

***Case No COMP/M.4640 -  
BAE SYSTEMS / VT / JV***

Only the English text is available and authentic.

**REGULATION (EC) No 139/2004  
MERGER PROCEDURE**

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Article 6(1)(b) NON-OPPOSITION  
Date: 17/10/2007

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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 17-X-2007

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In the published version of this decision, some information has been omitted pursuant to Article 17(2) of Council Regulation (EC) No 139/2004 concerning non-disclosure of business secrets and other confidential information. The omissions are shown thus [...]. Where possible the information omitted has been replaced by ranges of figures or a general description.

PUBLIC VERSION

MERGER PROCEDURE  
ARTICLE 6(1)(b) DECISION

**To the notifying parties:**

Dear Sir/Madam,

**Subject: Case No COMP/M.4640 - BAE Systems / VT / JV  
Notification of 12 September 2007 pursuant to Article 4 of Council  
Regulation No 139/2004<sup>1</sup>**

1. On 12 September 2007, the Commission received notification of a proposed concentration pursuant to Article 4 of Council Regulation (EC) No. 139/2004 ('the Merger Regulation') by which the undertakings BAE Systems plc ('BAES', United Kingdom) and VT Group plc ('VT', United Kingdom) acquire within the meaning of Article 3(1)(b) of the Council Regulation joint control of a newly created company ('ShipCo') constituting a joint venture.
2. After examination of the notification, the Commission has concluded that the notified operation falls within the scope of the Merger Regulation and does not raise serious doubts as to its compatibility with the common market and the functioning of the EEA Agreement.

**I. THE PARTIES**

3. BAES is a global company engaged in the development, delivery and support of advanced defence and aerospace systems. BAES designs, manufactures and supports military aircraft, surface ships, submarines, combat vehicles, radars, avionics, communication, electronics and guided weapons systems.

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<sup>1</sup> OJ L 24, 29.1.2004, p. 1.

4. VT is a UK-based support services and shipbuilding company supplying services and products to governments, government agencies and businesses worldwide.

## **II. THE OPERATION**

5. The proposed transaction involves the formation of a joint venture, ShipCo, between BAES and VT ('the parties'). Each party will contribute its existing naval surface shipbuilding and support operations in the United Kingdom<sup>2</sup> to the joint venture, including Fleet Support Limited ('FSL') which is an existing 50/50 joint venture between the parties<sup>3</sup>. FSL integrates most of the parties' activities in naval support (i.e. ship repair and refit).
6. On 25 July 2007, BAES and VT entered into a framework agreement ("the Framework Agreement") and an agreed form joint-venture agreement ("the Agreed Form JVA"). The Agreed Form JVA provides that each party will have the right to appoint three directors to the Board, which will decide on matters by simple majority vote. The Board will be chaired by an independent, non-executive chairman. Unanimous agreement will be required in relation to various reserved matters, including approval of the business plan and budget, and the appointment of senior management. The joint venture will therefore be deadlocked.
7. As regards the full-functionality of the JV, ShipCo will have its own management dedicated to day-to-day operations. It will also have access to sufficient resources since each party will contribute its entire naval surface ship building and support operations in the UK to ShipCo. The Parties' existing contracts with MoDs for the construction and support of naval surface ships will be undertaken by ShipCo. Finally, ShipCo will operate on a long-lasting basis<sup>4</sup>. The Framework Agreement does not specify a finite duration for the joint-venture.
8. The proposed transaction therefore constitutes a concentration within the meaning of Article 3(1)(b) of the Merger Regulation.

## **III. COMMUNITY DIMENSION**

9. The undertakings concerned have a combined aggregate world-wide turnover of more than EUR 5 000 million (EUR [...] million for BAES, EUR [...] million for VT). The aggregate Community-wide turnover of BAES and VT is more than EUR 250 million. [...]. The proposed transaction therefore has a Community dimension within the meaning of Article 1(2) of the EC Merger Regulation.

## **IV. COMPETITIVE ASSESSMENT**

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- <sup>2</sup> VT and FSL's facilities are located in Portsmouth. BAES' activities in shipbuilding and naval support are carried out in Scotstoun, Govan, Portsmouth, Farnborough and Filton.
- <sup>3</sup> The Parties have also agreed that VT will acquire BAES' share in Flagship Training Limited ('FTL'), a 50/50 joint venture between the Parties which is active in providing naval training to the British Navy. In line with paragraph 41 of the *Commission Consolidated Jurisdictional Notice* the FTL transaction has not been assessed together with the creation of ShipCo.
- <sup>4</sup> Under the JVA, VT will have a put option, exercisable on or after the end of Year 1, to put the whole or part of its shareholding onto BAES (where the put is partial, VT's shareholding must remain between 24.9% and 20%). UK Ministry of Defence approval will be required if contrary to its current intentions VT wishes to exit within 3 years of the formation of ShipCo. Under the JVA, VT will also grant BAE a call option over VT's shareholding, exercisable as of the third anniversary of ShipCo.

