

# 6 Views of other parties

## Contents

	<i>Page</i>
Government departments.....	123
MoD.....	123
Department of Trade and Industry, Sponsor Command.....	135
HM Treasury.....	136
Department of Employment.....	137
Scottish Office Industry Department.....	137
Shipbuilders and shiprepairers.....	138
VT.....	138
KG.....	139
DML.....	140
Equipment suppliers.....	140
BAe.....	140
David Brown Group plc.....	141
Racal Electronics plc.....	142
Siemens Plessey Electronic Systems Ltd.....	142
Thorn EMI Electronics Limited.....	143
AMEC Plc.....	143
Loral ASIC.....	143
Rolls-Royce Nuclear Engineering Ltd and Rolls-Royce & Associates Ltd.....	144
EDS Defence Ltd.....	145
Trade unions.....	145
Confederation of Shipbuilding and Engineering Unions.....	145
Barrow and District CSEU.....	146
YSL trade union representatives.....	146
Other organizations.....	147
Barrow-in-Furness Borough Council.....	147
Furness Enterprise Ltd.....	147
Members of Parliament.....	147
Scottish National Party.....	149

## Government departments

### MoD

6.1. The MoD said that (for the reasons set out in paragraph 6.73) it was its current policy that warships (but not their systems) should be procured only from UK companies, so long as adequate competition was available. This policy of limiting warship procurement to a domestic source was adopted by virtually all countries that had a warship-building capability, and in the case of the UK it was sustained by considerations some of which were specific to UK circumstances and some of general application.

6.2. Specific considerations were British history as a naval power, and the political and strategic implications linked to it. There was, too, the particular problem of the Royal Navy's submarines, now exclusively nuclear-powered, and developed originally from nuclear propulsion technology from the USA.

The technology was supplied under an agreement negotiated in 1958 which forbade the transfer of the technology to any other party, thereby effectively preventing the UK from contracting abroad (except in the USA) for any design of nuclear propulsion that depended on that technology. Moreover, the design of much of the submarine was profoundly influenced by the requirements of nuclear-powered propulsion, and this had implications for submarine construction capacity as well as supply.

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

6.4. Hitherto the criterion of adequate competition had not presented difficulties for the MoD in pursuing its policy of relying on domestic sources, but the maintenance of competition when there was a single domestic source might lead to the MoD contemplating contracting outside the UK for some classes of vessels, as in an earlier round of minehunter competitions, when bids involving subcontracted French and Belgian hull construction had been obtained before the competition was terminated. But, for the reasons given in paragraphs 6.2, 6.3 and 6.73, it was unlikely that this course would be adopted for the procurement of other than the smaller non-combat vessels. It was not to be ruled out that technology trade-offs might lead to some foreign procurement of warships, but that did not seem likely at present.

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

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

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

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

6.9. The competitive process entailed negotiations between the MoD and the tendering builders that could be brief or extensive, depending on the circumstances of each case. It was not an auction, and the device of seeking 'best and final offers' (as in the LPH competition) was not always adopted. In the OSV case, for example, there had been only two bids; the MoD had been satisfied that both were genuine, and had had no difficulty in deciding which was better. That was the best situation from the MoD's point of view. But where there were several bidders, starting from different states of knowledge (as was expected to be the case with the next Type 23 frigate order-see paragraphs 6.40 to 6.42), the MoD would go through a much more complicated process, attempting to ensure that the terms and conditions of the contract were well understood (without which the price would be meaningless).

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

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

### ***Prime contractors and subcontractors***

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

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

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

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

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

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

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

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

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

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

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

### ***Competition issues***

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

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

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

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

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

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

## ***B2TC***

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

6.29. The MoD had funded a studies contract involving VSEL, GEC, Rolls-Royce and BAe. The MoD saw these companies as likely prime contractors in any B2TC competition. BAe had withdrawn and there were now two potential prime contractors: VSEL, with Loral ASIC and BAeSEMA as main subcontractors, and a GEC/Rolls-Royce team, with BMT and AMEC as main subcontractors. The GEC/Rolls-Royce team was exploring the adoption of a different and potentially attractive construction strategy using practice developed by the offshore oil and gas industry. This would entail the building of modules, either by AMEC or VSEL, with the reactor core being loaded at either Devonport or VSEL. However, GEC had also expressed considerable scepticism about the MoD's ultimate willingness to see nuclear-powered submarines assembled outside VSEL's facilities. With the impetus of competition, both teams could be expected to introduce innovative construction, fitting-out and commissioning techniques, but this would require substantial investment during the bid phase.

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

6.31. If GEC acquired VSEL it would be involved in both the teams that the MoD hoped would bid for the B2TC. With that in mind GEC had offered the MoD arrangements to maintain competition for at least

---

\*Figures omitted. See note on page iv.

six months after the tender return date. In outline, VSEL (in GEC ownership) and the GEC/Rolls-Royce team would remain quite separate and would continue to tender. If necessary there could be representation from the MoD in one or both of the bid teams to ensure that the rules were followed (although in practice it might be difficult to keep track of the bid process). GEC had provided a maximum price for the first three submarines, giving an assured ceiling from which competition and subsequent negotiation should achieve a price which the MoD could afford.

6.32. The MoD said that the continuing involvement of the main subcontractors in each team would offer some assurance of credible competition. If they could be convinced that the competition remained genuine, and adopted appropriate risk-sharing arrangements, it might still be possible to proceed with the competition, underpinned by GEC's maximum price safeguard. The involvement of Rolls-Royce and the subcontractors, if sufficiently significant, should serve to prevent undue GEC influence. An arrangement of this kind would be less satisfactory than two completely independent bids, but the MoD's assessment was that GEC's proposals could form the basis for securing value for money, especially since, by the time the future ownership of VSEL was determined, bids would probably have been submitted, or be very close to the submission deadline (of end-June). However, it would be important to maintain these separate team arrangements for as long into the assessment period as was necessary to prevent changes in key elements of the bids.

6.33. The MoD told us that it would regard a GEC/Rolls-Royce team bid for the B2TC as credible in the sense that it believed it would be a practical proposition that could lead to the construction of at least three of the vessels at a location other than VSEL that met all the Royal Navy's requirements. (However, the MoD as yet had no view on whether the cost would be acceptable.) It was not essential that the B2TC should be constructed at VSEL; there was nothing that the GEC/Rolls-Royce team might require that either the MoD could not give it or which it would not be able to acquire elsewhere. In particular, both the initial fuelling, and the much more demanding refuelling, operations could be undertaken at the Devonport dockyard.

