

EXPLANATORY MEMORANDUM TO
THE COMPETITION ACT 1998 (PUBLIC POLICY EXCLUSION) ORDER
2007
2007 No. 1896

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 The Order excludes agreements between two or more members of Team CW or between a member of Team CW and any other person together with conduct by a member of Team CW from the prohibitions contained in Chapters I and II of the Competition Act 1998 provided certain conditions, as to the purpose and effect of the agreement or conduct, are satisfied.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None.

4. Legislative Background

4.1 Paragraphs 7(1) and (2) of Schedule 3 to the Act provide that the Secretary of State may, if satisfied that there are exceptional and compelling reasons of public policy, by order, exclude agreements of a particular description either generally or in specified circumstances from the Chapter I prohibition. Paragraph 7(4) enables the Secretary of State, if satisfied that there are exceptional and compelling reasons of public policy, to disapply the Chapter II prohibition from conduct in particular circumstances.

4.2 The Chapter I and II prohibitions are modelled on and can apply in parallel to the prohibitions in Article 81(1) and Article 82 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 (UK).

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 The UK Ministry of Defence's (MoD) Defence Industrial Strategy (DIS), published in December 2005 (Cmd. 6697), identified the need to maintain indigenous industrial capabilities and technologies within a number of defence sectors, including Complex Weapons, to ensure that the UK retains appropriate operational sovereignty in order to protect its national security. This strategy was amplified in the MoD publication entitled "Defence Technology Strategy for the demands of the 21st century" (DTS), published in October 2006 which identified specific technologies and capabilities that should be sustained within the UK, where this is feasible and can demonstrate value for money.

7.2 Current military capability assumptions, reflected in the DIS, forecast that there will be a decline of approximately 40% in UK investment in Complex Weapons from 2007 with little significant planned design and development to retain Core Competencies within industry beyond the next two years. This is likely to result in market rationalisation which may, without MoD intervention, result in some of the UK suppliers in Complex Weapons, on which the MoD relies for its operational sovereignty, leaving the UK Complex Weapons market. This puts at risk the ability of the UK to maintain operational sovereignty in the Complex Weapons sector as set out in the DIS. Therefore, the MoD wishes to influence the restructuring of the UK Complex Weapons sector.

7.3 The MoD is examining options in support of this initiative and, following the announcement of the creation of Team CW in July 2006, indicated its intention to develop a Strategic Partnering Arrangement with Team CW for the UK Complex Weapons sector, with the aim of delivering value for money, provision of long-term military capability and the achievement of operational sovereignty for Complex Weapons through the retention of an appropriately resourced and sized indigenous industrial base.

7.4 Team CW is a group of legally separate UK based Complex Weapons suppliers. The criteria for membership of Team CW are that the supplier:

(a) has one or more Core Competences (defined as the ability to research, develop, manufacture, upgrade, provide support in service or dispose of a part or whole of a Complex Weapon or its Supporting Technology);

(b) is a party to an agreement or agreements with the Secretary of State concerning Complex Weapons and/or Supporting Technologies; and

(c) is a party to an agreement with the Secretary of State which designates that supplier as a member of Team CW.

7.5 In order to examine how best to deliver a partnering arrangement, including the rationalisation of the sector in light of the reduced UK investment, it is necessary for Team CW participants to share commercially sensitive information. Such information exchange would infringe the prohibition provided under Chapter I of the Competition Act 1998.

7.6 It may also be necessary in the future for members of Team CW, which would have a position of collective dominance in the UK Complex Weapons market, to put in place long-term exclusive supply arrangements and/or choose particular suppliers in the Complex Weapons supply chain in order to protect UK operational sovereignty. Such arrangements may infringe the prohibition provided under Chapter II of the Competition Act 1998.

7.7 Therefore, for the proposed Strategic Partnering Arrangement to be put in place, it is necessary for the Secretary of State to use his powers under the Competition Act 1998 to make an order excluding the application of the Chapter I and II prohibitions for agreements entered into, and conduct by, members of Team CW to maintain or develop a Core Competence in relation to the whole or part of a Complex Weapon or its Supporting Technology insofar as such an agreement or conduct is for the purposes of protecting the essential interests of national security in the United Kingdom and does not prevent, restrict or distort competition in markets other than the UK Complex Weapons market.

