
Completed acquisition by Alenia Marconi Systems Limited of BAe Systems (Combat and Radar Systems) Limited

A report under section 125(4) of the Fair Trading Act 1973 on the advice of the Director General of Fair Trading, given on 26 March 2002, to the Secretary of State for Trade and Industry under section 76 of the Act

The parties

Alenia Marconi Systems Limited (AMS) is a wholly owned subsidiary of AMS NV, a joint venture between BAE SYSTEMS plc and Finmeccanica S.p.A. BAE SYSTEMS was created in 1999 when British Aerospace and GEC's Marconi Electronic Systems ('MES') merged, and took over joint control of AMS.

BAE SYSTEMS (Combat and Radar Systems) Limited (CaRS) was created by the transfer and subsequent amalgamation of certain parts of two BAE SYSTEMS subsidiaries (relating to Land and Sea Systems and Defence Systems).

Finmeccanica S.p.A. (FNM) is the holding company of a group active in the defence and aerospace sectors. The Italian State is the largest (minority) shareholder in FNM. As a result of the AMS joint venture (originally with, MES), FNM's activities in the fields of radar systems, missiles systems, naval systems, command and control systems, traffic control systems and the relevant customer support services were contributed to the AMS joint venture. BAE SYSTEMS acquired MES on 30 November 1999, thereby acquiring joint control of AMS with FNM.

BAE SYSTEMS plc (BAE SYSTEMS) is a public company incorporated in England and Wales, active in several defence and aerospace sectors. It is not controlled by any other undertaking. It is primarily active, either directly or through joint ventures, in the design, development, manufacture and service of aircraft (commercial and military), defence electronics and defence systems, space, shipbuilding and guided weapons and guided weapons systems/sub-systems. BAE SYSTEMS was created through the merger of British Aerospace and the defence electronics business MES on 30 November 1999.

The transaction

The transaction involves the acquisition on 18 December 2001 by AMS of control of CaRS.

Background

In the context of the merger of British Aerospace and MES, the Secretary of State accepted certain undertakings from BAE SYSTEMS on 28 March 2000 in lieu of a reference to the Competition Commission. A number of those undertakings covered all members of the BAE SYSTEMS group including CaRS.

The creation of BAE SYSTEMS by that merger and its consequent acquisition of joint control of AMS appears to have resulted in certain business overlaps between AMS and its new parent, BAE SYSTEMS. The present transaction, through which AMS has acquired the overlapping activities of BAE SYSTEMS, is intended to rationalise this situation. In any event, MoD has told us that it has viewed AMS and CaRS as essentially being one company since that merger.

This transaction must be seen in the context of a wider reorganisation of the defence industry in which BAE SYSTEMS, FNM and EADS have formed a new enlarged guided weapons/guided weapons systems joint venture known as MBDA. The MBDA transaction is itself the subject of a separate notification (ME/1066/02).

This transaction was notified to the Italian Competition Authority on 14 December 2001 and clearance was granted on 15 January 2002.

ASSESSMENT

My assessment focuses on the competitive effects of the transaction in the UK.

Relevant markets

Product markets

The parties overlap in the supply of: (1) systems integration services for Command Control Information Systems (CCIS) and Naval Combat Management Systems (Naval CMS); (2) Naval CMS (programmes); and (3) Land and Naval defence radar.

Systems Integration for CCIS and Naval CMS. Systems integration is the process by which electronic components and IT are combined into a single system (CCIS or CMS). The parties provide systems integration services to all three branches (army, navy and air force) of the UK armed forces.

Naval CMS. Naval CMS can be sub-divided into **Naval CMS for surface ships** and **Naval CMS for submarines**. More generally, Naval CMS includes equipment that integrates platform sensors, weapons systems and data communications to provide early correlated information of an impending hostile attack. A CMS system can also provide tactical picture information, allowing system operators to evaluate hostile threats before controlling target engagements. In other terms, Naval CMS are essentially complex computer programmes that co-ordinate information and allow naval personnel to understand a battlefield.

Land and Naval (Defence) Radar. Land and Naval radar are used in commercial and defence applications for identification and surveillance. Commercial applications include ship navigation radar, air traffic control and automotive radar. It would not appear,

however, that commercial radar systems are substitutable for defence radar systems. Essentially, commercial systems are not as rugged as defence systems and the cost of modifying a commercial system to make it appropriately durable would be prohibitive.

Defence radar may be **ground based** or **naval based**. The major differences between the two systems are associated with mechanical configuration.

