

## **Decision to review the undertakings given following the BAE Systems plc/Marconi Electronic Systems merger**

### **Introduction**

1. The Competition and Markets Authority (CMA) has decided to conduct a review of the undertakings given by British Aerospace plc, now BAE Systems plc (BAES) arising from its acquisition of the Marconi Electronic Systems business of GEC on 29 November 1999.
2. The CMA has a statutory duty, by virtue of paragraph 13 of Schedule 24 of the Enterprise Act 2002 as amended by the Enterprise and Regulatory Reform Act 2013, to keep under review the carrying out of undertakings accepted under section 75G of the Fair Trading Act 1973. From time to time, the CMA must consider whether, by reason of any change of circumstances, an undertaking is no longer appropriate and either:
  - (i) one or more of the parties to it can be released from it, or
  - (ii) it needs to be varied or to be superseded by a new undertaking
3. If it appears to the CMA that the undertaking has not been or is not being fulfilled, that any person can be so released or that the undertaking needs to be varied or superseded, the CMA has a duty to give such advice to the Secretary of State as it may think proper in the circumstances.
4. The CMA has set out in its published guidance, *Remedies: Guidance on the CMA's approach to the variation and termination of merger, monopoly and market undertakings and orders* (CMA11),<sup>1</sup> that when deciding on whether to launch a review, it will assess the review against its published prioritisation principles and whether there is a realistic prospect of finding a change of circumstances.<sup>2</sup>

### **Background**

5. This transaction was assessed by the Office of Fair Trading (OFT) under the merger provisions of the Fair Trading Act 1973. To address competition and

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<sup>1</sup> [CMA Remedies Guidance](#).

<sup>2</sup> [CMA11](#), paragraph 3.10.

other public interest concerns arising from the transaction, British Aerospace plc gave undertakings, in lieu of a reference to the Monopolies and Mergers Commission, to the then Secretary of State for Trade and Industry on 28 March 2000.

6. The undertakings included measures to safeguard competition at prime contractor and sub-contractor level and to address national security concerns arising in the defence sector.
7. The undertakings have been subject to three reviews to date. On 10 January 2002, BAES was released from one of the obligations in the undertakings which had become redundant. On 29 September 2005, the undertakings were varied again to allow for the extension of the then Compliance Officer's appointment. A further review was conducted in 2006 which led to a further variation, with most of the obligations in the undertakings being removed on 2 February 2007. Revised undertakings were issued that are based on two of the original undertakings.

### ***The undertakings***

8. The undertakings now consist of two provisions following the last review in February 2007:
  - (a) **The appointment of a Compliance Officer** – BAES is obliged to appoint a Compliance Officer to facilitate and oversee compliance with the undertakings, including through annual reports to the OFT (now CMA) and the Ministry of Defence (MOD); and
  - (b) **Access by Prime Contractors to BAE Systems In House Suppliers** – to make available on request and on fair, reasonable and non-discriminatory terms access to its capabilities to other actual or potential third party Prime Contractors to permit them to bid for or undertake work on MOD programmes and, relatedly, to seek the prior written consent of the OFT (now CMA) before entering into certain teaming agreements involving another BAE Systems company.
9. The Access undertaking related originally to concerns that, following the merger, BAES could distort competition at the Prime Contractor level. In December 2006, the OFT recommended its retention in order to protect the potential for effective competition with BAES production capacity for the following specific sectors:
  - (a) warship-building;
  - (b) combat aircraft; and

- (c) general munitions (defined as simple munitions not requiring interventionist maintenance procedures).
10. In retaining these undertakings in 2006, the OFT noted that whilst the MOD's procurement practices had lessened the economic benefits of being a vertically integrated defence contractor, the downstream production capacity of BAES was still deemed to be important. The OFT accepted the MOD's arguments that the undertakings should be retained as BAE Systems retained a significant amount of production capacity in sectors such as warship building, combat aircraft and general munitions.

### ***Jurisdiction***

11. The undertakings were given in March 2000 to the Secretary of State for Trade and Industry under section 75G of the Fair Trading Act 1973.
12. The CMA's role in a review of these undertakings will result in advising the Secretary of State for Business, Energy and Industrial Strategy (BEIS) under Section 75J of the Fair Trading Act 1973 on whether the undertakings should be varied, superseded, or released. The decision will be made by the Secretary of State for BEIS.