7.8 A formal unclassified review of the success of DIS in the Complex Weapons sector as it relates to Team CW will take place after three years. The aims of the review will be to evaluate:

- (a) whether Team CW is effectively delivering military capability across MoD's requirements;
- (b) whether Team CW needs revisiting in light of any changes to the industrial landscape;
- (c) whether Team CW is delivering value for money;
- (d) whether MoD intervention is still required; and
- (e) whether or not there have been any unforeseen impacts.

If, following the review, the exclusion order is not considered necessary, it will be revoked.

7.9 This is the second occasion that an order has been made under Paragraph 7 of Schedule 3 to the Competition Act 1998, but the first in which an exclusion from the Chapter II prohibition has been sought. The first order (2006 No. 605) which came into force on 3 April 2006, excluded 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.

8. Impact

8.1 A Regulatory Impact Assessment (RIA) has been prepared for this order by the MoD. The RIA is attached to this Memorandum. It is available on the MoD website at

<http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/PolicyStrategy/RegulatoryImpactAssessmentria.htm>.

9. Contact

9.1 Paul Bannister at the Department for Business, Enterprise and Regulatory Reform, Tel: 0207 215 5009 or e-mail paul.bannister@dti.gsi.gov.uk, can answer any queries regarding this instrument.

**REGULATORY IMPACT ASSESSMENT
COMPETITION ACT 1998 (PUBLIC POLICY EXCLUSION) ORDER [XXX]**

1. PURPOSE AND INTENDED EFFECT

1.1 Objective

1.1.1 The UK Ministry of Defence's (MoD) Defence Industrial Strategy (DIS), published in December 2005, identified the need to maintain indigenous industrial capabilities and technologies within a number of defence sectors to ensure that the UK retains appropriate operational sovereignty in order to protect its national security. This strategy was amplified in the Defence Technology Strategy (DTS), published in October 2006, which identified specific technologies and capabilities that should be sustained onshore, subject to the achievement of Value For Money (VfM).

1.1.2 Within the Complex Weapons (CW) sector, the MoD's work to determine the most effective solution to deliver the Government's DIS and DTS intentions is underway. Following a Ministerial announcement in July 2006, the MoD has been working to develop a Strategic Partnering Arrangement (SPA) with Team CW, an industrial federation of a number of UK based companies involved in the CW sector. Although the MoD's work to assess and validate the options being considered for the DIS CW initiative has still to conclude, initial evidence indicates that the concept of a partnering arrangement with Team CW has the potential to offer an optimal approach.

1.1.3 The Team CW companies are key UK CW suppliers which possess the key sovereign capabilities and technologies identified in the DIS and the DTS. Team CW currently comprises MBDA (UK) Limited, Thales Air Defence Limited (TADL), Thales Missile Electronics Limited (TME), Roxel (UK Rocket Motors) Limited and QinetiQ Limited. Other UK-based CW companies are able to join Team CW.

1.1.4 In order for a partnering arrangement between the MoD and Team CW to operate optimally, it is judged necessary to exclude it from the application of UK Competition law by means of a Public Policy Exclusion Order (PPEO) under the Competition Act 1998.

1.2 Background and Rationale for Government Intervention

1.2.1 CW¹ are tactical weapons that rely upon guidance systems to achieve their mission. Over the last ten years, the UK has invested heavily in the upgrade and development of CW systems, with many of these new systems now coming to the end of their demonstration and manufacture programmes.

1.2.2 Industrial Over-Capacity against Declining MoD Funding. There is a significant over-capacity in the UK CW sector which MoD judges to be unsustainable in the medium to long-term. This over-capacity has a particularly

¹ An example of a CW is the *Storm Shadow* long range missile operated by the RAF. CW does not include the strategic nuclear deterrent, and underwater weapons (torpedoes) are being considered separately.

acute impact on the CW sector in the current environment because of the planned reduction in MoD spending on CW (particularly on new development which will be key to sustaining industrial capabilities) by over 40% over the next five years. Without intervention, the MoD judges that this over-capacity will result in companies that supply key capabilities and technology leaving the UK market. It is judged that the prospect of export sales by UK CW companies is insufficient to ameliorate this situation to any measurable degree.

