
Completed acquisition by BAE SYSTEMS Plc of 28.95 per cent stake in Alvis Plc

The OFT's decision on reference under section 22 given on 21 November 2003

PARTIES

- 1 **BAE SYSTEMS Plc** (BAE SYSTEMS) is active in the development, production and support of advanced defence and aerospace systems in the air, at sea and on land.
- 2 **Alvis Plc** (Alvis) designs and manufactures defence and other specialised vehicles and systems for military applications. In 2002 Alvis acquired Vickers Defence Systems. In the year to 31 December 2002 Alvis had a UK turnover of £46 million.

TRANSACTION

- 3 In 1998 Alvis acquired GKN's armoured vehicles division as a result of which GKN took a 28.95 per cent shareholding in Alvis. BAE SYSTEMS have now acquired this shareholding. The transaction completed on 2 September 2003.
- 4 The transaction was notified by BAE SYSTEMS on 25 September 2003. The 40 working day deadline expires on 24 November and the statutory deadline 1 January.

JURISDICTION

- 5 As a result of this transaction, BAE SYSTEMS and Alvis have ceased to be distinct by virtue of section 26 of the Enterprise Act 2002 (the Act), since, in the OFT's view, the 28.95 per cent shareholding acquired confers on BAE SYSTEMS the ability materially to influence the policy of Alvis¹. The parties overlap in the supply of prime contractor services for the design, manufacture and supply of armoured vehicles and associated systems. The share of supply test in section 23 of the Act appears likely to be met. Thus a relevant merger situation has been created.

¹ 'A shareholding conferring on the holder 25 per cent or more of the voting rights in a company generally enables the holder to block special resolutions; consequently, a 25 per cent share of voting rights is likely to be seen as presumptively conferring the ability materially to influence policy.' From OFT's Substantive Guidelines

RELEVANT MARKET

- 6 The Ministry of Defence (MoD) is the only UK customer for armoured vehicles and associated systems². The MoD determines the type of product it requires and if a suitable off-the-shelf product is not available, procurement will enter the Concept, Assessment, Development, Manufacture, In-Service, Disposal (CADMID) cycle. The CADMID programme typically lasts 10 years, and in the concept and assessment stages the MoD will work up a detailed specification to meet its requirements, usually with the assistance under contract of one or more suppliers.
- 7 The MoD will enter into a contract with a prime contractor who is required to manage and deliver the armoured vehicles and associated systems in question. Both BAE SYSTEMS and Alvis provide prime contractor services. The prime contractor will not generally supply all products for the entire programme, even if they have the capability. A substantial proportion of the work will be subcontracted. Both BAE SYSTEMS and Alvis have, in the past, subcontracted to one another under their prime contractor roles. For example for the Challenger 2 and Warrior vehicles contracts, BAE SYSTEMS is a sub-contractor to Alvis for the supply of sub-systems for turreted weapons and for the Terrier contract BAE SYSTEMS sub-contracted the manufacture of the armoured vehicles to Alvis³.
- 8 The parties, therefore, overlap specifically in the supply of UK prime contractor services for armoured vehicles and associated systems. At a systems level, Alvis is only active in turreted weapon systems, where there is some overlap with BAE SYSTEMS. However, Alvis is not active in the manufacture of communication systems and BAE SYSTEMS is not active in the actual manufacture of armoured vehicles, and so these sectors are not considered further.

Product market

- 9 The MoD has a flexible approach in considering whether certain firms are capable of fulfilling the role of a prime contractor. It believes that capability depends on the scale and nature of the programme. BAE SYSTEMS submits that a prime contractor needs, in addition to project management skills, engineering integration and sector-specific skills. However, despite Alvis specialising in the manufacture of armoured vehicles and BAE SYSTEMS in associated weapons systems, they have both shown the capability to provide prime contractor services for these contracts, as have other suppliers, suggesting that supply side substitutability exists.
- 10 In the area of overlap in turreted weapon systems, demand side substitutability is limited as products are designed to meet MoD specific needs. There are often few direct substitutes, thus the relevant frame of reference may appear to be very narrow.
- 11 On the supply side for weapons systems, there does appear to be scope for substitution. Suppliers of one type of associated weapon system appear to be

² Associated systems include the weapon and communication systems that are integrated into the armoured vehicle.

³ The Office has subsequently learned that the Terrier contract may be awarded to other party and not Alvis as originally envisaged.

able to meet various types of contracts. BAE SYSTEMS submitted that even though it is a subcontractor to Alvis for the supply of sub-systems for the turreted weapons systems, there is no shortage of defence suppliers with broader weapons system capability in this area. However according to one third party contacted, the ability to supply would depend on the value of the contract, the complexity of the specification and the cost of capital investment required.

- 12 For the purposes of this analysis the relevant frames of reference will be taken to be: the supply of prime contractor services for armoured vehicles and associated systems and; the supply of associated weapons systems.

Geographic market

- 13 The MoD will invite global competitors to tender in the procurement process. It has informed the Office that there are very few exceptions where a UK supplier is essential on the grounds of national security. Previous tenders have involved non-UK participants either as bidders or as part of a bidding consortium. Although two third parties believed that foreign firms may have difficulty in entering the UK market, they both submitted that the market was global.
- 14 For the purposes of this paper, given the evidence of successful international contracts, the appropriate geographic scope is considered to be global.