### **BAES**

13. BAES employs over 82,000 people, predominantly in the United States, the UK, Kingdom of Saudi Arabia and Australia, with around 33,000 people employed in the UK.
14. Within the UK, BAES consists of four domains: Air, Maritime (including the design and manufacture of complex warships, the design and manufacture of submarines and the provision of in-service support to surface ships in the UK), Land and Security.
15. BAES's sales of defence, aerospace and security products and services worldwide in 2015 were split 53% in air, 28% in maritime, 13% in land, and 6% in cyber security. It achieved global sales of £17.9 billion in 2015, 23% of which (approximately £4 billion) was in the UK and with global EBITA of approximately £1.7 billion.<sup>3</sup>
16. BAES is involved in a number of ongoing MOD programmes, including but not limited to, the production of Typhoon combat aircraft and the manufacture of two Queen Elizabeth Class aircraft carriers, River Class Offshore Patrol

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<sup>3</sup> BAE Systems plc Annual Report 2015.

Vessels and seven Astute Class submarines, the design of the Successor submarine and Type 26 frigate, as well as the provision of upgrade and support of combat vehicles and the supply of general munitions.

### **Submissions received regarding possible change of circumstance**

17. The CMA launched an Invitation to Comment on a request to review the BAES undertakings on 3 November 2014.<sup>4</sup> In response to this Invitation to Comment we received submissions from BAES and MOD. These are summarised below.
18. Following the Invitation to Comment, the CMA postponed a decision on whether or not to launch a review of the undertakings due to the MOD's Strategic Defence and Security Review.<sup>5</sup> This review was published in November 2015, and the CMA received a further submission and request for a review of the undertakings from BAES in February 2016.

### **Views of BAES**

19. BAES told us that the undertakings were no longer justified for the following reasons which applies to the various areas of defence activities it undertakes in the UK:
  - (a) the MOD's procurement arrangements have changed, as have the intervening changes in EU defence procurement rules. The MOD no longer uses the prime contractor model to the same extent to meet national security considerations as was the case when the undertakings were put in place. Instead the MOD has encouraged consolidation and collaboration between contractors in order to meet the UK's defence capabilities and deliver value for money;
  - (b) over and above its declared intentions, the MOD has no demand or no plans to have demand in the known future for some of the relevant equipment (such as manned fixed wing aircraft, submarines and complex surface warship);
  - (c) BAES does not control UK production in some cases as a result of competition from overseas providers and in others as a result of closures or sales of its relevant businesses; and

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<sup>4</sup> Details of the Invitation to Comment are [available on the CMA website](#).

<sup>5</sup> [2015 Strategic Defence and Security Review \(SDSR\)](#).

- (d) The undertakings were not put in place, and should not be retained, as a general regulatory measure.
- 20. To support its submission, BAES has provided a detailed list of changes in the MOD's procurement approach or changes in the market in which BAES operates to support its suggestion that a change of circumstance has arisen.
- 21. BAES also noted that ensuring compliance with the undertakings costs it approximately £400,000 to £500,000 annually.

### ***Views of the MOD***

- 22. The MOD told us that:
  - (a) BAES remains its largest single prime contractor;
  - (b) as was the case in 2001, there are areas in which it would expect to continue to procure within the UK due to national security concerns;
  - (c) decisions concerning how procurement is undertaken for defence matters are expected to remain a highly sensitive political matter. While the MOD would seek to limit UK-only procurements, where this is the only option it would wish to retain the ability to run competitive procurements in the future;
  - (d) enforcement of the provisions of the Competition Act 1998 are not, in its view, a viable alternative to the existing undertakings; and
  - (e) it is open to considering the undertakings further, particularly given the cost imposed on BAES from the obligation to grant access to third parties to use its capabilities.
- 23. The MOD is aware that we are considering launching a review and it is content with the timing of this. The MOD has sufficient resources available to contribute to the review.

### **Recent changes to defence procurement**

#### ***2012 Defence White Paper***

- 24. The 2012 UK Defence White Paper, [National Security through Technology](#) set out the MOD's desire to be able to procure equipment from across the EU or globally in some cases, except where national security concerns require it to seek providers from a more limited geographic area. The White Paper

described MOD's intention to, 'seek to fulfil the UK's defence and security requirements through open competition in the domestic and global market'.