1.2.3 Ensuring UK Military Capability. The MoD needs to have absolute confidence in the capability, performance and safety of the CW it uses on deployed and other military operations. As the DIS states at paragraph B7.28, such performance “*can only be guaranteed if the UK has access to, and a comprehensive understanding of, the entire system and its design and controlling software. Full access to this mission critical software and information cannot always be secured when procuring complex weapons from offshore suppliers.*” The MoD is therefore seeking to avoid such risks by retaining an indigenous sovereign industrial capability in respect of key technologies and capabilities. Without this retention of capability, the MoD is concerned that it might find itself in a position where it has to rely on foreign technologies to meet its CW requirement without having rights of use in the Intellectual Property Rights (IPR) and without knowing the provenance of key systems and sub-systems. This is particularly so of mission critical software.

2. CONSULTATION

2.1 Within Government

2.1.1 The MoD has established a dedicated CW Implementation Team to assess the options for success in the DIS CW sector, including the development of the SPA with Team CW. This team has consulted widely within the MoD and with key stakeholders in the Department of Trade and Industry (DTI), Office of Fair Trading (OFT), and HM Treasury (HMT).

2.2 Wider Consultation

2.2.1 The MoD’s analysis of the impact of the DIS for the CW sector identified prime contractors, key suppliers, Trade Associations and foreign governments as parties which would be directly or indirectly affected by the MoD’s work in this sector.

Industry

2.2.2 A wide variety of prime contractors and key suppliers, both working within and outside the Team CW construct, have been consulted on a bilateral and a wider basis, including:

MBDA (UK and international)
Thales Air Defence Ltd
Corporation

BAES Insyte
Lockheed Martin

Thales Missile Electronics Ltd	Lockheed	Martin
UK Insys		
QinetiQ Ltd	Selex UK Ltd	
Roxel (UK Rocket Motors) Ltd	SD (UK)	
Raytheon Inc, and Raytheon Systems Ltd (RSL)	Saab	Bofors
Dynamics		

2.2.3 Between them, these companies currently provide the vast majority of the MoD's CW systems and are the likely potential suppliers for any future acquisitions.

Trade Associations

2.2.4 The principal Trade Association covering the CW sector is the Society of British Aerospace Companies (SBAC). The SBAC's involvement in this sector is focused through the 'Guided Weapons Tower of Excellence' which is a grouping consisting of the MoD, defence industry companies (including Small and Medium Enterprises (SME) where appropriate) and academic research laboratories. It has the mission to enhance the UK's overall technical performance in Guided Weapon (GW) (ie CW) systems through data and other interchange. The MoD CW Implementation Team has briefed this grouping regularly in order to ensure that any suppliers that may be affected are aware of, and have had the opportunity to comment on, the MoD's ongoing work in response to DIS in the CW sector.

Foreign Governments

2.2.5 The MoD has routinely engaged with the US Department of Defense, the French D el egation G en erale Pour L'Armement, the German Federal Ministry of Defence, and the Swedish Defence Material Administration (FMV) (as hosts to current CW suppliers or partners on international collaborative work) through official channels to discuss both UK national and shared policy objectives.

Issues Identified During Consultation

2.2.6 The process of consultation has highlighted a number of issues which will be addressed during the MoD's ongoing work. These include the need to demonstrate the achievement of VfM when set against the delivery of military capability and industrial sustainability; finalising the legal framework for Team CW, and understanding the impact any arrangement might have on foreign suppliers.

2.2.6.1 *Value for Money.* This is addressed at Section 7 to this document.

2.2.6.2 *Legal Framework for Team CW.* The Team CW companies have formed themselves into a consortium rather than a joint venture or a formal alliance. In terms of Team CW's linkage with the MoD, and subject to a SPA being agreed, it is envisaged that a model will be adopted whereby the MoD will contract directly with the most

appropriate industrial structure or company within Team CW, and that sub-system work will either be competed or directed as UK sovereignty requirements dictate.

2.2.6.3 Treatment of Foreign Suppliers. Under a SPA, and subject to VfM and affordability being demonstrated, it is envisaged that Team CW will become the default supplier of those CW deemed to contribute towards the sustainment of industrial capabilities and technologies in this sector. Nevertheless, there will continue to be scope for contracting with non-UK CW suppliers at prime contractor level where there are compelling VfM or capability requirements to do so – for instance where the UK does not currently have an industrial capability to create a particular product and where DTS has not identified a need to retain or develop the associated industrial capabilities and technologies.

