

EXPLANATORY MEMORANDUM TO THE
COMPETITION ACT 1998 (PUBLIC POLICY EXCLUSION) ORDER 2006
2006 No. 605

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. **Description**

- 2.1 This order excludes agreements relating to the maintenance and repair of surface warships of the Royal Navy from the prohibition in Chapter I of the Competition Act 1998.

3. **Matters of Special Interest to the Select Committee on Statutory Instruments**

- 3.1 There are no matters of special interest.

4. **Legislative Background**

- 4.1 Paragraph 7(1) of Schedule 3 to the Act provides that the Secretary of State may, by order, exclude agreements if satisfied that there are exceptional and compelling reasons of public policy why the Chapter I prohibition ought not to apply to those agreements. This is the first time an exclusion order has been made under paragraph 7.
 - 4.2 We note that the Chapter 1 prohibition is modelled on and can apply in parallel to the prohibition in Article 81(1) of the EC treaty in cases where there is an effect on trade between Member States. No inconsistency between EC and domestic competition law will result from this order because the competition provisions of the EC Treaty are disapplied by virtue of Article 296(1)(b) which provides that the provisions of the Treaty shall not preclude the application of the rule that “any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material”.

5. **Extent**

- 5.1 This instrument applies to all of the United Kingdom.

6. **European Convention on Human Rights**

- 6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. **Policy Background**

- 7.1 As part of its work on the Defence Industrial Strategy, the Ministry of Defence (MoD) has carried out work to identify the optimum approach to the future maintenance and repair of surface warships. Current arrangements, which involve openly competing individual repair and maintenance contracts, have helped to improve competitiveness in the market and have driven down costs. However, recent force level reductions and over-capacity in the surface warship repair market prompted MoD to review whether the policy remained appropriate.
- 7.2 The MOD has concluded that the option most likely to deliver sustainable, efficient and affordable support to Royal Navy surface warships into the future is the formation of an alliance between the MOD and the providers of surface warship support to whom an alliance approach would offer a sustainable and predictable workload that allows them to make a reasonable profit. The MoD is establishing a team that will work with the companies concerned to develop the detail of how an alliance approach would work in practice. Decisions as to whether to implement the alliance approach will be taken following the conclusion of this exploratory work. The MoD expects to conclude this work within two years.
- 7.3 Exploring the alliance approach will necessarily involve the exchange of commercial information and the conclusion of agreements that restrict competition in the market for provision of repair and maintenance services for military surface warships in the UK. Such conduct may be prohibited under Chapter I of the Competition Act 1998. To enable this work to proceed, it is therefore necessary for the Secretary of State to use his powers under the Competition Act 1998 to make an order that excludes from the Chapter I prohibition agreements relating to the maintenance and repair of surface warships of the Royal Navy.

8. Impact

- 8.1 A Regulatory Impact Assessment has been prepared for this order by the Ministry of Defence. The RIA is attached to this Memorandum. It is available on the DTI website at www.dti.gov.uk/ccp/topics/pdf2/ppex.pdf or from Paul Bannister, Consumer and Competition Policy Directorate, Department of Trade and Industry, 1 Victoria Street, London SW1H 0ET.

9. Contact

- 9.1 Paul Bannister at the Department of Trade and Industry Tel: 0207 215 5009 or e-mail paul.bannister@dti.gsi.gov.uk can answer any queries regarding this instrument.

REGULATORY IMPACT ASSESSMENT (RIA)

1. The Competition Act 1998 (Public Policy Exclusion) Order 2006

2. Purpose and intended effect

Objective

2.1 The objective of this proposal is to exclude an agreement meeting the requirements of the Order relating to the repair and maintenance of Royal Navy surface warships from the application of UK competition law. This is in order to ensure the continuing availability going forward of sustainable, efficient and effective maintenance and repair services for surface warships.

Context

2.2 Competition for surface warship refit and repair has been successful in driving out inefficiency in the market, but recent force level reductions coupled with industrial over-capacity has prompted a review of surface warship support arrangements. Although significant price benefits have been achieved from the MOD's competitive upkeep programme, serious doubts have emerged concerning its sustainability.

