfactorily, although BAe emphasized that it would be otiose.

Undertakings

5.90. On the question of whether in principle an undertaking furnished a satisfactory safeguard of the public interest that we might recommend as a remedial measure, BAe said that it was much better to rely on not creating the ability to do things against the public interest than to rely on undertakings by parties. This was so particularly where the commercial interests of the party giving the undertaking would lead it to wish to act in a manner contrary to that prescribed by the undertaking. An undertaking was satisfactory only when it related to a discrete issue which could readily and conclusively be remedied within a relatively short period. This avoided the problems associated with monitoring undertakings over a protracted period.

Merger intentions

5.91. BAe formally confirmed that if, following our inquiry, it was cleared to bid again for VSEL it was its present intention (on 21 February 1995) to do so unless some development were to occur, which had not then occurred, which would render it nugatory to make a bid.

5.92. BAe said that in late 1992 it had had informal discussions with GEC about a merger of all or part of their defence interests. Exchanges of sensitive information were covered by a confidentiality agreement that also contained provisions which precluded GEC and BAe from buying each other's shares before 30 June 1995. The discussions had been broken off following a newspaper report.

*Details omitted. See note on page iv.

5.93. Quite separately, during 1993, BAe and GEC had discussed the feasibility of a joint venture combining the sea, and possibly the land, systems of BAe, GEC and VSEL. The discussions did not go to BAe's main Board because those concerned believed the proposals would be unacceptable to the MoD on competition grounds.

5.94. BAe said that, during the period when it was considering making an offer for VSEL, GEC clearly indicated that it had no desire to make an offer for VSEL itself. However, BAe met GEC on 7 October 1994 following its announcement on 4 October that it was in discussion with VSEL. GEC suggested at that meeting that BAe and GEC should consider a joint offer for VSEL. A further meeting took place on 18 October, when GEC made a definitive proposal for a joint venture in naval systems which would include the whole of VSEL. This proposal was considered, and rejected, by BAe's Board on 25 October, and that decision was reaffirmed on 1 December.