

5 Views of main parties

VSEL

Background

5.1. VSEL told us that it welcomed GEC'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, in view 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 GEC it believed it would have greater prospect of obtaining export orders than it would if it remained independent. There could also be greater opportunities for utilization of its engineering manufacturing facilities.

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 actual or potential competition in the supply of warships, and on the provision of prime contractor services for warships, VSEL said that it 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 (teamed with Loral ASIC) on the B2TC.

5.8. VSEL was confident that it would secure the B2TC contract, 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. Nevertheless, VSEL thought it was extremely improbable and politically inconceivable that the Government, in order to ensure the preservation of VSEL, would be prepared to pay higher prices for its products than could be justified commercially. If it was to submit affordable prices for the vessels in the categories it was offering it would have to win additional naval construction work. This would enable it to use its facilities more fully and to spread the recovery of its overheads over more projects. The only credible source of such additional work (in addition to the LPH and LPD programme) was the Royal Navy's frigate programme and the possible export of vessels of that kind. This was where the GEC merger was most relevant.

5.9. VSEL's confidence that it would secure the B2TC contract 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. It believed it was best able to judge the requirements of the Royal Navy and convert them into a design which would meet them. VSEL doubted whether there was credible competition for B2TC submarines at the present time. It did not believe anyone would think of building the B2TC vessels in the UK without using Barrow's excellent facilities. VSEL thought it inconceivable that a competing facility, costing £300 million, could be justified for such a small programme.

5.10. VSEL recognized that the MoD was seeking a fresh approach to some of the technical problems involved in the design and construction of the B2TC class, and hoping that competition would stimulate the prospective bidders. VSEL had accepted this challenge. [

Details omitted. See note on page iv.

] It would include costed options in its tender which the MoD could select or reject so that ultimately VSEL could offer the most operationally acceptable submarine at the best possible price. It was at that stage, rather than during the competitive process itself, that VSEL believed pressure would be applied by the MoD to make sure that VSEL's price was affordable.

5.11. VSEL's initial price offer for the B2TC had not yet been set. It would be dependent *inter alia* on whether it was confident of securing orders for surface ships, which could carry a share of the yard's overheads and fixed costs. [

Details omitted.

See note on page iv.

] (The tender for Type 23 had to be submitted by 13 June 1995, having been extended from 21 March. The B2TC tender was not required until 29 June.) So far VSEL had been able, in general, to maintain the overhead rate at the same level by cutting indirect costs at least at the same rate as direct costs. But a point would be reached where VSEL could go no lower because of its fixed costs.

5.12. VSEL said that for Type 23 and future CNGF tenders it believed it could offer cost-competitive solutions. It was able to do so because, although the facilities in Barrow had been built for submarines, they were just as suitable for constructing frigates. VSEL said, however, that if it was to have any chance of winning the next batch of Type 23 orders, against a competitor already well along the learning curve, it would have to use some of its reserves. There would be no point in bidding otherwise. But this was a view reached by VSEL as an independent company; there had been no discussions of tenders with either of the prospective owners.

5.13. In the case of CNGF VSEL believed it would have a marked advantage over any shipyard which built ships on an inclined slipway. This was because CNGF would be designed to be built in a wide variety of facilities, owned by YSL, Direction de Construction Navale (France) and Fincantieri (Italy). VSEL believed that France (which was closely engaged in the design work) would want to build its ships in a manner similar to that appropriate for VSEL's DDH and so would want CNGF designed to be built in blocks weighing up to approximately 1,500 tonnes each. All the equipment would be installed and commissioned in these blocks, before assembly as a complete hull. VSEL thought it impossible for YSL to do that. So if CNGF were designed to meet this French requirement VSEL believed it would be able to build the UK ships more cost-effectively at Barrow than would be possible at a shipyard which built its ships on an inclined slipway. VSEL had, therefore, urged the MoD to pursue the same policy on the placing of the CNGF follow-on contracts as it had adopted for the first two Type 23s (when it had allocated one to YSL and one to SH) so that two parties (ie YSL and VSEL) would be able to compete on equal terms for the subsequent build.

5.14. VSEL told us that it had thought about whether GEC might wish to amend tenders that had been submitted by VSEL before the ownership question was resolved. It believed that, if GEC were to acquire VSEL, GEC and the MoD would engage in post-tender negotiations on the LPD and B2TC, and possibly on the Type 23. In the course of due diligence inquiries in late 1994 VSEL had refused to give GEC any information about its tender preparations for the B2TC and the LPD.