HORIZONTAL ISSUES

- 15 The Office requested share of supply data from the parties. However, the figures provided are not comparable as they cannot be separated into distinct categories and there are no estimates of the total size of the sector. Nevertheless, the parties are two of the UK's major prime contractors in the armoured vehicles sector and it seems likely that the share of supply test in the Act would be met on any reasonable measure.
- 16 As this is a bidding market the parties submit that past shares of supply figures are not necessarily a good indicator of future competitive pressures. Since shares of supply in the defence sector are the result of long term, high value contracts they may be lumpy and may not present an accurate picture over time. (According to data received from the MoD, its expenditure on armoured vehicles in the last five years has shown some variation.) It would also appear from the bid data provided that the parties do not bid against each other for contracts, which may suggest that they are not each others' closest competitors.⁴
- 17 The MoD believes that there are potentially 10 firms able to provide prime contractor services in the armoured vehicle sector and that there may be more in the future.
- 18 The parties have also been unable to provide share of supply data on weapons systems. BAE SYSTEMS submits that there is no shortage of defence suppliers with broader weapons system capability in this area.

⁴ The Office has been advised that in one instance the parties have bid against each other in relation to the Terrier contract however, this does not alter the conclusion of this paragraph.

Portfolio effects

- 19 The transaction may alter the incentives of the parties to obtain a degree of portfolio power because they will together, be able to supply both armoured vehicles and a wider range of associated systems. As a subcontractor, the transaction may enable Alvis to tie purchases of, for example, an armoured vehicle to the provisions of associated systems by BAE SYSTEMS. As a prime contractor, BAE SYSTEMS and/or Alvis may favour the other in any sub-contract competition. Thus the transaction may foreclose the supply of armoured vehicles and/or systems to competing suppliers. However, in practice, this seems unlikely to materialise since a prime contractor has an incentive to subcontract to the most efficient supplier. Moreover, it is unlikely that it would be in the interests of Alvis to refuse sub-contract work simply because BAE SYSTEMS is not involved. In addition, BAE SYSTEMS is required by the undertakings it gave to the Secretary of State for Trade and Industry in March 2000 (following its acquisition of the Marconi Electronic Systems business of GEC) not to discriminate in the selection of sub-contractors for MoD programmes and to deal on 'fair and reasonable terms' with all persons. Following this merger, Alvis will become part of the BAE SYSTEMS Group⁵ and, as such, BAE SYSTEMS is required to use 'reasonable endeavours' to ensure that Alvis complies with these undertakings. The MoD's strategy for purchasing is to select the most appropriate system and it does not appear to have a preference to source both these products from the same supplier. Post-merger, there remain a number of other suppliers of vehicles and/or systems.

Barriers to entry and expansion

- 20 The MoD submits that, in fulfilling a prime contractor role, there is a need to mitigate financial exposure. As such, the financial capability to take on the risk, especially for smaller firms may act as a barrier to entry or expansion for prime contractor services. However, according to MoD there is no reason why a small or medium sized enterprise should not be a prime contractor for a small programme.
- 21 For associated weapon systems, one third party thought that once the knowledge of production method is known, supply is relatively easy, however this is dependent on the contract size and costs.
- 22 The MoD informed the Office that the market for armoured vehicles has been in long-term decline, which has led to overcapacity and rationalisation. 'New' entrants have included newly formed merged companies and those making the transition from the civil to defence sector. One third party had concerns that the acquisition would mean that overseas prime contractors would be less likely to bid against an Alvis/BAE SYSTEMS proposal in the UK, unless they had a competitive edge and a strong team to back them. However, from information received it would appear that there have been a number of international entrants into the UK market.

⁵ For the purposes of the undertakings.

Buyer power

- 23 The MoD is a monopoly buyer of armoured vehicles and associated weapons systems in the UK and contracts are awarded following competitive tenders. For the MoD to exercise buyer power it must have a choice of competitors or have the ability to sponsor new entry. As discussed above there are a number of competitors in the market from whom MoD can source. The MoD may also be able to exercise some degree of buyer power due to the excess capacity that exists in the market.

VERTICAL ISSUES

- 24 These have been discussed under portfolio effects above.

THIRD PARTY VIEWS

- 25 Of the third party comments received, no significant competition concerns were raised.

ASSESSMENT

- 26 BAE SYSTEMS has acquired a 28.95 per cent shareholding in Alvis which the OFT believes will confer on BAE SYSTEMS the ability materially to influence the policy of Alvis for the purposes of section 26 of the Act. The transaction qualifies on the share of supply test under EA02 and therefore a relevant merger situation has been created. The relevant frames of reference are: the global supply of prime contractor services and; the global supply of associated weapon systems.
- 27 Post-merger the parties' behaviour is likely to continue to be constrained by: the competitive tendering process; the degree of international competition; the existence of spare capacity in the market; the effect of the 2000 undertakings given by BAE SYSTEMS; and the countervailing buyer power of the MoD.
- 28 The OFT does not believe, therefore, that it is or may be the case that the creation of the relevant merger situation has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom for goods or services.

DECISION

- 29 This merger will therefore **not be referred** to the Competition Commission under section 22(1) of the Act.