6.34. The MoD told us that it had reached this view after the fullest and most careful consideration, starting with the initial studies contract, which was transparent between the four participants, who had accepted pre-conditions of continued co-operation, notwithstanding competition between them thereafter; then, when the GEC/Rolls-Royce team entered into the risk reduction studies contract, ensuring that its staff concerned with the project had a close and detailed understanding of all that submarine construction entailed; followed by a detailed MoD study and critique of the team's planned construction strategy (which seemed to the MoD to be both attractive and feasible). There were three technical developments in recent years that greatly facilitated the team's approach to the concept of transferring submarine modules between construction locations, eg Newcastle and Devonport. First, the feasibility had been demonstrated of building the reactor compartment of the Trident propulsion plant in one location (VSEL) and then moving it several hundred miles to be tested in another (the UKAEA establishment at Dounreay). Next, the MoD was satisfied that the Royal Dockyards could undertake the initial fuelling and the (much less benign) refuelling processes, in addition to the immensely complex task of commissioning nuclear submarines. Thirdly, developments in CAD/CAM (in which YSL, as a subcontractor to the consortium, was much further advanced than VSEL) made it feasible to transfer the B1TC design into the B2TC datapack.

6.35. The MoD, however, thought the team might well find VSEL an attractive option for the final assembly, integration and test of B2TC submarines. Access to VSEL's fuelling facilities, too, would provide competition with Devonport.

6.36. The MoD thought the most difficult aspect for it of a GEC/Rolls-Royce team bid for the B2TC, against the background of GEC ownership of VSEL, would be ascertaining the validity of the tender price, although Rolls-Royce and the team's major subcontractors could exercise a strong constraining influence on the extent to which considerations of VSEL ownership influenced GEC's pricing. The MoD, having picked the best technical features of both bids (which would be independently appraised), would follow the single source NAPNOC procedures, the effect of which it thought was easy to underestimate.

6.37. If BAe were to acquire VSEL it was possible that GEC would be unwilling to continue to compete for the B2TC contract. On the one hand, GEC had indicated a willingness to continue until the VSEL ownership question was resolved (which would be close to the tender submission date of end-June 1995) and might complete the remaining work and make a bid for the B2TC notwithstanding a pending BAe take-

over of VSEL. On the other hand, GEC was undertaking the initial technical study to underpin the bid at the MoD's expense but would be spending its own funds in the final stages and so might choose to cut its losses and pull out. However, the MoD hoped that GEC would see the B2TC as a potentially lucrative and forward-looking contract that it would want to win on its merits.

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

6.39. The MoD said, however, that if both the GEC/Rolls-Royce team and VSEL submitted bids for the B2TC, and VSEL were in BAe's ownership, it would require complex and difficult negotiations to arrive at a contract that selected the best features of both bids, entailing the adoption of a variant of the sole source NAPNOC regime.

6.40. The MoD said that there had been intense pressure from France to take the B2TC forward as a collaborative venture. It had been decided that this would not be sensible for what was essentially the updating of an existing class of submarine. But it was to be expected that French pressure for collaboration in the next new nuclear submarine project would again be intense, and the possibility of such a project being realized could not be ruled out, perhaps in the manner of the CNGF (see paragraphs 6.43 to 6.51).

### ***Type 23 frigate***

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

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

6.42. The MoD said that Lord Weinstock had given a written assurance to the Secretary of State for Defence that if YSL was awarded this contract the ships would be built at YSL, provided that GEC acquired VSEL. However, if YSL did not win the contract its survival would be in grave doubt, there being little else to sustain it until the order for the first-of-class CNGF (which itself would go to YSL only if there was agreement with the MoD on the price).

6.43. The MoD said that the Type 23 competition was unlikely to produce much in the way of innovative cost reduction. The only possibility of significantly reducing the price of the Type 23 order would be if VSEL in BAe ownership submitted a low bid by accepting the risk of taking a loss. If such a bid won the contract YSL would probably go out of business: there was little prospect of export orders, and no prospect that the Government would meet the cost of preserving unused capacity. The MoD would be under no obligation to accept a VSEL loss-risking bid (though it would have to be ready to defend publicly a decision not to do so). If the MoD did not accept the bid the only financial benefit to the MoD would arise if YSL were tempted to match its price. The MoD thought it unlikely that GEC (through YSL) would submit a bid which did not allow a reasonable profit; and it would be for the MoD to decide whether or not to accept the advantage of a lower bid by BAe/VSEL and risk the consequences of the closure of YSL.

### ***CNGF***

6.44. The MoD said that in February 1994, after extensive preliminary appraisal of the competition possibilities, a GEC/BAe/VT team led by GMNS (of which YSL is a subsidiary) had been selected (in competition at that stage only with a VSEL/Hunting team) as the UK partner in IJVC, the joint

---

\*Figure omitted. See note on page iv.

British/French/Italian group that was designing a 6,000-tonne frigate known as the CNGF or Project Horizon.

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

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

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

6.48. The MoD said that a GEC acquisition of VSEL would remove a potential source of UK competition to YSL for follow-on CNGF orders. If YSL secured the Type 23 order and built the UK first-of-class CNGF the MoD found it difficult to suppose it would forgo the opportunity to bid for the follow-on orders for CNGF.

6.49. Lord Weinstock had given a written assurance to the Secretary of State for Defence that, if GEC acquired VSEL, the first-of-class CNGF would be built at YSL, which would maintain the necessary capability to carry out that task. If GEC acquired VSEL, therefore, the future of YSL would be more assured than if it did not. The MoD noted that the implementation of both Lord Weinstock's assurances (on the CNGF and on the Type 23-see paragraph 6.42) would depend both on GEC's bid for VSEL being acceptable under the Fair Trading Act 1973 and on it succeeding in the market-place thereafter. The MoD did not regard the assurances as legally binding, or enforceable in the courts, but believed they had been given in good faith and would be honoured in all reasonable circumstances.

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

6.51. A corollary of this was that in the follow-on ships there would be a reduced likelihood of GEC companies securing major systems orders. The normal incentive for the prime contractor not to change from the systems regime established for the first-of-class ship would thus be reinforced.

6.52. It was to be expected, too, that there would be differences of view within the design team on such matters as the size of modules, but the MoD would not allow the design to be dependent on the construction of modules of a size incompatible with YSL's capabilities.

### ***Other large warships***

6.53. The MoD said that VSEL had been invited to tender for the construction of up to two LPDs with a total value of some £[ \* ] million. (There had been no other bidder for this contract.) Two AOs were due

---

\*Figure omitted. See note on page iv.

to be ordered from 1996 onwards, with a total value of £[ \* ] million. Competition was likely to be at the prime contractor level, possibly involving a commercial yard either bidding on its own or in a teaming arrangement to build the hulls, on the model of the VSEL/KG arrangement for the LPH.