5.15. VSEL told us that it did not believe the proposed merger with GEC would materially reduce actual or potential competition in the supply of warships. VSEL's yard was the only one in the UK big enough to handle the construction of warships over 6,000 tonnes displacement. The acquisition of VSEL by GEC would therefore have no impact on the market for large warships. As far as frigates were concerned, VSEL said:

- (a) supply in the UK was to a single customer, the MoD, which, in VSEL's opinion, should be able to counteract any increase in selling power which the merged company might be thought to have;
- (b) the MoD would in any event still have VT available to it as a potential supplier;
- (c) the Government seemed increasingly willing to procure defence equipment from other EC countries, and the development of the CNGF, built to a common trinational design, would widen competition to French and Italian yards;
- (d) the level of demand for frigates in the UK was insufficient to sustain three independent yards by the end of the decade unless there was a significant increase in exports; and
- (e) the merged company would be better able to compete effectively in world markets. It was more likely to attract a greater volume of business to the UK than would be the case if GEC and VSEL were attempting to compete against each other in the already competitive world market-place.

Subcontracting

5.16. 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 there was a potential conflict of interest with an in-house source. Under this procedure, tenders by subcontractors in respect of MoD orders were made on a 'sealed bids' basis, the bids being opened in the presence of an MoD representative, who was then involved in the assessment and allocation of the subcontract.

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

5.18. 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 where subcontractors were not willing to provide it with bids or technical information because it might be transferred to their competitors.

5.19. In the case of the B2TC the requirement was to have a design of submarine meeting enhanced requirements, but retaining as much Batch 1 equipment as possible. That meant going back to the same suppliers because in many cases they were uniquely able to provide the equipment. GEC turbines and condensers had been used in every nuclear-powered submarine that VSEL had built, [*Details omitted. See note on page iv.*]. A brief analysis of the prospective B2TC subcontractors suggested that, in respect of about one-half of the equipment GEC could supply, it was effectively the only potential source. The potential problems arising from the merger, therefore, would not be all that great. VSEL thought there were perhaps six to ten firms which might have concerns about subcontracting that VSEL would hope could be alleviated by continuing the subcontracting arrangements which had worked effectively on Trident.

5.20. 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 it could not afford to take a risk with an untried component merely to achieve a small reduction in its cost.

Resources

5.21. On the resources likely to be available to develop and support the VSEL shipbuilding and armaments facilities after a merger, VSEL told us that it had no reason to doubt that, if GEC proceeded with its bid, it would support VSEL's business objectives. In the negotiations and discussions that VSEL had had with GEC before the bid was referred to us it was assured that GEC would be committed to developing those business objectives. VSEL was convinced that GEC would remain committed to its products and to Barrow as a location in which to produce them. VSEL also noted that GEC had given the MoD certain assurances.

5.22. VSEL had gone through its strategic plan with GEC. VSEL had GEC'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. VSEL had identified a programme of investment of about £8 million that was necessary to support the LPD programme. This could be wholly justified on the benefits which VSEL would gain from the LPD as a result and would be required only if it won the LPD contract. VSEL had not identified any other large expenditures on its facilities during the next decade.

5.23. 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 it had to reach £350 million.

5.24. 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.

5.25. 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 whole 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-powered 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, it would remain uniquely important to the building of warships for the Royal Navy.

5.26. 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 the company 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.

5.27. 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 subject to the normal NAPNOC disciplines. It 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.

5.28. 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 LPH and unsuccessfully for the OSV. VSEL said that it had encountered some difficulties in the management of the LPH contract but it did not believe there was any reason why GEC should wish it to adopt a different arrangement for future larger ship contracts. 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 have objected strongly if KG had bid independently or jointly with another party, because such a bid would inevitably involve use of expertise gained from VSEL.

5.29. VSEL said that, before the GEC and BAe bids were made, it had been planning to rationalize quite a large part of the facilities outside DDH, but that the GEC bid had the advantage that it gave a greater chance of using part of those facilities, perhaps for commercial work. VSEL expected GEC to support its armament business and facilities and believed GEC ownership would marginally improve the prospects of the business. VSEL also drew attention to its own prime contractor role for the AS90 self-propelled howitzer as an indication of its strength in this area.

5.30. On possible employment effects of the merger, VSEL said that it had received assurances from GEC, when it made its bid, that employment at Barrow would not suffer because of the acquisition. But this did not guarantee that there would be no redundancies there, and the assurance could not be exactly quantified.

5.31. VSEL said that if GEC bought it and then closed YSL, transferring all YSL's work to VSEL, VSEL would benefit from the increased throughput. But the jobs lost at YSL would not be fully replicated at VSEL: roughly the same number of direct workers would be needed, but there would be fewer indirect workers employed at Barrow, because of the saving of duplicated overheads. [*Details omitted. See note on page iv.*]

*Details omitted. See note on page iv.

5.32. 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.

5.33. 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 its poor 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 well-being 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.

5.34. 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.

5.35. 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 for growth in the industry was through exports, the prospects for which would be enhanced if VSEL were acquired by GEC. If there were insufficient export orders then eventually, whatever their ownership, either Barrow or YSL would have to close. VSEL was confident of its position in that event, since it could construct at Barrow the whole range of vessels that the MoD might want.

5.36. 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 in the ownership of a much larger company possessing contacts with foreign governments at the highest level. GEC met this requirement. [

Details omitted. See note on page iv.