25. This creates the possibility that MOD competitions would be opened to suppliers outside the UK. For those tenders that are conducted wider than the UK, there are two relevant matters to consider:
  - (a) first, prime contractors seeking to compete with BAES would no longer need to be based in the UK in these circumstances; and
  - (b) second, prime competitors outside the UK will have their own capabilities which they could utilise themselves or could be utilised by a range of other prime contractors in the UK in seeking to bid for MOD contracts, thus extending the scope of contracting with the MOD.
26. The White Paper identified limitations to the intention to source through open competition in cases where MOD seeks to protect, 'our operational advantages and freedom of action, but only where this is essential for national security.'
27. More generally, the CMA notes that many of the MOD's procurements will need to follow broader EU procurement rules so that in at least some cases it would need to seek suppliers across the EU rather than limiting itself to those in the UK.<sup>6</sup>

### ***2015 Strategic Defence and Security Review***

28. In 2015, the UK Government published the 2015 Strategic Defence and Security Review (SDSR). This paper builds upon the principles of the White Paper by, for example, emphasising a policy requirement for the MOD to procure defence requirements through open competition, on domestic and global markets.
29. BAES noted that since the 2015 SDSR there has been rationalisation of suppliers in the market, including at BAES who have sold or closed a number of its businesses in the UK. BAES provided examples of how the demand for defence products has changed since the 2015 SDSR, noting that the procurement strategy for a number of major programmes such as submarines and complex warships have been declared.

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<sup>6</sup> Procurement on a narrower basis may be possible where there are objective justifications for such action.

## ***Creation of the SSRO***

30. The Single Source Regulations Office (SSRO) was established in December 2014. Its statutory aims are to ensure that good value for money is obtained for the UK taxpayer in expenditure on qualifying defence contracts, and that single source suppliers are paid a fair and reasonable price under those contracts. The SSRO examines contracts that are a qualifying defence contract. These apply if the Secretary of State for Defence purchases goods, works or services for defence purposes, and the contract is not the result of a competitive process and has a value of £5 million or more. Whilst BAES has to date not suggested that the SSRO's creation is a specific change in circumstance, we consider it is appropriate to examine if this is relevant. The SSRO is aware that we are considering a review and it has confirmed its ability to participate in this.

## ***Areas of national security concerns***

31. The MOD has indicated<sup>7</sup> that wherever possible, it will seek to fulfil the UK's defence and security requirements through open competition in the domestic and global market, buying off-the-shelf products or services and that it would only take action to protect the UK's operational advantages<sup>8</sup> and freedom of action<sup>9</sup>, in areas where it was regarded as essential for reasons of national security. Hence exceptions to the approach of buying off-the-shelf may apply if this does not provide the required superior technology (e.g. UK specific variant based on the MOD's assessment of threat) or allow the MOD to secure the necessary freedom of action i.e. there is a need to build/procure in the UK due to national security considerations. The areas where this is likely to be most relevant include the following:

(a) Maritime

- (i) Naval ships – BAES Naval Ships Business entered into an agreement with the MOD in 2009 to sustain a minimum level of work to maintain facilities and Sovereign capability in the shipbuilding sector. This included an exclusive right under the agreement for the award of the design and manufacture of complex warships.

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<sup>7</sup> See section 6.54 of the [2015 Strategic Defence and Security Review](#).

<sup>8</sup> Operational advantage relates to the recognition that the MOD often need superior technology and other forms of battle-winning edge.

<sup>9</sup> Freedom of action is defined as being able to operate, maintain, and refresh certain capabilities effectively, without being dependent on others. It applies if there is a need to build/procure in the UK due to national security considerations.

- (ii) Minor naval design – the MOD established an industry-wide Naval Design Partnership with companies, including BAES, pooling resources into a single organisation.
- (iii) Submarines – BAES participates and collaborates in the Submarine Enterprise with other suppliers for the design, build, support, and disposal of nuclear submarines.<sup>10</sup>
- (iv) Maritime services – the MOD established joint working between the two large providers in this sector including BAES with the aim of delivering an affordable solution for warship repair and maintenance.<sup>11</sup>

(b) Land

- (i) General munitions – BAES has entered into a munitions agreement, through which the MOD aims to preserve and modernise the UK's Sovereign capabilities in munitions, through life capability and engineering services considered important for national security.