6.54. The MoD thought that if GEC acquired VSEL the impact on competition for these orders would be limited, since YSL did not have the capability to build large ships. The loss of competition involved in a GEC acquisition of VSEL would be confined to the loss of YSL as a potential prime contractor. But YSL had been unable to bid for the LPDs because of its inability to identify a suitable commercial yard, which had clear implications for its participation in any future competition for large ships.

### ***Gun systems***

6.55. The MoD said that since GEC was not involved in the manufacture of large-calibre guns no new capabilities would be created as a result of a merger with VSEL, but there could be advantages from the interfacing of GEC software-related programs with platforms produced by VSEL. A prime example was GEC's BATES which would be interfaced with the AS90 howitzer. A merger of GEC and VSEL would maintain the separate identities of VSEL and RO in the large-calibre gun market and thereby preserve opportunities for competitive procurement of a lightweight 155 mm towed howitzer.

6.56. The MoD thought GEC's ownership of both VSEL as a gun system manufacturer and YSL as a platform-builder might result in improved production times and installation costs, through improved co-ordination, but no other advantages or disadvantages were foreseen.

### ***Future of the warship-building industry***

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

6.58. The MoD said that it believed it was too simple to measure the viability of a warship-building yard in terms of a specified critical mass of employment. In 1990 VSEL had 12,000 employees; in 1991 VSEL's view had been that 10,000 was the critical mass; then it moved to the view that it was about 6,000; and now it believed it was 4,000. This, in the MoD's view, clearly was much too high. It might be half as many if VSEL was in the project management assembly mode, and not in the vertical integration mode. In the MoD's view the minimum size was determined by whether a shipyard could be run efficiently and effectively, and competitively enough to stay in the market.

### ***Ownership of strategically important capabilities***

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

6.60. The MoD said that GEC had consulted the Secretary of State about these provisions before making its bid for VSEL. It was told that the Secretary of State would give his consent to the necessary amendments to VSEL's Articles of Association to facilitate the take-over, provided that the amendments

---

\*Figures omitted. See note on page iv.

were approved by ordinary shareholders, and subject to the necessary regulatory approvals and to his receiving satisfactory assurances about the protection of his other existing rights as special shareholder. (The MoD, however, did not think the special shareholder's rights offered the most satisfactory means of safeguarding its interests: it had better means at its disposal.)

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

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

## ***Exports***

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

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

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

6.66. The MoD said that in recent years many countries had thought, for perhaps security or economic reasons, that they should have the capability to build warships, and so had attempted to establish a yard. Malaysia, for example, intended to turn an old patrol boat repair yard into a shipbuilding yard, which implied that further frigate orders from them were unlikely. Indonesia had adapted an old naval dockyard at Surabaya for both warship and commercial shipbuilding. Turkey had created a yard for the purpose of building frigates to the MEKO design. Portugal had bought its first MEKO frigate from Germany and now wished to build its own.<sup>1</sup> There were many other examples. However, Korea, surprisingly, had not adapted

---

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

its highly-developed commercial shipbuilding skills to naval purposes. It was clear, too, that the establishment of a national submarine-building capability was technically much more difficult. India had had a large programme which had been a failure. In consequence there was a tendency for countries to buy submarines rather than attempt to build them with a newly-established capability.

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

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

### ***Wider issues***

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

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

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

6.72. The MoD said that it had often been content to see its competitions for defence products be the means of resolving issues of industrial restructuring and consolidation. The competition for the LPH between SH and VSEL (which SH lost, and had gone into receivership as a result) was an example. The consequences of the B2TC competition might have been similar, with either VSEL or GEC dropping out of the business. But, with the merger bids occurring before the outcome of the B2TC competition was known, this mechanism was not available. The MoD accepted that the form and timing of consolidation would be likely to depend on whether GEC was successful in its bid for VSEL, but it did not consider that public interest arguments were affected by this.

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

- (a) *Mutual reliance for support.* The UK had to be able to rely upon the builder's support, and its supply of spares and consumables to keep the ship in operation, particularly during an outbreak of

hostilities. There had been cases where foreign partners had not provided support services when they were needed. Reliance on foreign countries was tolerable only if there was mutual reliance that made it likely that support would continue to be provided. National construction expertise was an important-though not always essential-component of providing a secure support service.

- (b) *Reciprocity of access to markets.* It was difficult to permit warship imports from competing countries that denied reciprocal access to their markets. In many European countries warship-building yards were publicly owned and state aided, which could be an impediment to free trade and competition.
- (c) *Intellectual property.* Foreign procurement would entail reliance upon intellectual property that others were willing to sell, and risk the leaking away of UK intellectual property if UK designs were constructed abroad. Foreign procurement was possible when the strategic lead was not a material issue, or when the UK could not afford to generate its own national intellectual property (eg in designing a new front-line fighter aircraft). In the case of nuclear submarines, the UK was bound under treaty to keep certain US-supplied intellectual property within the UK.
- (d) *Management of a uniquely complex system.* The MoD argued that the warship-builder had to integrate an extremely large and varied weapons system, because a warship was a much larger weapons platform than any other military platform (eg a tank or an aircraft). The physical remoteness of the supplier and, in some cases, its language added to costs in proportion to the complexity of the management of the system. These factors could also increase the cost of training the crew to run the ship and its systems.
- (e) *Availability of a suitable product.* International defence procurement normally took the form of using an off-the-shelf design with minimal modification. The Royal Navy had only a small number of ships and these had to be matched carefully with its operational needs and methods. The costs of modifying a foreign design to the Royal Navy's needs would rarely be different from those of commissioning a new UK design.
- (f) *Short production runs.* Substantial savings could be obtained where long production runs resulted in optimization of production methods for standard items with limited variation. This was rarely achievable for ships, thus reducing the cost advantage of international procurement.

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

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

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

## ***Conclusion***

6.77. In conclusion, the MoD believed the most significant factor in relation to competition in the warship-building industry was the B2TC programme: there was, for the first time, a prospect of placing a

competitive prime contract for nuclear submarine construction, albeit this possibility existed only because, at substantial cost to the MoD, GEC had been persuaded to provide the necessary leadership and resources. If GEC acquired VSEL competition might be maintained into the tender assessment phase, because VSEL's ownership might not be determined before the submission of the B2TC tenders.

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

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

6.80. The MoD's considered view, therefore, was that, with the assurances and commitments mentioned (see paragraphs 6.31, 6.42 and 6.49), it did not expect the acquisition of VSEL by GEC to operate against the public interest, and it saw merit in allowing the market to decide the outcome.

### **Department of Trade and Industry, Sponsor Command**

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

6.82. Sponsor Command said that in referring the bid the Secretary of State had made clear that he considered it raised not only competition issues but also wider public interest considerations arising from GEC's ownership of YSL, from its position in the supply of electronic equipment for warships, and more generally from the defence interest in VSEL as a main supplier of warships.