Geographic markets

In the UK, there is only one customer for the defence products described above, namely the MoD. Generally, companies bidding for MoD contracts in land and naval defence electronics are global companies. Indeed, the parties have argued that competition takes place at a global level. MoD has also stated that it sources land and naval defence electronics products on a world-wide basis.

At a European level, there would also appear to be scope for customers to procure land and naval defence electronics on an international basis. European Defence Ministers have signed an informal agreement aimed at creating an open market for defence equipment in Europe (the European Defence Equipment Market (EDEM)), and a Europe-wide defence procurement agency, OCCAR, has been created by the UK, France, Italy and Germany.

[.....] (see footnote¹).

[.....] (see footnote²). Even where the MoD wishes to place a contract with a view to preserving national capability, this does not preclude international suppliers from bidding. This is because international suppliers may themselves have national capability or may choose to enter into teaming arrangements with UK suppliers in order to satisfy this preference. As explained below, international suppliers such as Raytheon have on occasion done this when bidding for MoD defence electronics contracts.

Horizontal issues

Competitive assessment of this transaction must take into account the particular characteristics of defence procurement.

- First, encouraged by national governments, defence industry suppliers have been consolidating world-wide in order, *inter alia*, to bring down the very high costs and high risks related to defence product development and to reduce the inefficiencies that arise from duplicated technical development. This is particularly important as competition for contracts essentially takes place at the research and development stage.
- Second, defence procurement is characterised by significant buyer power. There is a sole customer in each country, the national defence department, which determines the type of product required and the identity of the suppliers that can bid for that contract, including on occasion "sponsorship" of new suppliers. Typically, a defence department will define a need for a new weapons system and then invite bidders (i.e. contractors) to develop a solution for that need. The MoD's procurement processes are designed to facilitate the exercise of buyer power through specifying prime contractors

and component suppliers, imposing transparent pricing, and requiring extensive data sharing. Above all, any product must meet strict 'value for money' benchmarks. The transfer of risk to the prime contractor increases the incentive on suppliers to secure and supply only the best product at the best price to meet the defence need.

Shares of UK supply

The cyclical nature of defence procurement and the bidding nature of competition for procurement contracts means that traditional measures of market power (such as review of shares of sales) may not provide a sound guide to future competition to the extent of future competition for MoD contracts. ([....] (see footnote³.) Moreover, in this case, national security concerns have made it difficult to calculate shares of supply accurately, since the parties have been unable to estimate the sales of their competitors for land and naval defence electronics contracts. In these circumstances, the number of credible bidders for future UK defence electronics contracts is arguably a better measure of the existence of competition.

Available shares of UK supply data indicate that, although the parties currently have high shares of UK sales, they have recently lost sales to other bidders. The land and naval defence electronics sectors were considered in August 1999 in the investigation of the BAE/ Marconi merger. Share data from that case (which relate to 1999 sales) may be compared against 2000 share data, as shown in the following chart. This chart of shares of UK supply should not be taken as showing shares of a relevant market for competition analysis; indeed there are reasons to think that competitive pressures operate globally: see further below.

	UK 2000 ²			UK 1999 ¹
	AMS	CaRS	Combined	Combined
Naval CMS (surface ship)	20-30%	40-50%	60-75%	60-75%
Naval CMS (submarine)	60-70%	5-10%	65-80%	80-100%
Ground-based Radar	30-40%	20-30%	50-60%	80-100%
Naval Radar	25-35%	50-60%	75-90%	80-100%

¹ Source: 1999 panel paper parties' joint shares of supply

² Source: the parties

These data suggest that this merger brings together the two largest UK suppliers of systems integration (CCIS, CMS systems and land and naval radar) and system components. It might therefore appear that the transaction will result in a reduction of competition for future MoD contracts in these fields. However, ([....] (see footnote⁴) there has been little competition between AMS and CaRS since the 1999 merger of BAE Systems and MES. Indeed, it does not appear that the MoD has switched supplier from AMS to CaRS in the past five years. In other words, the high combined shares above reflect contracts won some time ago under which sales have continued to the present.

The parties' combined UK shares of supply do appear to have been materially eroded over a short period of time. This suggests that the parties are not the only credible

bidders for MoD procurement contracts and that the MoD can and does procure from other bidders. MoD has confirmed that this is the case. In Naval CMS (surface ship and submarine), alternative suppliers for UK contracts include Lockheed Martin, Thales (which has UK defence electronics capability through its acquisition of Racal), and Raytheon, a US company that has used UK sub-contractors to ensure it maintains UK capability. In land radar, Thales has won MoD contracts. These facts are consistent with the parties' and MoD's submissions that competition is world-wide and national capability requirements do not prevent that.