10. The transaction combines the two remaining surface warship design and building capacities in the United Kingdom. The transaction will also consolidate the integration of the parties' naval surface support activities in the UK and create new vertical links between the activities contributed by VT to ShipCo and the naval systems and weapon's activities of ShipCo's joint owner, BAES.

## **Relevant product markets**

### **1. Surface warship design and build**

11. Both parties design and build naval surface ships. In previous decisions<sup>5</sup>, the Commission has typically considered there to be separate product markets for frigates, small naval vessels (including patrol boats, corvettes and other surface combatants) and Mine Counter Measure Vessels (MCMVs). Frigates were distinguished from other naval vessels due to their specific operational purpose such as long sea endurance, world-wide operation, heavy anti air warfare and/or anti submarine warfare combat systems. For small naval vessels, it was found that demand side substitution makes it possible to substitute one type of vessel with another in a particular mission. Finally, MCMVs have been found to constitute a separate product market in view of their distinct operational capability, namely clearing mines from navigation routes.
12. The Commission has not yet had cause to consider the markets for other warships that are relevant for the assessment of this case, namely destroyers, aircraft carriers, amphibious ships, auxiliary and survey vessels. In the parties' view, from both the customer and the supplier's perspective, there is a high degree of substitutability between frigates and destroyers with no clear distinction to be drawn either in terms of length or complexity of the ship. The parties note that the Type 22, which is described as a frigate, is longer than the current Royal Navy destroyer, the Type 42. The Type 22 is also comparable in length to the new Type 45, which is classed as a destroyer. As a result, the parties submit that it may be appropriate to treat frigates and destroyers as a single product market.
13. An aircraft carrier is a naval surface ship designed to deploy and recover aircraft, in effect acting as a sea-going airbase. Aircraft carriers thus allow a navy to deploy air power over greater distances, without having to depend on air local bases. The future aircraft carrier, or CVF, is currently being developed for the British Navy. Two ships will be built, entering in service in 2014 and 2016. As explained below, the blocks of the aircraft carriers are separately contracted. In this respect separate markets for blocks of the aircraft carriers could be defined, but this would not affect the competitive assessment.
14. Amphibious ships are designed to carry troops and equipment (including landing craft), in order to launch an amphibious assault, via, for example, helicopters or landing craft. These ships are likely to be armed (albeit lightly) and to be equipped with complex command and control systems. While there are various types of amphibious ship, which each have somewhat differing capabilities,<sup>6</sup> the market investigation has not revealed

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<sup>5</sup> See cases n° COMP/M.1709 Preussag/Babcock/Celsius of 19 January 2000, COMP/M.2722 HDW/Ferrostaal/Hellenic Shipyard of 25 April 2002, COMP/M.3596 Thyssen Krupp/HDW of 10 December 2004 and COMP/M. 4191 Thalès/DCN of 19 March 2007.

<sup>6</sup> For example, the LPD ('Landing Platform Dock') only carries sea-going landing craft, such as the LCU Mk 10, whereas the LPH vessel ('Landing Platform Helicopter') also carries helicopters.

that further segmentation of the market is appropriate: from a supply side perspective, the capabilities and facilities required to construct each type of amphibious vessel are largely similar.

15. Auxiliary ships are used primarily to supply warships at sea with fuel, food, stores and ammunition which they need to remain operational while away from base. They are ordinarily crewed by civilian personnel and unarmed.
16. Survey vessels are ocean-going ships, coastal vessels and inshore craft equipped with a range of hydrographic or oceanographic surveying equipment, used to chart waters both overseas and around the United Kingdom.
17. For the purposes of the present assessment, as VT has not constructed any destroyers, auxiliary ships or amphibious ships and BAES has not built any survey vessels in the past decade in the UK, the Commission does not deem necessary to come to a firm conclusion as regards the precise product market definitions of destroyers, auxiliary ships, amphibious ships and survey vessels. The only overlap between the parties' activities in surface warship building is the design and construction of the CVF (and/or blocks of CVF) and for reasons that will be developed below, the Commission considers that the transaction would have no competitive impact in this area.