] VSEL had been told by the MoD that it had failed to secure the UK first-of-class order for the CNGF mainly because of GEC's superior ability to represent the interests of British industry in a collaborative venture of that scale. VSEL did not have the weight, the resources, or the 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 acquisition could not be achieved by collaborative export ventures. This was because of the conflicts between its interests and those of the company responsible for managing the supplies covered by the relevant inter-governmental Memorandum of Understanding, eg GEC for Malaysia and BAe for Saudi Arabia.
- (d) VSEL contrasted its position with that of VT, which had not been forced to withdraw from surface shipbuilding, as VSEL had been 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.

5.37. On exports of other military equipment, VSEL believed there would be no adverse effects that might stem from a merger with GEC.

5.38. On operating efficiencies, VSEL said that, if GEC acquired it, there ought to be some opportunity to develop the best innovative ideas of each party. As an example, YSL's experience of plasma-cutting techniques in steel fabrication would be valuable to VSEL. There would be benefits for VSEL 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 GEC.

GEC

Background

5.39. GEC said that changes in recent years in international relations had hastened the contraction of UK demand for naval vessels, and the consolidation of naval shipbuilding was inevitable given the current and expected requirements of the MoD and the overcapacity of the industry. The much reduced requirement for domestic defence equipment meant that exports would play a critical role in maintaining the commercial viability of the industry and its ability to meet the Royal Navy's requirements.

5.40. VSEL was the only UK builder of nuclear- and conventionally-powered submarines and also had the capability of constructing large surface warships. GEC, through its subsidiary YSL, built medium-sized surface warships, and was the design authority for the Type 23 frigate for the Royal Navy, but it could not construct submarines or large surface warships. The combination of GEC with VSEL would maintain and strengthen centres of design and manufacturing excellence for the construction of submarines and both medium and large surface ships for the Royal Navy and for export. GEC's management and financial strength coupled with the design and construction capabilities of the two yards would create a group which would be a credible and efficient prime contractor for the whole range of warships.

5.41. GEC believed the merger would not materially reduce competition in UK naval shipbuilding in a manner incompatible with the public interest, since:

- (a) as regards frigates, the combined group would continue to face competition from VT; VSEL had not constructed a surface ship since 1982 and there was no indication that any further Type 23s would be ordered by the MoD beyond the final batch of three for which tenders had to be submitted by 13 June 1995 (for which it already had detailed cost information); and the only other orders for frigates in the foreseeable future were those for the construction of follow-on CNGF ships (which were unlikely to be placed before the turn of the century);
- (b) as regards submarines, the tenders for the B2TC had to be submitted by 29 June 1995, and these would almost certainly represent the full extent of the MoD's requirements for submarines for the foreseeable future; YSL itself did not have a submarine-building capability and GEC had already undertaken to the MoD to maintain both the VSEL and GEC teams' bids independently should it acquire VSEL;
- (c) YSL did not have the capability to construct surface ships with a displacement over 7,000 tonnes; and

(d) more generally, the merger would not prevent other UK companies, such as VT or BAe, or foreign companies, such as Loral ASIC (if necessary, in conjunction with VT or another shipyard), from acting as prime contractors for warships and naval systems; two major commercial shipyards, H&W and KG, were potential competitors to construct the hulls of warships; the MoD could seek bids from foreign naval shipyards if it thought there was insufficient competition in the UK; and the MoD had shown itself willing to sponsor competition, as in the competition for the B2TC contract.

5.42. GEC said that, to the extent that there could be a reduction in competition following the merger, the MoD was the sole UK customer for warships and was fully able to achieve value for money; any such reduction was more than outweighed by the benefits arising from the merger. The financial strength that GEC would bring to VSEL and the efficiencies that the merged group would enjoy would result in an improved prime contractorship capability in the VSEL business, a higher quality of service to the MoD and better value for money. Consequently, the merger did not cause any reduction in competition which would, or might be expected to, operate against the public interest. On the contrary, the merger would enhance centres of design and production excellence which would promote exports and help to ensure the long-term viability of the VSEL and YSL yards.

Public interest issues

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

5.44. On the issue of whether the proposed merger, when taken with changes in the MoD's procurement policy, would prevent, restrict or distort actual or potential competition in the supply of warships, in particular (but not solely) in relation to the B2TC contract, or in the provision of prime contractor services for warships, GEC said that the proposed merger would not prevent, restrict or distort competition in any of these activities for the reasons given *inter alia* in paragraphs 5.41 and 5.42. After the merger, effective competition would not be diminished. As regards MoD procurement policy, in a situation where there were two suppliers, the first of which was relatively efficient and the second inefficient, GEC did not believe the MoD would now place an order with the second supplier solely to keep two going: the closure of SH, following its failure to win the LPH order, was an example, and there would be more to come.