3. OPTIONS

3.1.1 In order to determine the best way forward for the UK CW sector, and to verify the effectiveness of a SPA with Team CW, the MoD is considering four principal options²:

- a. Maintaining existing competitive arrangements;
- b. Partnering with Team CW;
- c. Selecting a single UK Prime Contractor;
- d. Developing bilateral arrangements with CW Industry.

3.1.2 At this juncture, and recognising that the MoD has still to put forward a formal case setting out the adoption of the Team CW approach as part of its approvals process, the MoD believes that this is the option most likely to deliver the DIS challenges set out in para B7.45³ of the DIS White Paper. Compared to the other options being considered, the MoD judges that partnering with Team CW is most likely to produce an optimal outcome on industrial rationalisation and transformation, on the grounds that is the most coherent response to maximising the available expertise within industry on its knowledge of the supply chain. A Team CW approach is also likely to be achieved in the timeliest fashion. Furthermore, in the context of VfM, it is the option that is most likely to support increased commonality of systems and sub-systems in the CW sector that, in the long term, should reduce through life costs and, which in turn, should lead to better support to front line operations.

3.2 Option 1 – Maintaining Existing Competitive Arrangements

² The MoD is also assessing the potential impact of collaborating with our international partners; indeed, a Team CW solution could still involve collaborating with partners on individual requirements/programmes.

³ The key principles described in para B7.45 are: a tempering of competition, industrial restructuring, and different approaches to acquisition through life.

3.2.1 This option is based on the MoD's existing procurement processes based on the use of international competition and the assumption that this would feature principally the acquisition of Military-off-The-Shelf (MOTS) systems. As a consequence of the publication of the DIS, the MoD's focus in the CW sector has shifted towards the maintenance of UK sovereign industrial capability. To provide for this, the DIS proposes the need to temper such global competition.

3.2.2 If the MoD was to maintain existing competitive arrangements, it is judged that this would severely risk UK sovereign capability as there is insufficient volume of work to ensure the sustainment of UK CW industry players. The MoD considers that, if CW procurement was left to market forces, the ensuing industrial rationalisation would be unlikely to provide the sort of ordered transformation required to achieve the aims of the DIS, on the grounds that industry would be unable to plan with any certainty its business and its restructuring options. Such a situation would result in a loss of sovereign capability, which would impact directly on the availability of key CW capabilities for military operations. Additionally, the loss of sovereign capability is expected to lead to a proportionate reduction in the capability level of MOTS solutions made available to the UK. Moreover, market forces would dictate that decisions on divestment of capability would be taken by Industry shareholders who would understandably be more driven by ensuring a good return on their investment than retaining sovereign capability. Additionally, leaving matters to market forces would not provide a strategic view of vulnerabilities or military dependencies throughout the supply chain, with the likely outcome that sovereign capability in key technologies within the CW sector would be lost.

3.2.3 On the basis of the above, which does not meet DIS policy objectives, this option is judged to be sub-optimal.

3.3 Option 2 – Partnering with Team CW

3.3.1 This option is based on the development and signature of a SPA between the MoD and Team CW. The SPA will be supported by a linked Sector Transformation and Incentivisation Agreement (STIA) which will include performance metrics aimed at incentivising all parties to improve business effectiveness and efficiency.

3.3.2 Team CW currently includes five UK defence companies but is open to others who have a UK-based operating division and have design and development capabilities in the UK which lead to the retention of IPR in the UK that supports retention of sovereign capabilities and technologies. The retention of design and development skills and IPR in the UK is of critical importance to UK national security interests.

3.3.3 A partnering arrangement has the potential for all of these companies to work together to provide more effective delivery of CW programmes and supporting technologies, while providing the Government with overall VfM, and CW industry with a more coherent and long term understanding of MoD

requirements, thereby assisting rationalisation and efficiency. It is envisaged that the MoD would work with Team CW to deliver an industrial base that is rationalised to an optimum level in a way that avoids unnecessary duplication of capability and capacity and that retains sovereign capability in the priority areas of technology identified in the DIS and the DTS.

3.3.4 The MoD therefore considers that Option 2 will provide an optimal solution for sustaining the CW technologies and capabilities required under DIS and DTS.

3.4 Option 3 – Selecting a Single UK Prime Contractor

3.4.1 This option is based on the selection of the most appropriate CW sector prime contractor to act as the single source for future CW acquisition and associated support contracts. Currently, there is no one company that possesses all of the range of technologies identified in the DIS and DTS. Accordingly, this option would be unable to corral all of the critical sovereign capabilities under one umbrella, unless the prime contractor selected was able to acquire the relevant technologies from its competitors through merger and/or acquisition (M&A). While M&A might be feasible, the MoD cannot guarantee that this will happen, or that it will occur in a manner compatible to its DIS aspirations.