## **2. Naval support**

### Repair and refit

18. Once surface ships are in service, they require maintenance and repair. This work is often referred to generically as "naval support". Depending on the magnitude of the repair work to be undertaken, this can either be done whilst the ship is alongside the shore (and therefore with minimal interruption to service) or by taking the ship out of service and placing it in a dry dock.
19. The parties submit that there are separate markets for:
  - (a) the repair of vessels whilst in service (also known as 'fleet time maintenance') which normally takes place at the vessel's "base port" with the choice of base-port being decided upon the basis of naval operational needs; and
  - (b) the carrying out of major refits to upgrade or extend the useful life of a vessel, which require the vessel to be taken out of service and which can take place at any of the dockyards which hold the capability for this type of work.
20. This delineation is consistent with the Commission's previous decisions, including *HDW/Hellenic Shipyard* and *ThyssenKrupp/HDW*, in which the Commission found there to be a separate market for the repair of naval ships. In those cases, the Commission did not need to consider refits of surface ships in any detail as the parties were not active in this sector.
21. The parties suggest furthermore that a further distinction may be made between the repair and refit of complex ships and the provision of such support to non-complex vessels. They submit that the repair or refit of non-complex ships is often of a non-technical nature, (e.g. cleaning the ship's hull and repainting the ship), and therefore can

be (and predominantly is) carried out by commercial repair facilities in the UK.<sup>7</sup> The parties have only been active in the repair and refit markets in recent years through FSL, their existing joint venture, which is integrated in the proposed JV

22. According to the parties the provision of naval surface ship support in the UK is shifting towards a "through-life capability management", in which the industry should be able, on an availability basis, to plan, structure and implement all kinds of support for a surface ship for the duration of its in-service life. The anticipated support of Type 45 destroyer will be designed in following such an approach. At present, however, the parties consider that it remains appropriate to segment the market into separate activities for fleet-time maintenance and refit, in accordance with past Commission practice. This has been confirmed by market participants during the investigation. In any case, the precise product market definition as regard repair and refit can be left open as it does not alter the competitive assessment of the transaction.

#### Ancillary Design

23. The Parties consider that it may be appropriate to distinguish a particular element of naval support, namely, ancillary design work. Ancillary design covers instances where a new system, process or methodology is required and must be designed as part of the repair or upgrade of a vessel and the monitoring of key elements such as stability, survivability and safety. As BAES and VT carry out ancillary design activities, both independently and through FSL, the effects of the concentration will be assessed on a potentially separate market for ancillary design. Given the absence of competition concerns, it can ultimately be left open whether such a market has to be distinguished or forms part of a wider support market.

### **3. Supply of naval systems**

24. The Commission has traditionally considered land and naval systems to be separate because of the very different demand side characteristics of these categories of system.<sup>8</sup> Although the Commission has not found it necessary in previous decisions to reach a firm conclusion as to the relevant product market definition for various naval systems, it has expressed the view that each system, in view of its distinct functionality, is likely to form a separate product market. The Parties therefore submit for the purposes of the present notification that the following are relevant product markets<sup>9</sup>:

1. surface ship combat management systems (*CMS*), with possible further sub-segmentation by size of vessel; these systems provide early warning of attacks and convey information to the operation centres;

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<sup>7</sup> Such commercial repair yards are generally able to provide these simple services at a cheaper rate to the MoD than military repair yards. Examples of such commercial repair yards in the UK include Harland & Wolff's yard in Belfast, and A&P's Tyne, Tees and Falmouth yards.

<sup>8</sup> Case No. COMP/M. 3720 *BAES/AMS* - decision of 14 March 2005, para7

<sup>9</sup> Naval ships might be equipped with other naval systems namely electronic warfare, electro-optics, unmanned remote sensor systems (above, surface and underwater) and sonar systems for anti-submarine warfare and mine warfare. However, neither BAES nor Insyte, its subsidiary active in the naval systems business, supply currently any of these products in the UK

2. naval weapon and fire control systems which encompass all aspects of weapon planning, threat assessment, assignment and control;
  3. command, control, communications, computing, information, surveillance and reconnaissance systems (*C4ISR*) which include naval communication systems and networks and are systems with added intelligence functionality;
  4. military radar systems, with potential segmentation according to the platforms on which they are installed (ground-based, airborne, naval) and according to the specific function they serve (e.g. fire-control, early warning, weapon locating) and<sup>10</sup>
  5. naval simulation and training systems
25. For the purposes of assessing the transaction it is not necessary to conclude on the exact product market definition for naval systems.