5.45. In the case of the B2TC competition the MoD had asked GEC to quote against VSEL. After spending £[*] million itself in assessing the position, GEC had decided it could not make a satisfactory offer, and this had led the MoD to agree to meet £[*] million of the costs incurred by the GEC team in preparing a bid. (This was done through a contract for risk reduction studies associated with the team's novel production strategy.) The contract required that if the GEC-led team decided it was not practical to submit a bid GEC would inform the MoD; only if the MoD agreed this was so could the contract be terminated. GEC had undertaken to the MoD in terms agreed with the MoD that, if it bought VSEL, the B2TC competition would be maintained by keeping the GEC and VSEL teams in being for six months following the submission of tenders.

5.46. GEC believed it was practicable for it to continue competition for the B2TC. The GEC team would in any event have no information about the VSEL bid until after the ownership question was settled: GEC had given an undertaking to the MoD that it would seek none for the remainder of the six-month period. If the GEC team won the B2TC contract, or if GEC bought VSEL, GEC would consult the MoD to decide what use should be made of the VSEL and other facilities to achieve the best and most economical outcome for the contract consistent with the contractual rights of the members of the respective teams. The base costs would be established by the competition: GEC had undertaken to work to a maximum price specified for the first three submarines.

5.47. GEC said that the whole point of the B2TC competition was that the MoD should achieve a lower price through the application of the novel techniques of the GEC team. If GEC did not acquire VSEL, but won the B2TC contract, it was probable that final assembly would still be at VSEL, because

*Figures omitted. See note on page iv.

of its nuclear facilities. GEC would not withdraw from the B2TC simply because it was unable to acquire VSEL. It would withdraw only if it was certain that it would lose the contract, or if the bid failed to make any commercial sense. Subject to its contractual commitments, it would not keep the bid going at a substantial loss merely to satisfy the MoD.

5.48. GEC said that if it acquired VSEL, and the GEC team did not secure the B2TC contract, it would want Loral ASIC to continue as part of the VSEL team for the B2TC. Loral ASIC had said that this was acceptable to it.

5.49. GEC emphasized, however, that its contribution to the B2TC competition was not based on YSL's capabilities (since YSL could not build submarines and had contributed only limited CAD support for the bid) or other GEC subsidiaries' systems or equipment: it was based upon its own prime contractorship capability. But that was not unique: other firms, such as BAeSEMA, could offer it.

5.50. GEC told us that, if it acquired VSEL and if VSEL won the Type 23 contract, it would want to build the ships at the YSL yard, although (subject to the reservations in paragraph 5.79) it would accept the VSEL price. GEC said that the MoD recognized that the UK's centre of excellence in the design and construction of frigates was at YSL and that it would get better value for money from those ships being built there. GEC had at the MoD's request undertaken to keep the YSL yard open for the CNGF. YSL's own price for Type 23 would be set at a normal, competitive, commercial level that would not incur losses of the sort incurred by YSL on the batch at present under construction.

5.51. GEC said that its commitment to build the CNGF first-of-class at YSL was irrespective of it securing either the Type 23 order or orders for exports. The commitment had been given to reassure the MoD that if GEC bought VSEL it would not close YSL.

5.52. GEC said that it would expect VT to make a competitive, but not a predatory, bid for the Type 23 contract.

5.53. On the issue of whether the proposed merger, when taken with changes in the MoD's procurement policy, would prevent, restrict or distort competition between suppliers of defence services, systems or equipment by enabling GEC to favour its subsidiaries or associates in either the purchase or supply of such items, GEC said that no such prevention, restriction or distortion of competition would arise. The MoD retained strict control over the procurement of equipment for UK naval defence programmes. Its move towards whole ship prime contracting involved the transference of risks and responsibilities to the prime contractor, but did not involve the MoD relinquishing its control over the subcontracting process. A prime contractor had little influence on the selection of systems. In relation to subcontracting, the regime imposed by the MoD was substantially the same whether the project was for first-of-class or follow-on vessels, and whether the contract was let on a single tender basis or subject to competition. GEC thought the MoD's procedures on subcontracting were fair and transparent; it could not recall any cases in naval systems procurement where it thought the methodology had been unfair to it as a subcontractor. GEC said that, as a prime contractor, its own policy was to focus on design, assembly and testing and to procure systems and equipment from the suppliers that offered the best value for money. Not only in UK warship contracts, where it was under close supervision from the MoD, but also in exports it made every effort to ensure that its subcontractors not only were fairly treated but believed they were fairly treated.

5.54. GEC told us, in general terms, that although it would expect the MoD to nominate the main subcontractors for systems for its contracts, it would have some concern about its subcontracting prospects for export orders if BAe were to take over VSEL.

5.55. It was not GEC's impression that there was any lack of capability or shortage of effort on the MoD's part in supervisory contracts or subcontracting procedures. Indeed, the contrary was the case.