Shares of world-wide supply

On a world-wide basis, the parties are relatively small players. Post-merger, they will face major competitors in each of the above defence electronics categories.

- (a) In Land and Joint CCIS, the parties' world-wide share of supply (1998-2000) is between 1 - 5% (increment < 1%). Major world-wide competitors include Raytheon and Thales.
- (b) In Air CCIS, the parties' world-wide share of supply (1998-2000) is between 1 - 5% (increment < 1%). Major world-wide competitors include Raytheon and Thales.
- (c) In Naval CMS (surface ship), the parties' combined world-wide share (1998-2000) is estimated to be some 5 - 10% (increment 1-5%). Major world-wide competitors include Raytheon, Thales and Lockheed Martin.
- (d) In Naval CMS (submarine), the parties' combined world-wide share (1998-2000) is estimated between 10 - 20% (increment 1-5%). Major world-wide competitors include Thales and Lockheed Martin.
- (e) In land radar, the parties' combined world-wide share (1998-2000) is estimated to be around 10 - 20% (increment 5-10%). Raytheon is a major world-wide competitor.
- (f) In naval radar, the parties' combined world-wide share (1998-2000) is estimated to be some 10 - 20% (increment 1-5%). Lockheed Martin and Northrop Grumman are major world-wide suppliers of naval radar.

As described above, the MoD has recently bought defence electronics products from competing international suppliers (namely EADS, Thales, Raytheon). [...] (see footnote⁵). It therefore seems likely that the combined AMS/CaRS will have to compete for MoD procurement contracts with a number of credible international bidders, a number of which have already successfully won MoD contracts in this field.

[...] (see footnote⁶). For example, it [MoD] can encourage international suppliers to locate facilities in the UK or could compel a UK-based supplier (such as AMS/CaRS) to partner with an international competitor. [...] and [...] (see footnote⁷). In any event, the MoD is ultimately interested in acquiring the right systems for the UK armed forces at the right price. If that means purchasing from abroad, then it will do so.

Post-merger, AMS and CaRS will be the largest domestic supplier of land and naval defence electronics to the MoD. However, other international suppliers of defence

electronics equipment will represent a good alternative to the merged entity, as evidenced by the recent tenders won by EADS, Thales, and Raytheon.

Barriers to entry and expansion

The investment required to undertake the necessary research and development to compete for MoD contracts in this field is large. The parties have argued that IT companies are potential competitors for CMS contracts. The parties have also argued that civilian radar companies could bid for naval or land defence radar contracts but, as discussed above, there are significant differences between defence and civilian radar products that might make it costly for a civilian manufacturer to develop defence specific products. The threat of such entry appears unlikely to constrain the parties significantly.

[.....] (see footnote⁸), this barrier may be overcome by the MoD's stated policy of sponsoring new entry if the number of bidders for a particular contract is considered to be low. This could benefit international suppliers as well as UK companies.

Buyer power

The parties have argued that the MoD has significant buyer power. They noted that the MoD's Smart Acquisition Policy (and related programmes) is intended to generate the benefits of competition by transferring responsibility for and risk of the developing system to the prime contractor (systems integrator). MoD requirements that sub-systems comply with international standards and 'open architecture' makes potential sub-contractors aware of interfacing and protocol arrangements, facilitating interoperability between competing sub-systems and ensuring competition between potential suppliers of sub-systems. A systems integrator thus has a powerful incentive to keep prices low, source the best available component within the MoD's procurement budget, and ensure that the delivered solution meets the MoD's strict value for money benchmarks. The parties said that this policy may be enforced by the MoD holding back payments for a delivered system until the equipment has been in service for some time and has been proven to meet the customer's requirements.

The MoD believes that it will retain sufficient buyer power to offset any reduction in supplier choice. It believes that the loss of CaRS as an independent supplier will not result in any substantial reduction of its ability to exercise effective purchasing power for the following reasons.

- First, the MoD has stated that it is willing to purchase from international suppliers. Where appropriate, it can and will sponsor new suppliers to bid for UK procurement contracts. This 'entry' can be used to discipline other bidders to ensure that the MoD is able to procure the electronic systems it needs to meet the UK's defence requirements at a competitive price.
- Second, the MoD also believes that its procurement processes (including on-going monitoring of development costs and product quality, transparency of price contractor data and international price comparisons) are an effective constraint on suppliers' commercial behaviour. In particular, MoD believes

that, [.....] and [2] (see footnote⁹), it can dictate the price at which it will buy systems and sub-systems from its suppliers.