#### **4. Supply of naval missiles (guided weapons systems)**

26. BAES is active in the supply of naval missiles through MBDA<sup>11</sup>. These comprise the missiles and associated systems to launch the missile and direct it to its target. In its previous decisions, the Commission has considered whether the segment should be subdivided further between surface to air missiles on the one hand and anti-ship missiles on the other.<sup>12</sup> However, the question was ultimately left open. Also in this case such a distinction will not affect the competitive assessment.

#### **5. Supply of torpedoes**

27. There are two types of torpedo used by UK naval vessels: *heavyweight torpedoes* which have a 21 inch diameter and are designed to be fired by a submarine either at another submarine or at a surface ship and *lightweight torpedoes* which have a 12.7 inch diameter and can be fired by a surface ship, a helicopter or an aircraft. In a previous decision<sup>13</sup>, the Commission considered whether heavy and lightweight torpedoes constituted separate markets but ultimately left the question open.
28. Only lightweight torpedoes are relevant for the assessment of this case since they can be mounted on a surface ship. The product market definition might again be left open as BAES currently manufactures all torpedoes (heavy and lightweight) in the United Kingdom.

#### **Relevant geographic markets**

29. In cases involving the defence sector, the Commission has traditionally found markets to be national where domestic producers exist that are able to design and manufacture

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<sup>10</sup> Case No. COMP/M. 4288 *Saab/EMW* - decision of 31 July 2006.

<sup>11</sup> MBDA is a joint venture with EADS and Finmeccanica, in which BAE has a 37.5% shareholding and joint control. BAES' subsidiary, Insyte, also has one contract with UK MoD (for the Seawolf Mid-Life update)

<sup>12</sup> Case No. IV/M.945 - *Matra BAe Dynamics/DASA/LFK*, decision of 27 January, 1998, and Case No. COMP/M.1745 *EADS* - decision of 11 May, 2000.

<sup>13</sup> Case COMP/M.1797 *SAAB/Celsius* decision of 4 February 2000

products satisfying actual and future demand<sup>14</sup>. Remaining countries without such domestic producers have been viewed as forming a 'rest of the world' market.<sup>15</sup>

30. The Commission's market investigation has broadly confirmed the definitions noted above. Nevertheless, it is not necessary for the purposes of the present case to reach a definitive conclusion regarding the relevant geographic markets as the conclusions of the competitive assessment would remain the same.

## **Competitive assessment**

### **Introduction**

31. The parties submit that the proposed transaction should be assessed in the context of the United Kingdom Government's White Paper, published by the Ministry of Defence ('MoD') in December 2005 entitled '*Defence Industrial Strategy*'<sup>16</sup>. In this document, the Government outlines inter alia its strategy and consequences for the naval shipbuilding and support sectors.
32. It is noted that the expected increase in spend in the maritime sector over the next ten years as programmes such as the T45 destroyer, CVF and MARS (Military Afloat Reach and Sustainability) come on line will be followed by a longer term downturn. The increased demand during the next few years is viewed as offering a unique opportunity for industry and Government to explore new working methods. Although over-capacity in the industry offers the theoretical prospect of competition, this is not viewed as being sustainable in market that is shrinking in the longer term. The White Paper therefore foresees industry restructuring and consolidation around a core work load<sup>17</sup> that will be sufficient to sustain key industrial capabilities in the United Kingdom. According to the White Paper, this need to maintain appropriate domestic capability is driven by two fundamental strategic requirements; '*the need to develop and support military capability throughout its life; and the ability to mount operations from the UK base.*'
33. The White Paper also notes that the UK maritime business is characterised by high and increasing overheads and has failed consistently to deliver satisfactory performance with several high-profile maritime projects encountering delays and cost increases. In the MoD's view, the maritime business must be streamlined for greater efficiency and profitability whilst mirroring UK demand and maximising the opportunity for export.
34. The MoD's support for consolidation in the sector is founded on the premise that this is necessary to drive operational and financial benefits which would otherwise not be available in an industry where competitive procurement was maintained. These benefits

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<sup>14</sup> Case No. COMP/M. 2722, §30; Case No. COMP/M.4191, §20.

<sup>15</sup> Certain countries such as North Korea that are not open to western producers have been excluded.

<sup>16</sup> Available at <http://www.mod.uk/DefenceInternet/DefenceFor/Business/DefenceIndustrialStrategy/>

<sup>17</sup> In the case of surface ships, the Core Work Load is likely to be centred on, though not necessarily restricted to, an onshore build capability for large complex warships. This activity will provide the necessary experience for the management of build, integration and testing across the wider maritime programme. The Core Work Load will include support activities required to prepare and deploy UK forces.



are seen as flowing not only from horizontal consolidation but also from the integration of procurement and support delivery.