2.3 The Surface Ship Support (SSS) study was initiated in August 2004 to explore options for sustainable surface warship support. The SSS study concluded that the best way of achieving a sustainable, efficient and affordable surface warship support market for the future would be exploration with industry of an alliancing approach. During this exploratory phase, which is expected to complete within two years, the policy of competing individual upkeep contracts will be suspended, while the viability of an alliancing approach and the mechanisms required to enable it to operate successfully are considered. An implementation team has been formed to take this work forward with the clear objective of exploring whether or not an alliancing approach would provide effective, affordable and sustainable support to Royal Navy surface warships.

2.4 MOD has been advised by Leading Counsel, its own Legal Advisers, and those of other Government Departments, that this course of action restricts competition in the provision of repair and maintenance services for military surface warships in the UK. To proceed with exploring the alliancing approach results in a requirement for an Exclusion Order under the provisions of the Competition Act 1998. The restrictions of competition introduced by an alliancing approach and the scope of work to be undertaken by the parties involved would be the minimum necessary to provide sustainable surface warship support. Other MOD work, such as submarine support, will be excluded. This RIA supports the exclusion on public policy grounds of the proposed arrangement from the application of UK competition law.

Background

2.5 The SSS study addressed support within the current philosophy of delivering this through the UK industrial base, which has been reconfirmed by the Defence Industrial Strategy (DIS). The following vessels are covered: aircraft carriers, major amphibious ships, destroyers, frigates and mine warfare vessels. Submarines, Royal Fleet Auxiliaries (RFA), landing craft and other auxiliaries, such as survey ships, are excluded. Key stakeholders, including industry, were actively engaged throughout the review.

2.6 Maintenance and repair of conventional military surface warships is divided into three activities: fleet time maintenance (i.e. routine maintenance carried out without the ship docked down), upkeep (deeper, dock dependant maintenance, previously known as refitting) and spare part procurement. There are 3 Naval Bases (Portsmouth, Devonport and Clyde) delivering surface warship fleet time maintenance and 3 dockyards (Portsmouth, Devonport and Rosyth) providing surface warship upkeep. At the moment, each dockyard procures the majority of its spare parts.

2.7 Currently, Fleet Time Maintenance is delivered in a ship's base port through partnering arrangements under the Warship Support Modernisation Initiative (WSMI). All upkeep is delivered through a fully competitive programme.

2.8 There are currently 3 companies engaged in surface warship support:

- a. Babcock International Group (BIG) has 2 UK operating companies delivering maritime support: Babcock Naval Services Limited (BNSL) on the Clyde and Babcock Engineering Services Limited (BESL) at Rosyth;
- b. Devonport Management Limited (DML), at Plymouth;
- c. Fleet Support Limited (FSL) at Portsmouth.

3. Consultation

3.1 The making of the Exclusion Order will only impact on a very limited number of companies as only a few currently have the capability to perform surface warship support. Such companies have been consulted during the study on the options that were considered. Due to this limited impact, formal public consultation was not considered necessary.

4. Options

4.1 A range of options was considered during the SSS study. These options were developed with the current suppliers of fleet time and upkeep support for the affected classes of vessel. The study concluded that the only option that would safeguard operational effectiveness and defence output was the alliancing approach.

4.2 The objective of the alliancing approach is to achieve sustainable support and the ability to react flexibly to future changes in load, delivering

an agreed number of available ships for the Royal Navy to deploy. It offers the ability to provide value for money support in both fleet time maintenance and upkeep, inclusive of material supply where appropriate, by providing industry with a sustainable and predictable workload that allows them to make a reasonable profit. Workshare for each alliance member would not be guaranteed but would rely on cost and performance as the key determinants, with all parties sharing 'pain and gain'.

4.3 The alliancing approach is to be developed between MOD and industry over a period of up to two years. This exploratory phase will enable an alliance framework to be developed and alliancing behaviours to be tested progressively. MOD and industrial Stakeholder involvement throughout this period is key to successful demonstration of the proposal and its ongoing implementation and delivery. Only when all stakeholders are content will the recommended option be submitted for approval to proceed. Any new arrangement must be affordable within the current provision for surface warship support laid out in the Department's plans.