3.4.2 Option 3 is therefore judged to be sub-optimal.

3.5 Option 4 – Bilateral Partnering Arrangements with CW Industry

3.5.1 Option 4 is envisaged to involve the MoD negotiating, on a bilateral basis, with each of the key industry players to consider the extent to which the individual companies would need to rationalise and transform themselves to achieve the industrial rationalisation required.

3.5.2 The MoD considers that this Option does not offer the most optimal solution as it would not be as comprehensive or as coherent as a solution based on partnering with industry as a whole. Equally importantly, MoD believes that such bilateral agreements would take significant time to conclude, with the risk that sovereign capability may be lost in the meantime. From a national security perspective, the MoD cannot afford to take this risk. Given that the recent peak in the MoD's acquisition of CW has already passed and is now declining quickly, industrial rationalisation needs to commence soon. Such an arrangement will also be difficult for the MoD to manage effectively, in that the MoD will own the risk associated with the interfaces between the companies in the sector, but not the control to manage it in the way that Team CW could under Option 2.

4. COMPETITION ASSESSMENT

4.1.1 The MoD has consulted the OFT's guidelines "*Completing competition assessments in impact assessments*". According to these guidelines, the purpose of conducting an impact assessment from a competition law viewpoint is to consider whether the proposed regulation prevents, restricts or distorts competition (OFT876, page 7). The reason MoD requires a PPEO is precisely

because it recognises that the behaviour of Team CW would prevent, restrict or distort competition. However, the MoD believes that there are exceptional and compelling reasons of public policy which justify the suspension of the application of the competition regime.

4.2 Team CW Players

4.2.1 The companies which currently form Team CW are: MBDA UK Limited, Thales UK Limited (as holder of all shares in TADL and TME), Roxel (UK Rocket Motors) Limited, and QinetiQ Ltd.

4.2.2 *Prime Contractors' Market.* The MoD understands that the Team CW members are active in different markets. MBDA and TADL are active prime contractors in the UK market for GW and GW Systems (ie the CW market). Excluding torpedoes, which do not form part of the Team CW proposal and are the subject to separate consideration, the MoD believes that their (MBDA/TADL) joint market share is approximately 70-80%.

4.2.3 The other principal industry parties at prime contractor level which are not part of Team CW are RSL, Lockheed Martin, SAAB Bofors Dynamics and Boeing. In July 2006, RSL elected not to join Team CW, although discussions between MBDA, RSL and the MoD continue on RSL's potential participation. Although Lockheed Martin has a UK base, it is not considered critical to sustaining and maintaining UK sovereign CW capability as it would currently need to reach back to the US for its IPR, design and development capabilities for the delivery of CW systems. The other large American contractor, Boeing, does not have a prime contractor presence in Europe at all. SAAB Bofors Dynamics is the only other prime contractor which operates in the European market. Although DIS focuses on sustaining onshore capabilities, the partnering arrangement intended to be agreed with Team CW would be flexible enough to allow for possible inclusion of European companies, provided the appropriate safeguards were put in place regarding the protection of UK sovereign capability.

4.2.4 *Sub-Contractor and Suppliers' Market.* Roxel, TME and QinetiQ are active in the UK market for Sovereign CW sub-systems and components. The MoD believes that these parties do not compete with each other either directly or indirectly.

4.2.5 The key parties which are not part of Team CW at the sub-system/component level are Selex S&AS, BAE Systems Land Systems, BAE Systems Insyte and Chemring. All of these companies are expected to be key suppliers to Team CW: indeed, it is expected that there will continue to be healthy competition at sub-contractor level.

4.3 The infringements

4.3.1 The Chapter I Prohibition

4.3.2 Section 2 of the Competition Act 1998 states that:

"...agreements between undertakings, decisions by associations of undertakings or concerted practices which

*(a) may affect trade within the United Kingdom, and
(b) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom,
are prohibited unless they are exempt in accordance with the provisions of this Part.”*

4.3.3 As explained in Section 3.3 above, the implementation of DIS through Team CW requires a number of key players in the UK markets for CW and CW Systems and CW sub-systems and components to come together as a consortium of companies. In order for this grouping to produce optimum results, it must engage in a number of practices which will infringe Section 2 of the Competition Act.

