The General Electric Company plc
and
VSEL plc

A report on the proposed merger

MONOPOLIES AND MERGERS COMMISSION

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A report on the proposed merger

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

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

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Mr A J Nieduszynski *(Secretary)*

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

Note by the Department of Trade and Industry

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

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Part I

Summary and Conclusions

1 Summary

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

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

1.3. GEC, with total sales in 1994 of £9.5 billion, is a major supplier of defence electronics, including weapons systems and other equipment for warships. It owns Yarrow Shipbuilders Ltd (YSL) on the Clyde, currently building three Type 23 frigates for the Royal Navy and two smaller frigates for export.

1.4. The proposed merger, therefore, would bring together two of the remaining three warship-building yards in the UK under the ownership of a major supplier of warship equipment. The other yard is Vosper Thornycroft (UK) Limited (VT), at Southampton, which currently is building small warships for export and glass reinforced plastic (GRP) minehunters for the Royal Navy.

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

1.6. The modern warship is a platform on which a range of weapons and support systems, usually provided by subcontractors, has to be integrated. Until recently the MoD has designed the ship, procured some of the main systems and supplied them to the shipbuilder for installation. As part of its overhaul of naval procurement to introduce greater competitiveness and value for money the MoD now seeks to appoint a prime contractor for its warship orders, responsible for procuring and integrating all systems included in the contract, guaranteeing their performance and providing continuing support. This prime contractor is usually, but not always, the owner of a shipyard.

1.7. The main warships in the Royal Navy's forward programme are a final batch of three Type 23 frigates; up to five nuclear attack submarines (the Batch Two Trafalgar class (B2TC)); and 12 new frigates (the Common New Generation Frigate (CNGF), or Project Horizon, being developed as a UK/French/Italian joint venture). Tenders have been invited for the Type 23s and three of the B2TCs. VSEL is expected to bid for both, with competition expected from YSL and VT for the Type 23s and from a team led by GEC using innovative construction methods for the B2TC. From 2005 onwards there may be replacements for aircraft carriers and nuclear attack submarines. We looked at the effects of the proposed merger on the supply of prime contracting and of shipbuilding facilities in relation to all these prospective orders.

1.8. VSEL, besides being a shipbuilder, is potentially a prime contractor for all prospective MoD warship orders, as is GEC. For the B2TC order the proposed merger would bring the only two bidders into common ownership, and for other forthcoming orders it would reduce from three to two the number of prime contractors likely to compete. By placing the VSEL shipbuilding facilities under the control of a company which is already the owner of a shipyard as well as a substantial equipment and systems supplier, it would make it more difficult for other prime contractors to compete for future orders. We recognize the various means open to the MoD to obtain value for money where effective competition is not available. The MoD has accepted, however, that these cannot fully replace the pressures to reduce prices and to innovate which are created by competition between prime contractors.

1.9. We conclude that adverse effects from this loss of competition can be expected on the B2TC and the CNGF contracts, with the MoD paying higher prices than if the proposed merger had not taken place. Since the defence budget is constrained, less equipment would be bought. These contracts are expected to be for such large sums (together amounting to several billion pounds) that even a small percentage increase in the tender price would impose substantial additional costs for the MoD. The loss of competition would also reduce suppliers' incentive to seek new solutions and hence a loss of technical design and production improvements. Both consequences would result in a reduction in UK defence resources, which would be against the public interest.

1.10. We examined the effect of the proposed merger on the supply of warship systems by subcontractors. The MoD is withdrawing from detailed supervision of subcontracting arrangements for prime contracts let competitively. Even on single tender contracts, where the MoD retains close oversight, the transfer of risk from the MoD to the prime contractor means that it is the prime contractor that must have responsibility for final choices. GEC subsidiaries are major suppliers of systems and equipment as subcontractors. Other suppliers told us that they feared GEC as a prime contractor would favour its subsidiaries, particularly in specifying the requirements. When these contracts are for a first-of-class ship the prime contractor is particularly able to exercise its discretion over design and choice in ways which may give it an advantage in relation to that contract and to follow-on orders.

1.11. We therefore examined current competition to supply the main warship systems and the potential ability of GEC companies to supply systems and equipment for prospective MoD contracts that GEC might acquire as a result of the proposed merger. We concluded that we would expect that in due course the MoD would obtain poorer value for money on certain major orders and that some potential subcontractors would be discouraged from competing. This can be expected to result in a narrower range of choice and in higher prices for some equipment. Both detriments would reduce the resources applied to UK defence, which would be against the public interest.

1.12. VSEL supplies naval guns and artillery. GEC has no current interest in the supply of such products although it produces some supporting software programs. We identified no adverse effects from the proposed merger in this area.

1.13. We considered whether there were benefits from the proposed merger, in particular in encouraging exports or in assisting rationalization of the UK shipbuilding industry, that might offset the detriments we had identified. Access for VSEL to the full range of GEC's export marketing and sales support could strengthen it in competing for orders. However, the export market for warships is difficult. Foreign warship-builders are also looking for export orders to offset declines in their domestic demand, and potential foreign buyers are increasingly setting up their own yards. We think it uncertain how far export orders would be secured.

1.14. We identified some limited benefits arising from the proposed merger in the pooling of facilities and possible efficiency gains for VSEL from the transfer of expertise. But retaining the pressure of competition between prime contractors would be even more effective in promoting change and securing value for money. We noted the arguments that further rationalization of the UK warship-building capability, ie closure of one or more yards, may be necessary, but we do not think this is likely to happen over the next few years, whether or not the merger takes place. Closure is likely to be determined by other factors, in particular how the MoD contracts are awarded and whether any yards succeed in winning overseas orders. We see no reason to sacrifice the benefits of competition now in the hope that, if the merger were allowed to proceed, there would then be possible benefits from rationalization by the merged company. If there were financial benefits for the industry and the MoD from such a closure we would expect most of them still to be available if the yard to be closed was independently owned.

1.15. In summary, we do not think that the potential benefits outweigh the detriments we have identified. We conclude that the proposed merger may be expected to operate against the public interest.

1.16. We examined possible undertakings to remedy any detriments we have identified, in particular an offer by GEC to keep separate the two teams (currently led by VSEL and GEC) bidding for the B2TC contract. But we did not think this would remedy the loss of competition between prime contractors for this contract. We were unable to identify any other remedies for the adverse effects we had identified arising from the loss of competition for the warship contracts. We also considered whether undertakings could be framed to ensure competition between subcontractors where a GEC subsidiary might be bidding. But this would entail extensive monitoring by the MoD and run counter to its policy of withdrawal from close surveillance of prime contracts. We also thought such monitoring would not meet all the potential problems. The nature of the detriments we have identified is essentially structural and in this case undertakings relating to conduct cannot adequately remedy them.

1.17. As we are unable to identify any appropriate remedies for the detriments we have identified we recommend that the proposed merger should not be allowed to proceed.

1.18. Two members of the Group, Sir Archibald Forster and Professor A P L Minford, dissent from our conclusions. They argue that in the face of sharply declining orders for warships the industry will almost certainly be further rationalized and that the MoD is well-placed as a long-lived buyer with an effective monopsony to extract value for money from it; the key contracts in the near term are all in the process of being settled, independently of the merger; after that, rationalization will be needed regardless of VSEL's ownership, and the merger is unlikely to affect competition (and may facilitate rationalization); in subcontracting competitions that it runs as a prime contractor GEC has strong commercial incentives not to give its subsidiaries an unfair advantage.