(c) Air

- (i) Future provision – as detailed in the 2015 SDSR the MOD will invest in the next generation of combat aircraft technology (manned and/or unmanned). Freedom of action and operational advantage will be considerations.

***Reduced activity in certain areas by BAE Systems***

32. The OFT, in its 2006 review noted that BAES had divested or closed a number of businesses that were the cause of concerns in the original merger transaction. BAES has informed the CMA that since 2006, it has sold, closed or otherwise reduced the significance of business in a number of areas. The CMA notes that it is possible that these closures and divestments may, depending on their nature and significance, represent changes of circumstances relevant to the undertakings.

33. Changes of this nature include the following:

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<sup>10</sup> In order to facilitate this, the UK Government passed secondary legislation: The Competition Act 1998 (Public Policy Exclusion) Order 2008, No 1820 (Submarines PPEO). This excluded the arrangements from the Chapter I prohibition of the Competition Act 1998.

<sup>11</sup> In order to facilitate this, the UK Government passed secondary legislation: The Competition Act 1998 (Public Policy Exclusion) Order 2006, No 605 (Maritime Services PPEO). This excluded the arrangements from the Chapter I prohibition of the Competition Act 1998.

- (a) Air platforms and avionics – BAES submitted that it has sold most of its capabilities in avionics and electronics systems in the UK, in particular for helicopters, since the undertakings were agreed. Specifically, BAES submitted that its Avionics Group was divested in 2007 and followed by the sale of Inertial Products business which included a site in Plymouth. The only remaining avionics business is the BAE Systems Inc Electronic Systems' UK-based business in Rochester, Kent. BAES submitted that these disposals remove a significant vertical link established by the original merger transaction.
- (b) Combat vehicles – BAES submitted that it has undertaken rationalisation in this area, closing all of its five manufacturing and engineering support sites, the last closure was the Newcastle site in 2014.
- (c) Munitions – for munitions outside the agreement described above, BAES has closed a number of facilities since 2000, including sites in Chorley and Bridgewater in 2007 and 2008 respectively.

### **Decision to review the undertakings**

34. The responses to the consultation and our own assessment of the evidence presented to us, provide grounds for the CMA to consider there is a realistic prospect of finding a change of circumstances relating to the relevant defence markets. These are principally the following:
- (a) Market developments: there are a number of areas in which BAES has sold businesses or closed facilities. In some cases, these sales and closures may mean that BAES has a less significant market position, such that the competition concerns identified previously may have diminished.
  - (b) Changes to MOD procurement practices:
    - (i) Where competition is sought so that the MOD can secure value for money, in a number of areas the MOD now seeks to procure goods and services from suppliers on a European or worldwide basis rather than just from the UK. This means that the number of competitors to BAES may be greater than would be the case for procurements on a more limited geographic basis;
    - (ii) Alternatively where the MOD's focus is on preserving defence capability, there are a number of areas in which the MOD now seeks co-operation between suppliers when seeking to maintain UK sovereign capabilities; and,

- (c) Regulatory change: the SSRO was established in December 2014 and is involved in securing value for money in defence projects procured from single source as an alternative to competitive procurement.
35. There have also been some changes in demand for certain capabilities relevant to the undertakings. However the CMA notes that defence spending remains politically sensitive, and priorities and planned expenditure may change depending on both the views of the Government and the nature of defence activities undertaken in the coming months and years.
36. In conducting a review the CMA will have regard to any changes arising from the referendum result and the impact of the future withdrawal of the United Kingdom from the European Union. This development is significant but it is not considered to be a reason to delay the review of the BAES undertakings. The undertakings arose from a merger in 1999 rather than any EU procurement directives. It is also relevant that defence procurement is now done on a European or global basis, and is not restricted to EU member countries.
37. The review will also be mindful of recent developments in defence strategies, such as the recent<sup>12</sup> Parliamentary vote to continue with the Trident programme.