## **Horizontal issues**

### **I. Surface warship design and build**

35. Although the proposed transaction combines the UK's two remaining companies with the capability and capacity for the design and construction of naval surface ships, it should be noted that there has been no actual competition between the Parties for UK shipbuilding orders in the past ten years. During this period, BAES' activities have focused on larger and more complex vessels such as destroyers, frigates, amphibious ships and auxiliary ships. VT, due in part to the physical limitations of its facilities, has concentrated on small naval vessels such as offshore patrol vessels ('OPVs') and modules for larger vessels. A review of the past procurement policy of the UK MoD has shown that in the last decade, one contract has been awarded directly to BAE without competition (Type 45 destroyer). In all other instances, the parties did not submit competing bids.
36. In light of the above, there appears to be hardly any actual competitive pressure exercised by the parties on each other, and the parties submit that the proposed transaction does not give rise to any affected markets in the design and build of naval surface ships. The potential effects of the proposed transaction on competition should however be assessed in the context of the alliance of industry participants and the UK MoD for the design and construction of the future aircraft carrier (CVF).

#### Current programmes

37. The UK government gave final approval for the construction of two new aircraft carriers on 25 July 2007. Both BAES and VT are members of the Aircraft Carrier Alliance ('ACA'). The ACA is a co-operative arrangement between the UK MoD and industrial participants formed and designed for the express purpose of delivering the CVF project. For the manufacturing phase of the project, the ACA will consist of the proposed joint venture, BAES Marine and BAES Integrated System Technologies Ltd, Babcock Support Services Ltd, Thales Naval Ltd and the MoD as both participant and client.
38. The CVF manufacture contract will be placed through the joint venture with an overall ACA agreement that frames the respective roles and incentives across all alliance members. This procurement model differs from the traditional procurement model of a prime contractor and subcontractors and the financial incentives will be based on the degree to which the ACA members can drive down the overall target cost. Any savings will be shared between the alliance industrial members and the UK MoD with the industrial shares based on the initial work content awarded to each member.
39. The UK MoD has already determined the split of a large proportion of the work between the ACA industrial participants for the construction of the future aircraft carriers<sup>18</sup>. No

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<sup>18</sup> Construction of the CVF is to take place on a modular basis. The allocation of work so far is as follows: Lower Blocks 2 and 4 to the joint venture; Lower Block 3 to BAE Systems Barrow (this shipyard is predominantly a supplier of submarines to the MoD and is not included in the joint venture) and Lower Block 1 (the bow) and final assembly to Babcock.

further competitive process will be held in relation to these elements and the proposed transaction will not have any effect on competition for these supplies.

40. The blocks for which contracts have yet to be awarded (for those parts above the hangar deck) are primarily of low complexity although some more complex blocks (such as the vessel's engine room and 'island' (i.e. the superstructure built on the deck of the carrier)) are also still currently unallocated. These remaining blocks will be subject to competitions to be conducted by industry participants within the alliance<sup>19</sup> and consequently the proposed transaction will not lessen the options available to the sole customer, the UK MoD, for the remaining blocks of the CVF.
41. In addition, as the two CVFs, which are due to enter into service in 2014 and 2016, have an expected operational life in excess of 30 years, no new programme requirement is foreseen in the medium to long term. Consequently, the proposed transaction will not have any impact in the foreseeable future in this market.
42. As regards other warships, BAES has concentrated on larger and more complex vessels in the past decade. As such it has been the only provider of frigates and destroyers during that period. To date, the MoD has awarded contracts to BAES in respect of six Type 45 destroyers. VT's role in the Type 45 programme was that of a sub-contractor to BAES, directed by the MoD. Although the MoD initially considered calling for competition between BAE and VT for ships after the 'lead' ship, in the end VT was not invited to tender for the delivery of an entire ship. In practice therefore, BAES is responsible for the integration and delivery of the whole ship, with VT's subcontract relating to the bow section and masts of each ship.
43. The UK MoD has indicated that no decision has yet been taken regarding the ordering of the 7<sup>th</sup> or 8<sup>th</sup> Type 45 destroyer and that the acquisition strategy would be decided at the same time the ordering decision was made.<sup>20</sup> However, in the light of the MoD's White Paper and the procurement pattern for the six previous vessels of this type, it is unlikely that the proposed transaction will have any impact on competition regarding this programme.