### ***Implications for competition of a GEC/VSEL merger***

6.83. If GEC's bid succeeded, it would be the predominant group in naval contracting, combining ownership of the two yards best placed to build large ships with a major presence in the supply of defence electronics to them. GEC had indicated that it would aim to use each yard for what it did best, with frigates built at YSL, and submarines and large ships at VSEL. The competition implications of placing the two yards in common ownership related most directly to frigates, in which YSL had specialized. The number of probable competitors for the final batch of Type 23 frigates would be reduced from three to two. Competition would remain from VT, albeit it had not recently built vessels of this size; it was moreover uncertain how much competition VT could provide for the next generation of frigate-the CNGF-given physical constraints at VT's yards. In addition with a GEC take-over of VSEL there would be only one group well placed to fulfil the prime contracting role for future warship provision by combining both a hull-making and an equipment-making supply capability.

6.84. These considerations should, however, be seen in context. The Type 23 competition involved a product with an established price level from previous tenders. YSL had already been selected to build the first-of-class of the CNGF; the first of the follow-on orders was not planned until 2000, the exact number of vessels must be speculative at this stage, and the date for implementation could slip. Much the biggest tender in the next few years was the requirement for B2TC submarines for which VSEL looked the likeliest contractor. It had a strongly established tradition of building submarines; and, while GEC had been persuaded to tender, Sponsor Command was uncertain how good its prospects were.

6.85. The claim that GEC predominance in the building of hulls for warships would reduce competition in the supply of electronic systems represented a real concern of its competitors. On the other hand, the

MMC had not found evidence of such abuse when it investigated the GEC take-over of Plessey and it was the responsibility of the MoD to prevent abuse by the effective policing of subcontracting arrangements.

6.86. Sponsor Command concluded that a GEC take-over bid would reduce competition, particularly in the supply of frigates, although there might be an offset from the circumstances of the tender for B2TC submarines. From a Sponsor Command point of view, the main counter-considerations derived from the arguments for concentration.

6.87. GEC had argued that efficiency would be best obtained by creating one operation utilizing the strengths of each yard. It had also been questioned whether it was realistic to seek to maintain two warship yards servicing mainly the MoD's requirements for ships of frigate size and above, given the reduction in the MoD's expenditure on warships. Reductions in defence expenditure below present plans were possible; historically, there had been a tendency for the MoD's purchasing of defence equipment to fall short of that shown in forward projections, and the final outcome of the 'peace dividend' was uncertain. On the other hand, it could be argued that a single main supplier of warship hulls might develop a close relationship with the MoD, with inadequate stimulus to remain competitive in international terms.

6.88. If the B2TC contract did not go to VSEL, and the contract for Type 23 frigates did not go to YSL, neither yard was likely to survive on an independent basis. But the prospects for both were not as unfavourable as that, and Sponsor Command concluded that it would be premature to write off the chances of both yards surviving independently. However, it seemed clear that the MoD's programme was only just sufficient to sustain the two yards as independent forces and it was a matter of judgment whether it would be preferable to combine them into a single operation, or to retain competition. Sponsor Command was unable to comment on the relative efficiency of the two yards.

6.89. Sponsor Command supported VSEL's belief that its combination with GEC would enhance its export prospects by providing access to a major sales organization. Sponsor Command said that the prospects for UK civil shipbuilders were currently uncertain. The expected recovery in demand had not yet materialized and, although subsidies were to end in December 1995 by OECD agreement, competition from other suppliers was very strong. While the recent involvement of KG in the LPH contract was an innovative development, demand for warships was unlikely to make a big difference to the civil yards' workload.

6.90. The MoD was responsible for export promotion of the UK warships industry, but the DTI lent active support. Export markets for warships were extremely competitive and would remain so. VT had done well with exports of smaller ships and it was disappointing that YSL had failed to break into that sector of the market. It might be able to improve export performance. VSEL had suffered from offering a product with limited export potential though it was now planning to break back into surface ships. The market was difficult with prospects depending on the outcome of a small number of competitions. It was difficult to predict whether substantial export orders would be won by UK yards.

6.91. As regards the preservation of capacity, the loss of either VSEL or YSL-both in Assisted Areas-would be a blow for regional policy. GEC might be prepared to give indications that YSL and VSEL would be maintained in production for a number of years. On one view, however, the company might find that the optimum course in the medium term was to minimize overheads by concentrating production at VSEL. The MMC might wish to consider the scope for undertakings from GEC about the future of YSL in the event of its bid succeeding.

## **HM Treasury**

6.92. The Treasury said that it had two areas of policy concern: the impact of a take-over on warship procurement costs (and hence on the defence budget and public expenditure) and on wider competition policy (and hence the need to challenge potential reductions in competition if the supply side performance of the economy was to be enhanced). It started from a presumption that competition was the most effective means of reducing procurement costs over the medium term, and that the benefits could be expected to exceed those predicted by any analysis done in advance.

6.93. The Treasury said that the GEC bid gave it cause for concern. It would reduce competition in warship procurement, with potentially harmful implications both for value for money in defence

procurement and for competition policy more generally. Alternative sources of competition for ship and submarine procurements had been suggested but these were at best unproven, if not optimistic. The Treasury was not persuaded that the real drawbacks that would arise from a successful GEC bid would be outweighed by any undertakings and commitments that the MoD might receive from GEC. The MoD's recent abandonment of the prime contractorship competition for the LPD project had shown how the scope for competition might be overstated.

6.94. If GEC acquired VSEL it would be involved in both of the consortia bidding for the B2TC. GEC had indicated to the MoD that it would be prepared to preserve the competition for the B2TC by continuing with two independent bid teams. The spur of competition might make VSEL think more innovatively than before; but that spur could be blunted somewhat by the expectation that, whatever the outcome, GEC would arrange for construction at VSEL's facilities at Barrow. The Treasury was also sceptical that two bids from different GEC teams (albeit with different partners) would be competitive in practice.

6.95. The Treasury acknowledged the initiatives which the MoD had taken to achieve taut but fair prices in its non-competitive contracting, but the intrinsic difficulties it faced should not be ignored. To be successful, the MoD's NAPNOC negotiating philosophy required a good deal of well-informed, intelligent customer input. The ability to understand an individual company's costing structure, to establish realistic bench-marks for comparable manufacturing processes and to identify the potential learning curve benefits on those processes were examples of the type of expertise required. This was not easily achieved and would become progressively more difficult to sustain as the MoD continued to reduce its technical resources consequent upon pressures on service costs generally. The Treasury believed even the MoD's most skilled contractual negotiators were already hard pressed to compete with the far larger resources available to the largest defence contractors.