5.56. GEC said that it had received no representations from systems suppliers expressing concern that if it acquired VSEL they would be put at a disadvantage to GEC subsidiaries in securing subcontracts. GEC believed that in warship-building a prime contractor was generally not in a position to insist, and, in any event, would eventually fail if it insisted, on incorporating its own equipment when better value for money could be obtained elsewhere: it was a certain recipe for inefficiency. It was understandable that

prospective subcontractors should be nervous about what would happen if everything fell under single control. But GEC did not think it would be in its long-term interests to take advantage of such a situation if it arose. Nor did it think such a situation would arise. Major new systems and equipment were in any event subject to separate MoD or international competitions; the majority of those systems and equipment were common to more than one class of warship; the MoD held 'build to print' competitions for further batches, issuing the systems equipment at no cost or nominating the supplier where it thought appropriate. GFE and nominated supplier equipment accounted for 60 to 70 per cent of the systems and equipment for the Type 23 frigate. GEC had thought it essential, in the B2TC context, for example, to pursue the prospect of cost reduction and achieving savings by extending the subcontractor base to competition from firms that had not previously had an opportunity of competing. However, it had to be recognized that even if the MoD did not in this case make free issues or formally nominate preferred suppliers, commonality of equipment with existing classes of submarine and the nature of the vessels dictated that a proportion of subcontracts similar or greater than on the Type 23 frigates would be awarded to existing suppliers.

5.57. GEC said that, when acting as prime contractor, it pursued a policy of carrying out the design, assembly and test work internally and procuring all the systems and subsystems to be integrated into a vessel on a competitive basis from the supplier able to offer the best value for money. It would not be in GEC's interest to give preference to GEC subsidiaries when better value for money could be obtained elsewhere.

5.58. As prime contractor on MoD warship contracts, GEC's role in the procurement of equipment was constrained in two ways:

- (a) the MoD had competitions to select the supplier for much of the equipment (or selected a supplier without competition separately) and often well in advance of the award of the contract for the vessel or batch in question; and
- (b) where a prime contractor was responsible for selecting and procuring equipment, the MoD invariably imposed obligations and procedural controls on it which governed the subcontracting process in order to ensure that full value for money was obtained. The MoD knew which companies were likely to be competent to provide specific systems and subsystems, and would invite to bid if they did not come forward of their own initiative.

5.59. GEC said that on export contracts the customer would frequently nominate suppliers for particular equipment: for instance, the Royal Malaysian Navy selected suppliers for the search and surveillance radars, the torpedo tubes, the main propulsion units and the diesel generators. Most significantly, however, GEC faced considerable competition for the award both of MoD and export contracts for warships and naval systems. To be competitive, GEC had to procure equipment and systems from subcontractors on the basis of value for money and also choose the equipment or system which best met the customer's requirements; failure to do so would materially affect its ability to compete both for export and for MoD contracts.

5.60. Consequently, GEC's position was that there was no reason why any potential subcontractor for a system or subsystem should be discouraged in the medium and longer term from tendering, in circumstances where a GEC subsidiary would be able to supply the relevant system or subsystem and the overall prime contract was being performed by GEC; and this state of affairs would be unaffected whether or not GEC were to acquire VSEL.

5.61. On the issue of whether the proposed merger, when taken with changes in the MoD's procurement policy, would prevent, restrict or distort competition between suppliers of defence services, systems or equipment by giving GEC access to intellectual property including 'know-how' or to other relevant technical or financial information belonging to the actual or potential competitors of such subsidiaries or associates, GEC said that, as regards the great number of instances where it was itself a subcontractor, it was not seriously concerned that the reputable firms with which it worked would steal its intellectual property. GEC had never heard any complaints of misapplication of IPR from subcontractors in its capacity as a prime contractor. The law on the point was clear and readily enforceable; there were well-established procedures in place to ensure confidentiality and the staff

concerned were aware of the requirements. GEC believed it was fair to say that, although there might be concerns, they were misplaced.

5.62. On the issue of whether the proposed merger 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 armaments facilities, GEC said that the merger would have no such effects. GEC had substantial cash resources of its own and was not purchasing VSEL to obtain VSEL's cash. VSEL would benefit from sharing in the financial strength of the GEC group. Each managing director had authority for capital expenditure that formed part of his agreed budget and would also have a further discretionary limit: about £50,000 would be typical. Applications for approval of further unbudgeted capital expenditure could be made at any time; approval would be given if a good commercial case were made for such expenditure. Subsidiaries were expected to generate money in the course of running the business, but their needs could be met. The payment of dividends to the holding company would have no relationship to the financing of the business. It would be GEC's intention to supply both VSEL and YSL with sufficient capital to expand the capability of each to make more, and different kinds of, ships.

5.63. 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 and Clyde areas, GEC said that if the merger proceeded, the futures of both YSL and VSEL would be more secure. GEC could offer substantial benefits to VSEL which should lead to increased export orders. VSEL's efficiency as a high-quality supplier of submarines would be considerably enhanced and it would also be able to bid more competitively for large surface ships. Future employment prospects in this industry were closely linked to success or failure in export markets. The management team at VSEL would be built up from the existing staff, which it thought had considerable potential. It found nothing to complain about among the senior staff either at management or foreman level. The whole operation seemed good and merely needed a little tightening up.