#### Future programmes

44. Under the Heads of Terms for a Terms of Business Agreement ('TOBA') for Defence Industrial Strategy Implementation signed by the MoD and the parties on 25 July 2007, the joint venture is nominated as *'exclusive leader for defined Maritime programmes in terms of their design, manufacture and through-life support ('CADMID'<sup>21</sup> Cycle).'*
45. At this point in time, two such programmes are under discussion for the Future Surface Combatant ('FSC') and the Military Afloat Reach and Sustainability ('MARS') auxiliary ship programme. However, in both instances no firm decisions have yet been taken regarding the number of type of vessels concerned. In the case of the FSC, three different types of ship may form part of the programme: a larger destroyer/frigate type, a

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<sup>19</sup> See reply from UK MoD to question 9 in questionnaire sent on 19.09.2007

<sup>20</sup> See reply from UK MoD to question 10 in questionnaire sent on 19.09.2007.

<sup>21</sup> CADMID refers to the various stages of the procurement cycle: Concept, Assessment, Development, Manufacturing, In-service and Disposal

smaller destroyer/frigate type, and a still smaller ship (closer to an offshore patrol vessel or OPV in capabilities). However, if orders are placed at all, Main Gate<sup>22</sup> approval is unlikely to be within the next decade with in-service dates from 2021 onwards.

46. Similarly the precise content of the MARS programme is undecided but it is likely to include some less complex ships such as simple oil tankers, as well as more complex warships. The in-service dates of any complex vessels within this programme are not expected before 2018.
47. In view of the MoD's past procurement pattern, the absence of a competitive relationship between the parties in the past decade and the UK Government's future procurement methods outlined in the *Defence Industrial Strategy*, no competitive impact on these future programmes is to be expected.

## **II. Naval support**

### **A. Repair and refit**

48. The Parties currently carry out all their activities relating to the repair and refit of complex surface vessels through their existing joint venture, FSL. The proposed transaction will not alter this situation as FSL will be contributed to the joint venture. FSL accounted for nearly half of the market for the repair of complex surface ships in the United Kingdom in the period 2004-2006 and one third of the market for the refit of complex surface ships<sup>23</sup>. The other company active in this area is Babcock International Group plc ('Babcock').
49. FSL also carries out ad hoc repair of small naval vessels. The Parties do not believe that a separate market exists for such repairs and submit that their turnover from such work would represent an insignificant proportion of any hypothetical small naval ship repair market where other companies such as A&P, Northwestern Shiprepairers and Shipbuilders Ltd, Babcock and Harland & Wolff are active. Moreover, FSL is currently not pursuing any further contracts for the support of non-complex vessels. Therefore, the assessment of the proposed joint venture has focused on the support activities, both repair and refit, for complex naval surface ships.
50. As noted above, repair or fleet-time engineering (FTE) is undertaken at a vessel's base port for operational reasons. FTE is currently part of the UK MoD's Warship Support Modernisation Initiative ('WSMI'). The WSMI Partnering Agreements (contracts) were placed in 2002 with Babcock, Devonport Management Ltd<sup>24</sup> and FSL for support at Faslane, Devonport and Portsmouth Naval Bases respectively. The creation of the proposed joint venture, per se, will not make any difference to the current arrangements.

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<sup>22</sup> Before the MoD decides that a project is sufficiently developed for the formal contract to be awarded (thereby triggering full scale design and build work), the project must undergo a review known as "Main Gate". Until a programme has passed through this phase successfully, it will remain prospective as the precise value of the contract and timescale for delivery are not known.

<sup>23</sup> These estimates do not include equipment support work as this is and will continue to be to be carried out by the systems Original Equipment Manufacturers.

<sup>24</sup> Babcock completed the acquisition of Devonport Management Limited in 2007.