6.96. But while NAPNOC achieved lower prices it did not guarantee prices that were equitable as between customer and supplier. Without the opportunity to conduct an adequate number of representative post-costing reviews it was still too early to judge how reasonably priced the MoD's NAPNOC contracts had turned out to be. It should also be recognized that undertaking such reviews and policing the non-competitive contracting environment generally was, like contract pricing noted above, an expensive activity requiring a large number of skilled and experienced staff.

6.97. Additionally, non-competitive arrangements with prime contractors, even under NAPNOC, could never fully guarantee maximum competition at subcontract level. Although financial thresholds were imposed by the MoD above which competition at subcontractor level was mandatory, or other subcontracting targets set, this did not prevent potential grace-and-favour contracting for lower values or where specifications had been drawn up by prime contractors to favour preferred sources of supply. The Treasury understood this to be a particular concern of some non-GEC subcontractors in the case of the proposed VSEL merger.

## **Department of Employment**

6.98. DE said that any job cuts at YSL that resulted from a merger between GEC and VSEL would probably have an impact on the local economies. It was likely that the relative impact would be greater in Barrow, simply because the shipyard was much bigger in relation to the local economy; the effect on unemployment was likely to be slightly higher for Barrow as the local economy was more self-contained than that of Glasgow. It believed the best way of creating and preserving jobs was for the businesses concerned to do what was best for them, subject to maintaining a competitive market. It believed the decision should be made on competition grounds alone; therefore maintenance of employment in the short term should not, of itself, be a consideration. Any other course might allow some short-term respite for a shipyard, but possibly at the expense of its long-term future and of jobs elsewhere.

## **Scottish Office Industry Department**

6.99. The SOID was concerned that the bids for VSEL had potential implications for the future of YSL, which was owned by GEC, but more generally for the future of the Scottish shipbuilding industry.

6.100. SOID saw a strong public interest argument that YSL should be maintained as a viable yard. It believed it to be in the public interest for a strong shipbuilding presence to be retained on the Clyde, both in terms of the direct employment which would result and the benefits that would accrue to other related industries and to the Scottish economy as a whole. SOID was concerned at the substantial loss of shipyards and shipbuilding employment in Scotland and in the UK in recent years, and did not believe a continuation in this trend was either in the national interest, or that it was necessary for the sake of maintaining an internationally competitive industry. In making this last point, SOID noted the potential for export orders to be won by cost-effective and competitive naval shipyards provided they had a base load of orders, and the confidence that that implied, from their own Government; and believed in any case that theoretical exercises to determine a supposedly viable national level of shipyard capacity were likely to fail. This was mostly because the longer-term availability of orders was not certain; but also because the economic workload of a yard varied according to many factors which would vary over time, including its own efficiency, its input costs relative to competitors, its view of what was an acceptable rate of return, and so on. SOID believed that, as a general principle, the maintenance of competition among yards was likely to be the best guarantee of efficiency and longer-term success.

6.101. SOID considered that it might be made a condition of allowing a bid by GEC to require an undertaking that if successful in bidding for VSEL it would nevertheless maintain YSL as the main bidder for surface warship contracts.

## Shipbuilders and shiprepairers

### VT

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

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

*Details omitted. See note on page iv.*

]

6.104. VT believed the proposed merger was not against the public interest for the following reasons:

(a) VT would continue to provide prime contractor competition for the design and/or build of all MoD surface warships of sizes up to and including CNGF frigates (about 6,500 tonnes). VT told us that it was anxious to be able to bid to act as prime contractor on warships larger than the 6,500 tonnes that it could accommodate in its own yard. It had been unable to find a suitable partner to bid for the LPD; [

*Details omitted. See note on page iv.*

].

(b) VSEL had had a monopoly in UK submarine-building for many years and this would be unchanged. Should the MoD require VSEL to provide additional prime contractor financial security this could be provided by GEC.

(c) The Royal Navy demand for surface ships greater than 6,500 tonnes was small-up to two LPDs, up to two AOs and possibly one other ship over the next 10 to 15 years. Hull construction for these vessels would be limited by size to VSEL or the commercial yards of H&W or KG. Such projects could be adequately handled by existing MoD procedures for single sourcing or competitively by use of a third party prime contractor (eg VT) similar to the current LPH contract.

(d) The ability of UK yards to export warships would be unaffected.

6.105. VT told us that the export market for warships was extremely difficult and time was needed to secure sales. Effectively VT's potential export markets were limited to those countries which had no domestic capability, a warship requirement and the means to pay; these were found mainly in the Middle and Far East. VT attributed its recent success to the foresight of those who had set up its export department over 30 years ago, to an active and knowledgeable sales organization and to its ability as prime contractor to offer a complete support and after-sales service to overseas customers.

6.106. VT added that the proposed merger would be positively in the public interest by contributing to necessary rationalization and reducing the UK industry to the two companies it thought would be required, for the reasons set out in the preceding paragraph.

6.107. VT was, however, concerned that the proposed merger could be expected to increase the competition it faced in export markets as GEC was unlikely to find that the UK market gave adequate growth. It was also concerned that it might lead to a dilution of DESO support for VT as the UK's leading exporter of warships. If VT then failed to win further export contracts its ability to survive as a competitor for MoD warships would be put at risk.

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

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

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

## **KG**

6.110. KG is a subsidiary of Kvaerner AS, a Norwegian company. It is currently constructing the hull of the LPH for the Royal Navy under the terms of a subcontract from VSEL; it had also recently been approached by VSEL and other naval yards to participate in bids for forthcoming MoD surface ship projects. KG wished to remain primarily a builder of high-quality merchant ships. It did not regard the possibility of involvement in the present intensive MoD procurement procedures to be compatible with its market strategy, although it was keen to offer its expertise as a merchant builder in the construction of

naval ships which could benefit from merchant shipbuilding methods contracted under commercial terms. KG could offer value-for-money subcontract work on further LPH/LPD/AOR and other vessels which could have a high degree of merchant-type construction. KG might not wish to act as a naval prime contractor, for example, in relation to the AOR vessels.

6.111. Owing to the more complex procurement procedures involved in MoD contracts there was a wide difference in the organizational structure which existed between merchant and naval yards. KG was therefore sceptical as to the extent to which UK merchant yards could participate fully in naval programmes without a change in these procedures. With the demise of CL and SH, the number and nature of the remaining naval yards (VSEL, YSL and VT) effectively limited the extent of real competition that was possible, particularly in relation to larger surface vessels. YSL currently limited its construction size to large frigates, but could build larger surface ships in its dry docks subject to some capital investment.

6.112. KG could see potential benefits from a GEC acquisition through a possible reduction of its costs. However, it was a matter for conjecture whether such reductions would be reflected in lower prices to the MoD or whether the reductions in competition thereby created might offset such savings.