5.64. GEC said that it had told the trade unions at VSEL that the future level of employment would depend on how successful the yard was in securing business; on how efficient the yard could be made; and on its quality and speed of delivery.

5.65. YSL had moved to a much greater degree of skill flexibility, and abandonment of demarcation rules, than was the case at VSEL. At YSL, for example, boilermakers had been trained as outfitters and electricians, engineers and joiners as boilermakers: that helped to even out the peaks and troughs of demand for particular skills at the various stages of ship construction. YSL still had improvements to make, but this was the sort of flexibility that had to be brought to VSEL.

5.66. GEC said that it had given an undertaking to the MoD that, if it acquired VSEL, it would retain the capability at YSL to build the first-of-class CNGF. If in the interim GEC failed to win the last batch of Type 23 frigates and there were no export orders, that would involve the retention at the YSL yard of perhaps 500 design engineers and other staff working on the CNGF, but little employment for other skills. The suggestion had been made that GEC would in those circumstances close the YSL yard and transfer all of its work to VSEL, irrespective of its undertaking to the MoD. This suggestion was not sensible: the YSL facilities could not be moved and all but the most senior employees would probably refuse to move. GEC made it clear that it would observe its undertaking to the MoD and that it would not simply close the YSL yard.

5.67. On the issue of whether the merger might be expected to have any adverse effects on UK warship-building capacity, GEC said that it believed the problem of the UK warship-building industry was that there was an excess of capacity and a shortage of orders. The capability that the industry possessed was required, but its capacity was not. That said, GEC's undertakings to maintain YSL if it acquired VSEL, in order to build the first-of-class CNGF, would keep YSL open for seven years and GEC's strategy offered the best long-term prospect of keeping both YSL and VSEL open.

5.68. On the issue of whether the merger might be expected to have beneficial effects on UK warship-building capacity, GEC said that the merger would enhance centres of design and production excellence which would promote exports and would help to ensure the long-term viability of the VSEL and YSL yards.

5.69. On the issue of whether the merger might be expected to have any adverse or beneficial effects on UK exports of warships or other military equipment, GEC said that membership of the GEC group would improve VSEL's export prospects, and it was hopeful that orders would be secured well within five years. VSEL had a good record in submarine construction but suffered from a lack of credibility as a builder of surface ships; its productivity, too, needed to be improved if it was to be successful in export markets. VSEL had acknowledged that it would have a greater chance of export success as part of a larger group.

5.70. GEC believed it had a fairly comprehensive knowledge of what warships were required in overseas markets, and that it had the necessary contacts in all the relevant countries. VSEL, in GEC ownership, would not be competing in isolation but in combination with YSL and GEC Naval Systems; it would also have the backing of GEC-Marconi's extensive export sales and marketing organization and support from GEC.

5.71. GEC said that offset trade deals were an increasingly common requirement of export orders; there was an increasing demand for industrial investment in the recipient export country. Only a very large group with a broad spread of manufacturing activities world-wide, such as GEC, could meet these demands.

5.72. GEC thought there would be export opportunities in the foreseeable future for about 60 non-nuclear submarines, and that VSEL, with improved productivity, backed by GEC's sales, marketing and financial strength, and using the RDM, or perhaps the Kockums, designs could be successful in securing orders.

5.73. GEC suggested that UK export prospects for defence equipment could be harmed when more than one UK company was competing for a contract; other countries tended to concentrate support on a single 'national champion' in such bidding competitions and this improved its prospects of securing orders. It saw the increased likelihood of a single UK bidder for overseas warship contracts as a possible benefit of the merger.

5.74. On exports of other military equipment, GEC said that a merger with VSEL would allow both businesses more effectively to address artillery-related exports markets, offering a unique artillery system capability able to compete strongly.

5.75. On the issue of whether the merger might be expected to have any adverse or beneficial effects on the operating efficiencies of either party, GEC said it envisaged that VSEL and YSL would be operated as separate units, each under its own management, within GMNS. GEC subsidiaries enjoyed a great deal of managerial freedom, within the framework of agreed budgetary controls and performance scrutiny, and with ready access to higher authority. The system should prove as satisfactory in bringing about efficiencies in VSEL as it had in the generality of GEC subsidiaries.

Possible remedies

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

5.77. GEC made four general points:

- (a) It said that its primary position was that, for the reasons given in paragraphs 5.41 and 5.42, the merger with VSEL would not be against the public interest and therefore remedies should not be necessary.
- (b) It drew our attention to four sets of assurances or undertakings, conveyed by it to the MoD in exchanges of letters (see Appendix 5.1), that would have effect if GEC acquired VSEL. These related to the preservation of the rights attaching to the special share in VSEL, held by the Secretary of State for Defence; arrangements for ensuring separate GEC and VSEL bids for the B2TC; the construction of the CNGF first-of-class at YSL; and the construction of the next batch

of Type 23 frigates at YSL. All these assurances or undertakings were given in terms drafted or approved by the MoD itself.