51. However, it should be noted that the MoD's strategy for undertaking surface ship support is in the process of changing as a result of the findings of its Surface Ship Support Study. This study was undertaken to identify the optimum approach for the future maintenance and repair of these vessels. The study concluded that an alliance, the Surface Ship Support Alliance ('SSSA') comprising the MoD and the three dockyard companies active in the UK at that time (Babcock, Devonport Management Ltd (DML) now part of Babcock and FSL) would be best able to deliver improved and affordable support to front-line warships. The potential alliance would also provide industrial stability in the long-term and meet the MoD's requirement of sustaining appropriate sovereign capability in this part of the maritime sector.
52. As part of the developing SSSA, competition for refits has been suspended.<sup>25</sup> In September 2006 the MoD and the three industry parties (Babcock, DML and FSL) signed a non-legally binding Memorandum of Understanding and have since been working together to develop the business model and structures that could support an alliancing approach.<sup>26</sup> The alliancing strategy is one of a range of options being considered in advance of the government approvals process for the Surface Ship Support project and full implementation of the preferred procurement strategy is expected to occur during 2008.
53. Even though the proposed joint venture will be the designated leader for future defined maritime programmes, current arrangements for support under the WSMI for certain vessel classes already in service ('legacy vessels') will continue to apply. The support solutions for the Type 45 and the CVF will be developed by the Type 45 project and the CVF Alliance respectively and are therefore not affected by the creation of the joint venture. In the case of future programmes such as the FSC and MARS, it is recalled that their scope and precise timing remains uncertain. Although the proposed joint venture will be the designated 'class output manager'<sup>27</sup> ('COM') for future programmes, it is not expected that this role will in itself advance the interests of the proposed joint venture to the detriment of other industry participants for the reasons explained below.
54. Firstly, the decision regarding the choice of a vessel's base port, which plays a critical role in FTE arrangements, is and will continue to be an MoD function based on a range of factors including operational needs. This is the case for both legacy and future vessels. Second, the proposed role of the COM is to schedule and plan support work as well as to take responsibility for delivering the warship in accordance with the availability levels agreed with the customer. COM responsibilities are therefore expected to include the overall management of upkeep but not necessarily its conduct. Third, the role of COM does not entail any direct influence over where support work is carried out, as this will continue to be determined by the MoD's base-porting decisions insofar as FTE is concerned and by the capability maintenance principles determined by

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<sup>25</sup> UK Competition Act 1998 (Public Policy Exclusion) Order 2006, SI 2006/605

<sup>26</sup> The first batch of ships to be managed using the alliancing strategy involved a five ship package announced in November 2006. The workshare agreement was followed for a further twelve ships and discussions have also concluded regarding a third batch of upkeeps starting with HMS Ark Royal.

<sup>27</sup> The MoD has indicated that the precise role of the class output manager for future surface warship support is still under discussion but at the present time it is understood to include the integrated delivery of class management, equipment management and design management.

the MoD insofar as refit work is concerned. Finally, the MoD will retain strategic decision making on the categorisation of FTE and deep maintenance (refit) and the location of its delivery.

55. In the light of the above arguments, the transaction does not raise serious doubts as regard its impact on the UK market for repair and refit of complex naval surface ships.

#### B. Ancillary Design

56. The proposed transaction will give rise to a horizontal overlap in the provision of ancillary design work in the UK. There are five companies currently active in this area in the UK: BAES, VT, FSL (the existing joint venture between the Parties), Babcock and BMT. The parties estimate that the total ancillary design market in the UK in 2006 amounted to €[20-30] million and the respective shares of the various industry participants was as follows: BAES ([35-45] %), VT ([5-10] %), FSL ([5-10] %), Babcock ([30-40] %) and BMT ([10-20] %).
57. All the abovementioned companies (with the exception of BMT) participate in the MoD-led Design Support Alliance ('DSA') under which a substantial proportion of the work is co-operatively managed and allocated by the alliance members at the MoD's direction. Five design support contracts were awarded under the DSA in July 2003, one each to Babcock, FSL, BAE, VT and DML (now part of Babcock). Work is allocated by the Alliance members amongst themselves on an ongoing basis, dependent on which has available capacity at the time. These contracts cover all the design support work on the majority of in-service classes of surface ships.
58. In its decision relating to the acquisition of DML by Babcock<sup>28</sup> the UK Office of Fair Trading noted that the MoD had no competitive concerns regarding the design sector. The OFT reached the conclusion that there was no competition in this market pre-merger and none likely absent the merger. Even in the case of design work that is outside the scope of the DSA and to the extent that competitive procurement is used by the MoD on this market, the options available to the MoD are not strongly reduced by the proposed transaction.

#### **Vertical issues**

59. The proposed transaction gives rise to a new vertical link in the UK between BAES' upstream activities as a supplier of naval systems / naval weapons and the downstream VT's shipbuilding activities that will be contributed to the joint venture.
60. As regards naval systems, BAES has supplied [90-100] % of surface ship CMS, fire control systems and naval simulation and training in the United Kingdom in recent years. It has also been the principal supplier of radar and sensor systems with a market share of [80-90] % on average during the period 2004-2006. Its share of the market for the supply of naval C4ISR systems in the United Kingdom has historically been much

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28 OFT decision of 20 August 2007 under section 22(1) of the Enterprise Act 2002. Full text of the decision published 3 September 2007.

lower than in other systems markets (approximately [15-25] % in the period 2004-2006<sup>29</sup>).