- Third, ultimately the MoD wishes to buy the right product at the right price. If this means sourcing internationally, then it will do so.

Third party views

Third party competitors were specifically invited to comment. Only two replies were received and no significant competition concerns were raised.

NATIONAL SECURITY

The MoD has made representations that the merger might adversely affect the public interest on national security grounds.

[.....] (see footnote¹⁰). The MoD has identified two main areas of concern arising from this merger: the maintenance of strategic UK capabilities and the protection of classified information. These are outlined below. A more detailed explanation of the MoD's concerns can be found at [Appendix 1] (see footnote¹¹).

Maintenance of strategic UK capabilities

[.....] (see footnote¹²).

Protection of classified information

[.....] (see footnote¹³).

[.....] (see footnote¹⁴).

Undertakings in lieu

The test in the FTA relates to the effect of a merger on the public interest. The MoD has identified national security concerns arising from this transaction which relate to the protection of classified information and maintenance of a strategic capability.

The draft FTA undertakings at Appendix 2 are intended to remedy or prevent the particular effects adverse to the public interest identified by the MoD. Specifically, the undertakings seek to address the two areas of concerns identified above. They include provision for a compliance regime, consisting of the appointment of a 'Compliance Officer' for the purpose of facilitating, overseeing and reporting to the MoD on the security undertakings.

² [.....]

The MoD considers that having its concerns addressed under the 'public interest test' in the FTA would provide both a legal mechanism for imposing undertakings (either following or in lieu of a reference to the Competition Commission) and direct UK government influence over AMS if an appropriate mechanism was not put in place to monitor compliance with the undertakings. Were such undertakings not forthcoming, the MoD considers that the transaction should be referred to the Competition Commission.

The parties have confirmed that they are prepared to sign the FTA undertakings in the form attached at Appendix 2.

CONCLUSIONS

Competition

The transaction will reduce the number of UK-based bidders for MoD contracts for land and naval defence electronics, although in practice MoD told us that this reduction in bidding competition occurred in 1999. The existence of alternative credible bidders for procurement contracts, the potential for MoD-sponsored entry and, more generally, the substantial buying power exercised by the MoD suggest that post-merger AMS/CaRS will continue to face substantial competitive pressure. On balance, I have therefore concluded that this transaction does not result in a substantial lessening of competition and does not warrant reference to the Competition Commission for further investigation on competition grounds.

National security

The OFT is not expert in national security matters and must, therefore, rely heavily on the representations made by the MoD. I consider the MoD to be a body having a substantial interest in the above transaction within the meaning of section 76 of the FTA.

I have no reason to doubt the representations made by the MoD on the appropriateness of the security undertakings in order to remedy or prevent the specific effects adverse to the public interest identified by it and which are briefly described above. (The full MoD submission is at Appendix 1). I have therefore concluded that the transaction should be referred to the Competition Commission for further investigation unless the parties provide FTA undertakings in lieu of reference.

It appears that this transaction raises national security concerns but not substantial competition concerns. FTA undertakings (in lieu of a reference) have been prepared to deal with the security concerns of the MoD. It remains open to you to make a reference to the Competition Commission on wider public interest grounds, or to accept undertakings in lieu of such a reference. (As you know, it is proposed that national security will fall under the Exceptional Public Interest provisions of the Enterprise Bill). The MoD believes that FTA undertakings in lieu of a reference to the Competition Commission are the most effective means of remedying its national security concerns.

Following discussions with OFT officials, the parties have confirmed that they are prepared to sign the attached draft FTA undertakings. However, this will in no way

bind your decision whether to accept the proposed undertakings in their current form, nor in a modified version, if found appropriate following public consultation.

I therefore **recommend** that you accept the draft **undertakings** in lieu of a reference, but that before doing so, you should publish them for consultation.

¹ Excised at the request of the MoD on national security grounds.

² Excised at the request of the MoD on national security grounds.

³ Excised at the request of the MoD on national security grounds.

⁴ Excised at the request of the MoD on national security grounds.

⁵ Excised at the request of the MoD on national security grounds.

⁶ Excised at the request of the MoD on national security grounds.

⁷ Excised at the request of the MoD on national security grounds.

⁸ Excised at the request of the MoD on national security grounds.

⁹ Text and footnote excised at the request of the MoD on national security grounds.

¹⁰ Excised at the request of the MoD on national security grounds.

¹¹ Appendix 1 is excised at the request of the MoD on national security grounds.

¹² Excised at the request of the MoD on national security grounds.

¹³ Excised at the request of the MoD on the grounds of national security.

¹⁴ Excised at the request of the MoD on the grounds of national security.