- (c) It said that, subject to its primary position that no further undertakings were required, it approached the question of remedies and undertakings with a desire to solve problems, not create them. Some of the remedies proposed had already been met in substance or were contrary to assurances referred to in (b) above.
- (d) It saw no reason in principle why remedies, if required, should not be legally enforceable. It saw no problem which could arise as a result of changing circumstances or commercial pressures. Any undertaking could be drafted so as to be reasonably certain in its application, would be given with due authority of the GEC Board and would be enforceable under the Fair Trading Act 1973 unless and until release was given.

5.78. Turning to the specific remedies, on a measure under which GEC would maintain separate B2TC contract teams for a specified period, GEC said that it had entered into the competition at the MoD's request and again at the MoD's request-it had given an undertaking to maintain separate teams for six months following the submission of tenders. But a point would come when joint discussions and negotiation would be needed in order to give the MoD the best chance of securing value for money. It would be absurd to go on maintaining separate teams beyond that point. On the other hand, if continued separation beyond six months was clearly sensible GEC would have no great difficulty in agreeing to it. This would be a matter for discussion with the MoD, since it originally stipulated the six-month period. The MoD would have full access to both teams and their workings.

5.79. On a measure under which GEC (if not already committed by tender terms) would not withdraw any VSEL tender price for the order for the last batch of Type 23 frigates, GEC expressed some concern. It could accept an obligation not to withdraw a tender by VSEL for the Type 23 contract if the tender did not impose an unreasonably onerous financial obligation on GEC. But, if the tender had been submitted with other than a commercial intention, GEC would have to reserve the right at least to discuss it with the MoD. If the tender would impose a large loss GEC would regard that as a reason to withdraw.

5.80. On a measure under which GEC would maintain all or part of VSEL's capability for land or naval guns, GEC said that this was not an aspect of the VSEL acquisition to which it had yet given close attention, but it would commit itself to maintaining the capacity so long as there was a demand which would enable GEC to use it, and it would meet the existing support responsibilities that VSEL had for the AS90 and the Mark 8 4.5 Inch naval gun.

5.81. On measures under which GEC as a warship prime contractor would maintain specified procedures to ensure competitive tendering by subcontractors for systems and subsystems, GEC said that its essential function as a prime contractor, pursued over many years, was to design, assemble and test. It was part of GEC's standard policy and procedure as a prime contractor that everything that could be supplied from outside should go to competitive tender, in which GEC's subsidiaries would engage wherever possible. The MoD would be intimately involved in GEC's plans for awarding B2TC subcontracts; indeed, perhaps more closely involved than if the MoD were itself making the choice, reflecting its fundamental concern that whatever was bought should be effective and give the greatest value for money. The MoD's surveillance of subcontracting procedures and subcontractors was little different in a competitive situation from that adopted in a sole supplier situation. The same would be the case for future prime contracts and no other or special procedures would need to be adopted.

5.82. On the question of monitoring a prime contractor's procedures for ensuring competitive tendering by subcontractors, where the monitoring was the subject of an undertaking that had been given, or of an order made, under the Fair Trading Act 1973, GEC said that its experience, following the GEC/Siemens bid for Plessey, had been that many of the substantive provisions of the undertakings in that case had been included in an agreement between GEC and the MoD. In effect this meant that the MoD as well as the OFT had a direct interest in the undertakings, and in ensuring their due observance.

5.83. On measures under which GEC would keep the yards at YSL or VSEL or both open for a specified period, with or without a specified capability, GEC said that it was impossible to give an

undertaking concerning a specific number of people without knowing what work there would be for them to do. GEC would honour its undertaking to the MoD to maintain at YSL the capability required to undertake the building of the UK first-of-class CNGF there: the number of people involved in the design phase could be about 500. GEC also drew attention to what it considered to be its legally binding undertaking to the MoD that, if GEC acquired VSEL, 'there shall be no closure, decommissioning or disposal of the whole or a material part of [VSEL's nuclear submarine production] facilities without the approval of the Secretary of State' (see Appendix 5.1, letter from Mr Lester to Dr McIntosh, 26 October 1994).

5.84. GEC said that the CNGF was designed to be built in any of the three yards building first-of-class vessels. The French yard had facilities very similar to those of YSL; it could build larger modules than YSL but the design would present no difficulties for YSL. At present it could build vessels of up to about 7,000 tonnes displacement and 150 m in length overall, whereas the CNGF was expected to be about 6,000 tonnes and 146 m.

5.85. On a measure under which GEC would not transfer Type 23 work to YSL if VSEL won the Type 23 competition, GEC said that such a measure would be contrary to the undertaking that the MoD had sought, and been given, that GEC (if it bought VSEL) would build Type 23 frigates at YSL and submarines at VSEL. GEC's intention was to obtain orders in world markets to enable it to keep the capability (although not necessarily the capacity) of both yards going.