4.4 The alliancing approach forms a key element of the Maritime Industrial Strategy (MIS) sustainment strategy that aims to ensure retention of the key maritime defence capabilities identified by DIS.

5. Costs and Benefits

5.1 The sector most affected is the market for provision of repair and maintenance services for military surface warships. There are currently three companies engaged in this market, BIG, DML and FSL. The volume of work available has decreased significantly in the past few years as a result of a reduction in the size of the warship fleet and an improvement in the effectiveness of maintenance regimes. As a consequence, competition between the companies for this work has resulted in the achievement of low rates for individual packages of work. The SSS study confirmed, however, that such low rates are not sustainable and will result in an unaffordable programme with an inherent risk to the defence output.

5.2 The alliancing approach offers significant improvement opportunities and the ability to develop joint MOD/industry incentivisation mechanisms. It also offers increased predictability and stability for naval personnel. Joint risk/pain share arrangements will help to incentivise all parties to reduce the potential for cost growth.

5.3 Although savings are expected, it is not possible at this time to quantify the level that might be achievable as a result of this proposal. This will be the subject of future discussions between all parties to the alliancing approach.

6. Small Firms Impact Test

6.1 The alliancing approach involves the current 3 companies engaged in surface warship support and there are no plans to engage with other companies during the exploratory phase. However, as with current surface

warship maintenance and repair, it is anticipated that much work will continue to be subcontracted.

7. Competition assessment

7.1 The MOD has been advised that the proposed alliancing approach would have the effect of restricting competition in the provision of repair and maintenance services for military surface warships in the UK, as detailed at paragraph 2.4 above.

7.2 An analysis has been undertaken of the non-military markets potentially affected by the alliancing approach. The only market identified is that for the provision of repair and maintenance services to commercial ships. The geographic dimension of this market is at least European, if not worldwide.

7.3 Based on information currently available, it is estimated that the size of the commercial ship repair and maintenance market is approximately £2.2 billion in Europe and £4.12 billion in the rest of the world. The share of each of the proposed alliance members in any of these geographic areas is currently less than 1% and it is not expected to change substantially in the future. This is because in order to carry out warship repair, the companies need a large and expensive infrastructure, the cost of which is necessarily built into their prices when repairing commercial ships.

7.4 The proposed alliance would, therefore, not affect the conditions of competition in the market for the provision of repair and maintenance services to commercial ships. Even if, in the worst case scenario, the effect of the alliancing approach was to eliminate competition between its members in this commercial arena, it would not affect the overall competition given the relatively small market share held by the alliance members (both individually and collectively).

7.5 The restrictions of competition introduced by an alliancing approach and the scope of work to be undertaken by the parties involved would be the minimum necessary to provide sustainable surface warship support. As detailed in paragraph 2.5 above, other MOD work, such as submarine support, will be excluded.

8. Enforcement, sanctions and monitoring

8.1 This section is not applicable as the alliancing approach is to be developed between MOD and industry over a period of up to two years.

9. Implementation and delivery plan

9.1 Only when there is sufficient confidence in the proposal, the evidence for which will be collated during the exploratory phase, will the alliancing

approach be recommended for approval to move into the implementation phase.

10. Post-implementation review

10.1 The business case to proceed into the implementation phase will contain details of the monitoring and review process.

11. Summary and recommendation

11.1 The SSS study concluded, following thorough consideration, that the only way forward that safeguards defence output is for surface warship support to be delivered through an alliancing approach, the objective being to achieve a sustainable, efficient and affordable surface warship support market for the future. This generates the requirement for the Exclusion Order. During an exploration phase with industry, expected to complete within two years, the policy of competing individual upkeep contracts will be suspended while the viability of an alliance and the mechanisms required to enable it to operate successfully are considered.

11.2 The main benefits of such an approach are that it allows all parties to work together to develop joint incentivisation mechanisms and also to deliver the benefits of the improvement opportunities already identified within the SSS study. The level of savings that might be achievable as a result of this approach will be the subject of future discussions with all parties to the alliancing approach.

Declaration and Publication

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed ***John Reid***

Date ***March 2006***

Dr John Reid, Secretary of State for Defence, Ministry of Defence