Information Exchange

4.3.4 In order to ensure the sustainment of the UK CW industry, it is essential to rationalise the industrial base to an optimum level while at the same time securing sovereign capability. These two objectives must be achieved promptly, as it is the MoD's view that any significant delay is likely to result in key capabilities and technologies being lost. Such a loss would represent an unacceptable risk to UK national security.

4.3.5 A critical factor in the implementation of the DIS in this sector is the effective and optimum operation of Team CW. In order to achieve this, the Team CW members will need to share information to assess their current capabilities and capacities in the UK CW sector and how those capabilities and capacities may be rationalised. The information that will need to be shared will be commercially confidential information on matters such as capacity, costs, core skills, technologies, facilities, planning information, investment information and supply chain data. This information exchange constitutes an infringement of Section 2 of the Competition Act. The MoD judges that such an infringement should be excluded from the application of the Competition Act under paragraph 7 of Schedule 3 of the Act.

Market Sharing

4.3.6 The intention of industrial rationalisation is to enable industry to reduce duplications by, for example, foregoing one area of work in exchange for continuing with another area of work. In addition, under a SPA, the MoD intends that Team CW would be the default supplier of its CW requirements where these contribute towards the sustainment of indigenous industrial capability. This has the consequence that any prime contractor without a presence in the UK (which will therefore not generate UK-based IPR nor provide access to sovereign capability) will be excluded from the prime contractor market.

4.3.7 These arrangements will constitute market sharing in breach of Section 2 of the Competition Act. The MoD is of the view that such infringement should be excluded from the application of the Competition Act under paragraph 7 of Schedule 3 of the Act.

4.3.8 The Chapter II Prohibition

4.3.9 Section 18 of the Competition Act states that:

“(1) ... any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.

(2) Conduct may, in particular, constitute such an abuse if it consists in

–

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;”

4.3.10 It is envisaged that, as part of the overall aim of achieving long-term, through life VfM in the delivery of defence capability, Team CW will need to identify the availability (or otherwise) of competition in the suppliers market. As a general rule, where effective competition exists, Team CW will subject all new work to competition. However, there will be occasions where it is imperative to allocate the work to a particular supplier in order to guarantee that a key capability or technology is retained in the UK. Where there is more than one supplier with a key capability or technology, Team CW may choose which one it will support, although the MoD would still expect to see this capability competed. In such cases, Team CW would be applying dissimilar conditions to equivalent transactions. This constitutes an infringement of Section 18 of the Competition Act. The MoD judges that such an infringement should be excluded from the application of the Competition Act under paragraph 7 of Schedule 3 of the Act.

4.4 Public Policy Exclusion

4.4.1 Paragraph 7 of Schedule 3 of the Competition Act provides that:

“(1) If the Secretary of State is satisfied that there are exceptional and compelling reasons of public policy why the Chapter I prohibition ought not to apply to –

- (a) a particular agreement, or*
- (b) any agreement of a particular description,*

he may by order exclude the agreement, or agreements of that description, from the Chapter I prohibition.

(4) If the Secretary of State is satisfied that there are exceptional and compelling reasons of public policy why the Chapter II prohibition ought not to apply in particular circumstances, he may by order provide for it not to apply in such circumstances as may be specified.”

4.4.2 It is MoD’s understanding that the need to protect national security has in the past been considered an “*exceptional and compelling reason of public policy*” as requested by paragraph 7 of Schedule 3 (see the Competition Act 1998 (Public Policy Exclusion) Order 2006, SI 605). On this point, it may also be of relevance to refer to Section 42 of the Enterprise Act, which deals with the intervention of the Secretary of State in certain public interest cases. Section

42(3) provides that a public interest consideration is a consideration which is specified in Section 58. This section specifies “*the interests of national security*” as a public interest consideration and goes on to say that national security includes “*public security*”, as defined in Article 21(4) of the EC Merger Regulation. Article 21(4) states that public security shall be regarded as a “*legitimate interest*” which Member States may take appropriate measures to protect.