## **DML**

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

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

6.115. DML believed UK commercial shipyards had the potential to expand into the building and refitting of large surface warships, although return on investment and the availability of adequately skilled labour would probably preclude any such move in practice. Foreign shipyards also offered potential competition, subject to issues of national security and hidden foreign subsidies which distorted commercial competition. Export opportunities existed for the building of new warships, and would probably be only marginally affected whatever the outcome of the bids. An acquisition by GEC might promote further rationalization of the UK warship-building infrastructure.

## **Equipment suppliers**

### **BAe**

6.116. BAe said that it believed the proposed merger of VSEL and GEC would have profoundly damaging implications for the public interest. In summary, it would:

- (a) prevent the emergence of competition in naval whole ship prime contracting;
- (b) eliminate competition between the two principal UK major warship yards;
- (c) render the MoD heavily dependent in the naval sector upon a single vertically-integrated defence contractor;

- (d) undermine the ability of the MoD to obtain value for money in the procurement of naval equipment;
- (e) create a real risk of closure of one of the shipyards (probably YSL), with serious consequences for employment and the local economy; and
- (f) do nothing to improve the export performance of the UK warship-building industry.

6.117. BAe said that, overall, the merger of GEC and VSEL would strengthen GEC's position in the UK naval sector to such an extent that it would have virtually complete control of:

- (a) the supply of major naval platforms;
- (b) naval whole ship prime contractorship; and
- (c) the supply of many of the principal types of naval equipment and systems (including radar, sonar, and weapon systems, such as torpedoes).

6.118. BAe said that it was essential to increase the UK's naval prime contracting capability to ensure the existence of competition. In the absence of competition, the MoD and the taxpayer would be exclusively dependent upon GEC, a single highly vertically-integrated supplier with no proven record as a platform prime contractor. Dependence on a single vertically-integrated supplier would deprive the MoD of the benefits of competition, including increased cost-effectiveness, price performance and technical innovation. The MoD did not have at its disposal adequate means of safeguarding its interests by any form, or combination of forms, of substitute for competition. In particular, NAPNOC was not effective in the absence of a suitable external source of data on estimated costs, and competition at the subcontract level offered insufficient protection against the strength of a highly vertically-integrated supplier controlling a large proportion of the subcontract work. Furthermore, any requirement for additional MoD surveillance would run counter to its policy of contracting out risk to the private sector; the erosion of the MoD's skill base was such that it would be costly, and perhaps impossible to recover it.

6.119. BAe said that it had identified issues bearing on the merger of GEC and VSEL that it thought central to the public interest. These were:

- (a) the reasons for, and timing of, GEC's bid for VSEL;
- (b) the adverse effects of the merger on competition in the UK naval prime contracting and platform construction for major warships;
- (c) the resulting advent of GEC as the dominant naval contractor and its entrenchment as a monopoly in the emerging naval prime contracting market;
- (d) GEC's rationalization plans; and
- (e) the effects of the acquisition on the export performance of YSL and VSEL.

### **David Brown Group plc**

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

6.121. David Brown said that suppliers of naval equipment would almost certainly be disadvantaged if VSEL and YSL were to come under common ownership by GEC. If GEC were to gain a monopoly of large naval shipbuilding this would also lead in a short period of time to a monopoly being achieved by

GEC naval equipment companies. To prevent this the MoD would have to revert either to a degree of direct equipment specification, which it had given up when moving to the prime contractor system, or to take a direct role in overseeing competition and which it might no longer have the resources to support. A prime contractor would not necessarily be obliged to seek out the best terms; David Brown had not received any invitations to quote from YSL in the last three years. However, even if a contractor were required to put some systems out to competitive tender, there would be concerns about maintaining confidentiality. In the gears market prices for the same product were not usually dissimilar; the competitive edge was derived from producing a solution which was cheaper. In such circumstances, where the prime contractor owned a company making the same product, there was no way of ensuring that information about competing proposals did not pass to the subsidiary.

## **Racal Electronics plc**

6.122. Racal supplies electronic warfare equipment for naval defence. Its main interest is in the supply of electronic support measures equipment and electronic counter-measures equipment to the MoD and overseas navies for both surface ship and submarine contracts. It also supplies display equipment for command and control systems. Racal said that GEC had already achieved a dominant position in the UK defence market. If it was successful in acquiring VSEL its position would be further extended and this would not be in the public interest. The MoD's stated procurement policy of fair and effective competition could not be implemented if there was no credible alternative to GEC for major defence contracts. Since GEC already owned YSL its acquisition of VSEL would put an end to effective competition for larger warships in the UK.

6.123. Racal considered that an acquisition by GEC also raised major concerns as it would strengthen GEC's position as a prime contractor for ship programmes. GEC could then use its dominant position in the UK market for warships to inhibit effective competition for major subsystems. It was clear that GEC viewed the acquisition of VSEL as a means of strengthening its position as a prime contractor for ship programmes, and it was increasingly MoD policy to seek a single prime contractor for ship and submarine contracts. A prime contractor had considerable authority and influence in the selection of major electronic subsystems and Racal was concerned that GEC could favour its own interests as a supplier of such subsystems. Racal pointed out that it had provided the electrical support measures system for the Type 23 frigate. For the Royal Malaysian Navy frigates being constructed by YSL the GEC-Marconi Mentor system developed for the purpose had been chosen; as far as Racal was aware this was the only overseas sale of the system.

6.124. Racal was aware that the MoD believed it had the ability to ensure that the prime contractor undertook open and fair subcontract competition for major subsystems. But it was doubtful whether this would be so in future where a prime contractor was a supplier of such subsystems. The MoD currently had the technical ability to police single source suppliers, but this ability would be eroded over time as the MoD increasingly stood back from the selection process. There were also doubts over the MoD's will to be involved in the detail of supervision that would be required.

6.125. Racal was also concerned about the danger of leakage of sensitive information to a prime contractor, particularly in relation to applications of technology that were not themselves patentable. Racal had a particular processing technology that had not so far been disclosed to GEC; however, where a prime contractor was adjudicating bids he would need to understand such an aspect.

6.126. Racal thought that if the acquisition were to proceed some safeguards for supplies of subsystems would be necessary, involving independent adjudication of tenders, preferably by the MoD.

## **Siemens Plessey Electronic Systems Ltd**

6.127. Siemens Plessey Electronic Systems Ltd (Siemens Plessey) supplies surveillance radar, command systems and on-board communications equipment for naval applications. The company told us that it had won contracts worth in excess of £100 million over the last ten years to supply the Type 996 radar to the Royal Navy and substantial export sales in the naval sector. It was opposed to the GEC bid, which it regarded as against the national interest. An acquisition would close the UK competition position not only

on shipbuilding but also on the supply of major systems for ships. The company saw its routes to the UK market being acquired and cut off by GEC.