61. As regards guided weapons, BAES through its subsidiary MBDA has supplied all the naval guided weapons for naval surface ships in the last five years in the UK and the same is true for lightweight torpedoes.
62. The Commission has carefully assessed whether the joint venture would have the ability and the incentive to favour the wider BAES group as a naval systems supplier thereby preventing competitors in naval systems to have access to ShipCo as a customer (customer foreclosure). The market investigation showed that there are several factors that would militate against this scenario. First, the MoD has at its disposal a number of tools to ensure that competition is maintained within the supply chain. These include specifying the particular system to be used by the joint venture,<sup>30</sup> requiring the joint venture to seek approval for its proposed subcontracting arrangements<sup>31</sup> and even procuring systems directly and supplying them to the joint venture as Government Furnished Equipment. Furthermore UK MoD has confirmed during the investigation that arrangements with the joint-venture envisage full open books arrangements so that MoD staff will have full visibility and full access of pricing methodology.<sup>32</sup>
63. Second, the Heads of Terms for a Terms of Business Agreement ('TOBA') signed by the MoD and the Parties on 25 July 2007 contain a statement to the effect that the signatories are committed to maintaining appropriate competition in the supply chain. In particular, even in cases where the joint venture is the designated lead on systems integration, this will not mean that it can define and source systems without competition. In cases where sub-contracting is appropriate, the joint venture is expected after consulting the MoD, *"to select through competition or by other means consistent with relevant law, the 'best for project' provider"*. Finally, the main competitor of the parties in naval systems has confirmed that there are established procedures to ensure and control open competition for components where the market supports this with products that can meet MoD requirements<sup>33</sup>.
64. The principles set out above are equally applicable to naval missiles (guided weapons systems), and torpedoes. Furthermore, as regards these products, none of the missiles or

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<sup>29</sup> The only other company currently active to a significant extent in the naval C4ISR market in the United Kingdom is Thales UK.

<sup>30</sup> This occurs in respect of the medium range radar replacement to be mounted on frigates, currently being competed.

<sup>31</sup> The MoD's standard terms for defence contractors (DEFCON 176A, MoD Requirements for Competition in Subcontracting) require the main contractor to identify each sub-system, package of work, service or purchase order for which the contractor intends to seek competitive tenders with a value in excess of £200,000. The MoD will then notify the contractor of whether a different field of tenderers is required, or whether they wish to oversee the tender and approve the sub-contractor; and identify each sub-system, package of work, service or purchase order with a value in excess of £200,000 for which the contractor does not intend to seek competitive tenders. If the MoD does not agree with this proposal, it can decide to veto the subcontractor selected by the contractor or to be involved in the pricing of the subcontract

<sup>32</sup> See reply from UK MoD to question 21 in questionnaire sent on 19.09.2007

<sup>33</sup> See reply from Thalès to question 9 in questionnaire sent to Thalès on 19.09.2007

the torpedoes that BAES supplied in the last five years has been mounted on the vessels constructed by VT.

65. In the light of the above, it can be concluded that the transaction does not raise serious doubts as regards customer foreclosure.

### **Impact of the proposed transaction beyond the United Kingdom**

66. The above conclusions would not be altered should the markets mentioned above be considered broader than national. Indeed, the proposed transaction will not have a significant effect on markets beyond the United Kingdom. In the past ten years, the Parties have only bid against each other on six occasions for the supply of surface ships to non-UK customers, none of which was in the EEA.<sup>34</sup> Consequently, the creation of the joint venture does not raise serious doubts as regards its impact on competition in the markets for the supply of naval vessels in the EEA.
67. During the same period, Insyte, the BAES subsidiary active in naval systems, has bid to supply systems for ships built by VT just four times. Only one of these instances occurred in the EEA involving a bid to supply radars for ships being built by VT for the Greek navy. This bid was not in fact successful.
68. A similar picture emerges in relation to bids by MBDA to supply missiles outside the United Kingdom. MBDA has bid in response to a tender by VT to supply missiles for ships being built by them in just four instances in the last decade: these related to ships being supplied to Oman.
69. Moreover, it appears from recent data that the types of systems supplied by MBDA (and to a lesser extent Insyte) are more complex than those which would typically be installed on the types of ship which VT has historically sought to supply outside the United Kingdom. Consequently, the increased vertical integration arising from the creation of ShipCo does not raise serious doubts outside the United Kingdom.

## **VI. CONCLUSION**

70. For the above reasons, the Commission has decided not to oppose the notified operation and to declare it compatible with the common market and with the EEA Agreement. This decision is adopted in application of Article 6(1)(b) of Council Regulation (EC) No 139/2004.

For the Commission  
signed  
Neelie KROES  
Member of the Commission

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<sup>34</sup> Three bids were in [...], one each in [...], [...] and [...]. Neither party was successful in any of these instances.