4.4.3 The MoD is of the view that the anti-competitive practices identified above qualify for public policy exclusion on the grounds of national security. Such practices are necessary in order to preserve sovereign UK CW capabilities and technologies which, in turn, are considered essential for the protection of national security. This objective was highlighted in the Ministerial Foreword to the DIS which states: “*In this Strategy, we consider carefully which industrial capabilities we need to retain in the UK to ensure that we can continue to operate our equipment in the way we choose to maintain appropriate sovereignty and thereby protect our national security*” (*emphasis added*).

5. COSTS AND BENEFITS

5.1.1 The costs and benefits discussed in this section, which are tabulated at Annex A to this document, are presented principally as a qualitative assessment, as detailed quantitative analysis will only be possible following detailed discussions between the Team CW companies, and separately with the MoD, following the granting of an Exclusion Order. Nevertheless, the assessment examines the relative benefits of all the options that are being considered against a range of criteria, including economic, social, industrial sustainability, cost, and the provision of military capability.

5.2 Sector and Groups Affected

5.2.1 *Customers.* The sole customer for CW in the UK is the MoD. The MoD’s procurement activity in the sector is divided into the acquisition of new weapons systems (covering research, development and manufacture) and their subsequent support, and the support of in-service systems, some of which, historically, have been sourced from overseas (e.g. AMRAAM). In the context of the aims of the DIS and the proposed tempering of competition, the MoD will typically contract for future CW requirements with a single prime contractor for both acquisition and/or in-service support. The change in UK government policy as outlined in the DIS will therefore impact on those Industry parties involved in the supply of CW.

5.2.2 *Prime contractors.* Subject to the demonstration of VfM, and as already outlined, the use of the preferred option will mean that Team CW will become the MoD’s default supplier for its CW requirements. This will provide Team CW with increased understanding of the MoD’s future requirements in this sector, albeit in a declining sector overall. As the prime contractor members of Team CW, MBDA (UK) and TADL will benefit from this approach. The remaining major UK prime contractor, RSL, is currently not a member of Team

CW, but remains in close discussion with Team CW and the MoD regarding its potential to join.

5.2.3 *Supply chain.* As already indicated, the supply chain is a wide grouping ranging from key sub-system suppliers (such as Roxel and TME) to component suppliers at the lower end of the supply chain. The overriding effect of the implementation of a SPA with Team CW would be to help sustain the UK supply chain whereas maintaining the existing competitive arrangements (based on offshore military off-the-shelf procurements) would have a significant adverse affect on the supply chain. There may be specific cases where rationalisation being undertaken by Team CW leads to a reduction in the number of key suppliers for a particular niche technology. The impact of this will be quantified during the implementation phase, at which time further information will be available following the sharing of data between Team CW companies.

6. SMALL FIRMS IMPACT TEST

6.1.1 There are two main ways in which SMEs are involved in the CW supply chain: as a supplier to a prime contractor, and as a innovator of new technology.

6.1.2 The MoD's intention is for Team CW to compete as many of its supplier requirements as possible, except where the supplier requirement relates to a key sovereign capability. In the case of key sovereign capabilities, the requirement will be satisfied by placing the requirement with an agreed supplier.

6.1.3 The DTS sets out the MoD's technology strategy and provides industry, academia, and SMEs with a long term understanding of departmental priorities. "Technology trees" are used to show the underlying requirements of our larger, highly integrated capabilities, thereby giving smaller players an understanding of our current and potential future requirements. The MoD is currently running initiatives such as the 'Grand Challenge', a groundbreaking science and technology competition to discover new ideas for threat detection for soldiers on patrol. Initiatives such as these are open to all.

6.1.4 From a Team CW perspective, the primary source of successful innovation lies with the supply chain, which often can expose the best new technologies and innovative ways of delivering capabilities. Team CW recognises the need for innovation, which will be included as a measure of performance within the sector transformation objectives the MoD is negotiating with Team CW.

7. MONITORING

7.1.1 It is envisaged that a SPA with Team CW will be monitored against a range of criteria, including the achievement of VfM, the provision of military capability, and our success in sustaining indigenous industrial capabilities in the sector.

7.1.2 *VfM*. The MoD is aware that any procurement route it wishes to use must provide demonstrable VfM. The methods that will be used to demonstrate VfM as part of a SPA (and the associated STIA) are being finalised, but will include measures to show VfM both at the outset and subsequently during the life of the agreement. In this context, our measurement of VfM will balance a range of business criteria. The STIA will be legally binding and contain a suite of sector transformation incentivisation measures that will drive efficiencies both at project and sector level.