6.128. Siemens Plessey thought the MoD intended to move towards prime contracting although there were limits to the extent to which it could be applied to procuring weapons systems for warships. Siemens Plessey was in no doubt that a prime contractor, having seen prices and terms offered by the competition, would be able to select in a way which favoured its own interests. Competitors were normally evenly matched and there would be little threat to the prime contractor's performance through favouring its own subsidiary. Siemens Plessey added that if it were excluded from UK markets, this could affect its credibility as an exporter.

6.129. Siemens Plessey thought it would be difficult to introduce any safeguards to prevent GEC favouring its own subsidiaries.

### **Thorn EMI Electronics Limited**

6.130. Thorn EMI is chiefly engaged in various aspects of the music business. But its electronic and defence systems business supplies electronics equipment for naval applications. Thorn EMI told us that it was concerned at the prospect of a GEC acquisition of VSEL, which would make it the dominant supplier in UK naval shipbuilding. GEC was also a major supplier of on-board naval equipment. As the owner of both YSL and VSEL, it could wield significant influence over the selection of equipment, thus tilting the balance of competition against other suppliers. Thorn EMI recognized that the MoD might specify and procure on-board equipment separately from naval vessels, but the tendency to whole ship procurements and prime contractorship gave GEC an overwhelming ability to influence and prescribe equipment. In practice, the MoD was tending to relinquish control over system specification at a relatively early stage of contract negotiations; over time this approach would diminish the MoD's ability to make technical assessments of key areas. [

*Details omitted. See note on page iv.*

]

### **AMEC Plc**

6.131. AMEC is engaged in a range of building and engineering activities, including the construction of oil and gas platforms. AMEC said that it had been approached by GEC and Rolls-Royce to explore proposals to use its skills and facilities for the construction of nuclear submarines. The key to the proposed method of submarine construction being explored was modular construction. Although diversification from platforms to submarines might appear surprising, many of the skills required for the former-modular building experience, welding and outfitting skills, CAD design and project management-were relevant.

6.132. The precise role AMEC would play in the project had not yet been finally determined but within the team it was currently responsible for the build strategy, 3D CAD modelling and physical construction. The modules could be built and assembled at AMEC's Newcastle yards, with the use, where necessary, of temporary cover. How much of the fabrication might actually be carried out there could depend *inter alia* on cost. AMEC saw no need to draw on VSEL's facilities except possibly to load the nuclear core.

6.133. AMEC considered that its own contribution to the bid would meet the MoD's requirements and believed that other members of the team were equally confident that the bid would meet technical requirements and be competitive on price.

### **Loral ASIC**

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

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

6.136. Loral ASIC would seek to negotiate a suitable teaming agreement with GEC, and understood that GEC accepted a Loral ASIC role. However, it had two specific concerns in relation to the GEC bid. First, GEC would potentially have to know the precise details of the VSEL/Loral ASIC bid and how it was put together in order to support it. This would make it very difficult to continue the B2TC competition and must raise concerns about the maintenance of 'Chinese walls'. Additionally, the MoD might not be in a position to evaluate the offers and reach a decision, as scheduled, by June 1996. Secondly, GEC might want to explore the overlap of common capabilities between it and Loral ASIC in Submarine Combat Systems Integration after the acquisition of VSEL. Loral ASIC was concerned about such a proposal as it believed it could affect its system performance guarantees and possibly increase programme risk. Further discussions between GEC and Loral ASIC had indicated that GEC would be satisfied to accept without modification the VSEL/Loral ASIC solution and approach to the B2TC.

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

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

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

6.139. Rolls-Royce had been nominated as design authority and supplier of the nuclear steam-raising plant for the B2TC. For the VSEL B2TC bid Rolls-Royce would act as subcontractor to VSEL in providing this plant. In the consortium bid Rolls-Royce would be a risk-sharing partner with GEC, responsible for providing the main propulsion plant, ie not only the steam-raising plant but also for procuring the main turbines, gearbox and auxiliary systems. It would not be involved in the procurement of other equipment. The intention was that GEC would have the predominant share in the consortium, reflecting the work-share responsibility of the two parties. No formal agreement had yet been entered into and Rolls-Royce had so far funded its own design studies, the costs of which were recoverable from the MoD. The two other companies involved with the consortium were BMT, which was acting as a consultant on the submarine design, and construction methods, and AMEC, which would be a subcontractor responsible for the assembly, integration and testing of modules at Wallsend and, possibly in competition, for some steel fabrication work.

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

6.141. Rolls-Royce believed the consortium's proposals had substantial advantages, particularly in shortening the time needed for fabrication, installation, and commissioning. This would permit the risk associated with the first build to be accommodated within the programme time-scale; substantially shorter periods were envisaged for building the second and third vessels.

6.142. Rolls-Royce said that, in order to protect its own interests in the consortium bid, it would support a proposal that, if GEC were to acquire VSEL, the consortium and VSEL bidding teams would be maintained separately for six months. It thought it would not be possible to keep such separation in place for much longer than that. The six-month period suggested seemed reasonable; it would not be long enough for the MoD to reach the point of signing contracts but should enable it to decide whether to proceed on the basis of either one bid or the other or to mix features of both. Once that decision was made the MoD could negotiate on the basis of the reference prices set by the bidding process.

## **EDS Defence Ltd**

6.143. EDS Defence Ltd (EDS), an information technology service company, was concerned that an acquisition by GEC would act against the principles of fair trading, particularly in areas of the naval systems market. EDS said that the MoD had adopted a whole ship procurement regime which worked well in a competitive environment, but a take-over of VSEL by GEC would remove competition for the B2TC and LPD contracts. As a potential monopoly supplier, GEC might be able to distort competitions for subsystems by transferring costs from the subsystems to the ship platform. This was a specific short-term issue because in the longer term the MoD could select an alternative mechanism for dealing with a single source supplier.

6.144. EDS said that conditions should be attached to any take-over of VSEL by GEC to ensure fair trade at the subsystem level. Such conditions might include GEC withdrawing from subsystem programmes, or having its costs open to audit to ensure fair play.

## **Trade unions**

### **Confederation of Shipbuilding and Engineering Unions**

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

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

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

6.148. The CSEU said that the driving force behind defence company mergers was market share. The ability to manage defence contracts and to compete against other merged companies in the USA and Europe was the strongest argument in favour of the deals. VSEL, because of its geographical position and its

overwhelming dependence on military and, in particular, Trident contracts needed to be part of a larger company which could give it access to foreign markets. GEC was clearly better placed to ensure much of this access abroad and could also provide work at VSEL in the lucrative area of fitting weapons systems on warships. Investment was also needed to build surface ships, and a new channel might have to be dredged at Barrow. A crucial aspect of the take-over battle was the need to provide VSEL with financial support to make the conversion. Traditionally VSEL had been the main source of training for apprentices and skilled workers in this area of the UK; it was important that the high-quality training provided was not lost to the local community and to the UK.