### **Prioritisation principles**

38. In order to make the best use of its resources, the CMA needs to ensure that it makes appropriate decisions about which projects and programmes of work are undertaken across all areas of responsibility. The CMA has considered the information available in relation to the undertakings given by BAE Systems in the light of its [prioritisation principles](#). It has also sought the views of the MOD concerning the undertakings and the launch of this review

### **Strategic significance**

39. The CMA inherited over 200 sets of remedies from its predecessors (OFT/ MMC/CC), many of which had been in place for a long time. The CMA is committed to reviewing old remedies that potentially may no longer be fit for purpose (this commitment is set out in our Annual Report and Accounts 2015-16). Removing remedies that are no longer appropriate not only lightens the administrative burden on affected businesses but also enables the CMA to

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<sup>12</sup> July 2016.

focus its monitoring and enforcement activities on those remedies of greatest value to consumers and markets. The BAES undertakings date back to 1999.

40. UK spending on defence is a significant proportion of UK GDP, and in 2016, is expected to be around £45 billion, just over approximately 2% of UK GDP.<sup>13</sup> The MOD spends around £19.5bn on defence each year. In 2014/15 MOD spend with BAES plc was £3.5bn. BAES provides a wide variety of defence equipment and is one of the world's largest providers of defence equipment. It is the largest supplier to the UK MOD - 14% of MOD expenditure was with BAES in 2014/15, compared to the next highest provider representing 6% of MOD expenditure. These figures demonstrate the importance of defence expenditure for the UK and the significance of BAES within that sector.
41. BAES has stated that it experiences compliance costs for the current undertakings of around £400,000 to £500,000 annually. Hence since the last review in 2007 compliance costs of around £3m have been incurred.
42. In the context of the CMA's overall approach to remedy reviews, the significance of the defence sector, and the significant ongoing compliance costs on BAES, we conclude that carrying out a review of the undertakings would satisfy the strategic significance criteria of the CMA's prioritisation principles.

### ***Impact***

43. In addition a review would meet the Impact criterion. The review might lead to a conclusion that the remedy remains appropriate and justified in this market such that the compliance costs for BAES may be offset by wider benefits from the continued presence of the undertakings. Alternatively, a review may find that the remedy is no longer appropriate and should be retained, superseded, varied or released. Either way, BAES and its customers, including the MOD would benefit from the changes that a review may bring to the defence sector.

### ***Risks***

44. The CMA notes that there are a number of risks from carrying out a review of these undertakings, including:
  - (a) the outcome of any review is uncertain, so the nature of any benefits from the review are similarly uncertain;

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<sup>13</sup> See [UK Public Spending Figures](#) for details.

- (b) the UK approach to defence procurement is a politically sensitive area, and while the current policy might indicate that there is a reasonable chance of the CMA finding a change of circumstances in a review, it remains open to the Government to alter its approach to defence procurement either generally or in specific areas; and
  - (c) details of the views of third parties such as competitors to BAES are unknown in advance of the launch of the review.
45. The CMA will manage these risks by consulting widely with interested parties, and in particular with the MOD to understand likely developments in defence procurement in the UK.

### ***Resources and timetable***

46. In any review, the CMA needs to ensure that all necessary analysis is undertaken to provide a robust evidence base for its advice to the Secretary of State for Business, Energy and Industrial Strategy (BEIS).
47. We have identified a project team for this review of approximately three FTE who will have the capacity to engage in the work from September 2016. It is anticipated that a six month period would be required to complete the review.
48. We consider that the resourcing requirements are proportionate to the need.
49. At the end of the review the CMA will make a recommendation to the Secretary of State for Business, Energy and Industrial Strategy (BEIS).

### **Decision**

50. There are a number of reasons that indicate that there is a realistic prospect of finding a change of circumstances, as noted in paragraph 33.
51. Reviewing this remedy is in line with the CMA's objectives and strategy on the basis that it reflects the CMA's statutory duty, and the commitment set out in its [2015/16 annual plan](#) to 'ensure current merger and market remedies are still fit for purpose'. Given the significance of the sector, the size of BAES and the costs being incurred by BAES, the review would meet its impact and strategic significance criteria of its prioritisation principles.
52. The CMA also notes the risks inherent in carrying out a review, given the uncertainties identified above, which it will manage through a wide consultation exercise. The CMA considers that the resources necessary are proportionate and has allocated resource for this review in the second half of 2016.

53. The CMA has therefore decided to conduct a review of the undertakings given by BAES in the second half of 2016 and the first quarter of 2017.
54. As well as publishing this decision, the CMA will be informing relevant parties directly so that BAES, the MOD and interested third parties are able to contribute to this review.