5.86. On a measure under which GEC would not unreasonably refuse to make available VSEL's submarine-building facilities to any prime contractor who sought to use them, GEC said that it did not think VSEL would find it in its interest to decline to quote as a subcontractor to a prime contractor (such as GEC) that might be able to offer work which another prime contractor could not. GEC thought it right to be guarded as to the propriety of an undertaking in the terms proposed, but it thought it would probably be prepared to give an undertaking if circumstances were reasonable.

Undertakings

5.87. On the enforceability of undertakings, GEC said that it did not believe the management of any large industrial enterprise, such as itself, would enter into solemn and binding undertakings, entailing huge material costs, if it did not intend to honour them in all circumstances, subject always to the consent of the Government or the MoD in respect of any variation. GEC would not expect the validity of its own undertakings to be questioned, but in the extreme case that questions on them arose it would be a matter for the courts, and GEC would be responsible for any actions it had taken.

5.88. GEC's position was that if, contrary to its primary submission (see paragraphs 5.41, 5.42 and 5.77), its acquisition of VSEL was a case in which the public interest required the imposition of undertakings, they could be fashioned in a properly enforceable way and GEC would abide by them until it was released-an eventuality that the legislation covered.

5.89. GEC said that in the Plessey case the undertakings it gave were strictly in accordance with the MMC's report; it regarded itself as bound to the letter by their terms; they dealt not only with structural, but also with behavioural, matters; and it was aware of no problem which had arisen on the manner in which they had been met. The Plessey case, in GEC's view, supported its argument that, in appropriate circumstances, undertakings could be an effective method of dealing with a problem.

Merger intentions

5.90. GEC formally confirmed that if, following our inquiry, it was cleared to bid again for VSEL it was its present intention (as at 23 February 1995) to do so.

5.91. GEC told us that in 1992 and 1993 it had held discussions with BAe about a possible merger of their defence businesses. It was essential that confidential information be exchanged, and so a confiden-

tiality agreement was concluded. At the insistence of BAe the parties also entered into a standstill agreement whereby each agreed not to acquire shares in the other for two years ending in June 1995.

5.92. Shortly after the confidentiality and standstill agreements became effective the discussions were ended by BAe because (it said) press speculation had caused it a specific financial problem, unrelated to the proposed transaction, which had to be resolved before the discussions could go forward. On 5 July 1993 GEC and BAe made a joint announcement to the Stock Exchange that discussions had ceased.

5.93. GEC told us that in April 1993 it was consulted (by a third party known to it and to VSEL and BAe) about a proposal to merge the VSEL guns business with that of BAe and subsequently to merge the GEC and BAe naval activities with those of VSEL. GEC's position was that, if BAe confirmed to GEC that it was going forward with the proposition, GEC would follow. No such confirmation was received.

5.94. On 29 September 1994 VSEL announced that it had received approaches that might lead to a bid. Shortly afterwards, BAe informed GEC that it was in discussions with VSEL and made arrangements for representatives of BAe and GEC to meet. Meetings were held on 7, 11 and 18 October 1994. BAe tried to persuade GEC not to intervene, and promised that if GEC complied it would revive the earlier discussions about a merger of BAe's and GEC's defence businesses. At one or more of those meetings, GEC suggested that the two companies should bid jointly for VSEL, but no formal proposals were made.

Criticisms in BAe press announcement

5.95. GEC told us that it did not propose to make any representations about criticisms of its bid by BAe additional to those made in the submissions that it had put to the OFT (which we had seen).

5.96. In a memorandum of 8 November 1994 to the OFT GEC addressed points that had been made by BAe in press announcements. GEC said that in these announcements BAe had stated that GEC's offer would render it impossible for the MoD to implement its policy in relation to naval procurement as it would:

- (a) eliminate competition between the only two UK shipyards with the capability of building major warships;
- (b) prevent the emergence of competition in naval 'whole ship' prime contracting in the UK;
- (c) result in the concentration of future major UK naval programmes in the hands of a single contractor; and
- (d) result in GEC securing virtually complete control of the supply to the MoD of major naval platforms, naval whole ship prime contracting and the principal naval equipment systems.

GEC said that for reasons immediately apparent from its submission (see paragraphs 5.41 and 5.42) these claims were misconceived.

5.97. GEC said that BAe's announcements had also claimed that GEC's statement of its intention to keep open both VSEL and YSL offered the MoD no significant rationalization benefits to offset the adverse implications of the claimed elimination of competition. BAe's claim appeared to imply that rationalization necessarily involved the closure of one of the shipyards (with the attendant adverse effects on employment in the relevant area). This was not so. GEC considered that its offer would secure the long-term future of both shipyards and had given assurances to the MoD to this effect. At the same time GEC's offer would result in significant cost savings and other benefits.