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

### **Barrow and District CSEU**

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

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

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

### **YSL trade union representatives**

6.153. Representatives of the AEEU, EMA, GMB and MFS unions provided us with evidence. They said that YSL was the UK's leading surface warship-builder, particularly of frigates in recent years. The trade unions hoped that GEC would succeed in acquiring VSEL. The trade unions were most concerned that there should be no further reduction in the number of UK shipyards now remaining.

6.154. The trade unions saw no adverse consequences for YSL if GEC were to succeed in its bid for VSEL. They had had no direct contact at the most senior levels with GEC but they understood that it had guaranteed both the VSEL and YSL yards for seven years; they would expect the Type 23 frigates to be built by YSL.

6.155. The advantages that the trade unions saw for YSL if GEC acquired VSEL were chiefly that the resulting shipbuilding group would have a much-improved chance of securing new orders. There were hopes of diversification but there was no firm prospect of work being transferred from VSEL to YSL. There might be increased possibilities of subcontracting between the yards.

6.156. Under GEC ownership investment at YSL had increased and industrial relations had improved. The trade unions had co-operated closely with GEC in securing economies and heightened efficiency at YSL. This had been painful but worthwhile. The trade unions had been sceptical at the outset about the IMPACT programme but had viewed it favourably after members had attended the three-day course and other training sessions; they saw no threat to the skills at YSL and VSEL and drew attention to YSL's competitiveness and flexibility.

## **Other organizations**

### **Barrow-in-Furness Borough Council**

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

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

### **Furness Enterprise Ltd**

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

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

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

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

## **Members of Parliament**

6.163. *Mr Robert Atkins MP* expressed grave concern at the implications of a GEC acquisition of VSEL. It would have seriously detrimental effects on competitive procurement.

6.164. *Mr Julian Brazier MP* was profoundly against the idea of GEC acquiring VSEL. It was no criticism of GEC, as an excellent and innovative company, that it would be a disaster if it were allowed to take over VSEL and thus establish itself as an effective monopoly supplier of major warships in the UK.

6.165. *Mr Ian Bruce MP* said that VSEL was not in need of GEC to secure its future. He was totally convinced that to allow GEC to acquire VSEL would be wrong from both a competition point of view, and for any hope that shipbuilding in the UK would now start to increase rather than decrease.

6.166. *Sir John Cope MP* commented that the GEC bid was undesirable on the grounds of competition policy, UK industrial strength, defence procurement, public expenditure and the balance of payments. If GEC acquired VSEL it would have a monopoly in warship-building.

6.167. *Mr Phil Gallie MP* commented that the capabilities of GEC to win export orders should be taken into account. He did not consider a concentration on the home market requirement to be in the best interest of those involved in British shipbuilding or of the UK as a whole. GEC already owned the principal competitor yard, YSL, and there must clearly be demonstrated a system of design and costing which ensured a competitive approach at the tender stage for UK contract work. There should be strict guidelines which ensured that there was no collusion between the yards up to this point. In the event of GEC successfully acquiring VSEL, undertakings must be obtained which kept VSEL and YSL in the market-place for a minimum of ten years.

6.168. *Mr Thomas Graham MP* was concerned that if GEC were allowed to acquire VSEL it would create a single supplier of warships to the MoD, and the potential would exist for it to dictate terms. A take-over by GEC could also have a potential adverse effect on jobs in the Clyde area.

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

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

6.171. *Mr William McKelvey MP* expressed his concern, and that of many of his constituents, that a take-over of VSEL by GEC would be anti-competitive. It would lead to GEC controlling all submarine-building in the UK.

6.172. *Mr Keith Mans MP* was opposed to a take-over of VSEL by GEC as it would clearly create a monopoly in the building of warships in the UK.

6.173. *Mr Gary Streeter MP* was concerned that GEC might become the only major UK warship prime contractor. He was also concerned that GEC's ownership of both YSL and VSEL might lead to a GEC bid for Devonport Royal Dockyard, so giving GEC control of the bulk of UK warship repair facilities.

6.174. *Mr Nicholas Winterton MP* said that the GEC bid raised serious competition concerns. If it were allowed to proceed it would place a shipyard capable of building major warships in the hands of its principal competitor. The MoD's established policy of seeking, wherever possible, to ensure competition in the field of the supply of defence equipment and services clearly had a great deal to commend it; to permit GEC's bid to proceed could effectively reverse this policy. In considering the GEC bid, Mr Winterton suggested we should take into account the following:

- (a) whether the MoD could be expected to obtain best value for money in tendering if the two major warship yards were under common ownership; it was difficult to imagine that common ownership would not result in a loss of competition; and
- (b) how GEC could fairly claim that there would be economic advantages in bringing together Barrow and YSL under common ownership in a period when, according to GEC, there was excess naval warship-building capacity, yet at the same time claiming that it would keep both shipyards open.

6.175. *Mr Timothy Wood MP* said that a merger between GEC and VSEL would limit severely competition in military shipbuilding.

## **Scottish National Party**

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

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

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

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

6.180. The SNP said that even making allowances for the hyperbole of a bidding situation, it was difficult to appreciate that GEC was examining the potential of the same facilities and the likely direction of the MoD ordering programme. One of the chief fears in Scotland and on Clydeside was that, whoever owned and controlled VSEL, it would be underpinned by the stability of the nuclear attack submarine order and would be the survivor in the surface ship stakes as well, unless the MoD took appropriate steps to examine the allocation of costs and overheads between competing facilities. The SNP urged careful examination of the nature and direction of the MoD shipbuilding ordering programme, in order to ensure that the expertise and employment related to naval shipbuilding on the Clyde were maintained. The reduction of shipbuilding employment on the Clyde in the past 25 years had been dramatic and tragic. Today, there were only three shipyards on the river: YSL, KG and Ferguson at Port Glasgow, with the

latter Scottish-owned and employing around 250, compared with the 7,000 to 8,000 employed in the lower Clyde yards 20 or so years ago.

6.181. It was extremely important therefore that steps were taken to ensure, as far as was humanly possible, that the R&D, design, and building capacity of YSL were maintained at Scotstoun, whatever the outcome of bidding procedures.

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

D G GOYDER (*Chairman*)

R HALSTEAD

J F PICKERING

E C TRITTON

The following two members, being members of the Group, dissent from the conclusions for the reasons set out in the note of dissent included in this report.

A FORSTER

A P L MINFORD

A J NIEDUSZYNSKI (*Secretary*)

12 April 1995