7.1.3 *Military Capability*. Delivery against this objective will be measured at both project and sector level. Each CW project contracted for by the MoD is managed against well defined performance, cost and time parameters. All projects are subject to rigorous MoD scrutiny and post project evaluation, with higher value projects coming under HMT scrutiny and are included in the National Audit Office's Major Projects Report. At a sector level, the MoD will analyse the overall performance of Team CW against the basket of projects it has been contracted to deliver.

7.1.4 *Industrial Capabilities*. The MoD will periodically review the requirements for UK sovereignty through the DIS and DTS and, in conjunction with its overarching view of UK CW capability, will actively manage any changes through mechanisms within the SPA.

8. IMPLEMENTATION AND DELIVERY PLAN

8.1.1 Work to analyse the four principal options for the DIS CW sector is underway. In the event of securing a PPEO from the Competition Act 1998, the Team CW companies will assess in mid-2007 the opportunities open to them to make the UK CW sector as effective as possible. Team CW's deliberations will be negotiated with the MoD and the outcome will be set out in a formal approvals case submitted to the MoD approvals authorities and subsequently HMT. Approval of a partnering approach based on the use of a SPA and STIA at this "Main Gate" point, assuming similar approvals from the relevant company boards, will allow signature of the SPA and the implementation of the MoD/Team CW arrangement.

8.1.2 The SPA will capture partnering principles and detailed processes for addressing the long term planning arrangements for harmonising the MoD's future CW requirements and the engagement with Team CW in shaping the optimal procurement strategies to deliver those capabilities. The associated legally binding STIA will include defined measures and a programme of targets/milestones, initially over three years, with an annual review.

8.1.3 The assumptions that drive sector transformation and rationalisation will be enabled through the award of single source contracts to Team CW, where this is judged to be relevant to the sustainment of UK indigenous industrial capabilities. The contracts may be with one or more individual Team CW members. Given that Team CW sees itself as a consortium, it is unlikely that there will be a separate Team CW legal entity with whom MoD could contract for the foreseeable future.

8.1.4 *Exit Strategy*. In the event that the MoD is not granted a PPEO, it will still have to address the industrial issues described in the DIS White Paper. In this context, the MoD would still expect to adopt the defence values for acquisition as the basis for trying to retain the key partnering principles it is seeking to establish with Team CW. However, at the detailed level the MoD would have to negotiate bilaterally with Team CW companies to arrive at the rationalisation and transformation the DIS described as being necessary to have an effective defence industrial base in the CW sector. The MoD would also have to address what it believes to be a skills shortage within the MOD in being able to understand the nature of CW sector supply chains and the interdependencies that may exist between them. As is indicated elsewhere in this paper, the MoD judges that such an approach is likely to be much less effective than the Team CW approach and potentially puts at risk VfM (through the retention of duplication of capability within the supply chains) and the retention of sovereign capability (as companies come under pressure from shareholder to divest themselves of such capabilities, where future requirements from the MoD might be uncertain).

9. POST IMPLEMENTATION REVIEW

9.1.1 In addition to the monitoring regime described above, a formal, unclassified, review of the success of DIS in the CW sector (under a SPA/STIA) will be made after three years. The primary aims of this review will be to assess whether:

- The Team CW construct is effectively delivering military capability across the MoD's requirement set (this is to include on-going support of new and legacy systems).
- The Team CW construct needs revisiting in light of any changes in the industrial landscape.
- Team CW is delivering VfM.
- Ongoing Government intervention is still required and whether there have been any unforeseen impacts.

9.1.2 This review is not intended to be as a consequence of the statutory framework, but is to be seen as a commitment to review as a part of the MoD's ongoing open discussion with Industry and other stakeholders.

10. SUMMARY AND RECOMMENDATION

10.1 Summary

10.1.1 In addressing the needs of the CW sector, the DIS identified the need to maintain indigenous industrial capabilities and technologies in order to protect the UK's national security. This requirement has been positioned into a market place where the MoD's spending (as principal customer) will be significantly

reduced over the next five years. Against this background, the MoD has considered four options to take the initiative forward:

- a. Option 1 – Maintaining Existing Competitive Arrangements. As highlighted in the DIS, it is judged that maintaining current competitive arrangements would severely risk UK sovereign capability and would, therefore, not meet DIS policy objectives. On this basis the option is judged to be sub-optimal.
- b. Option 2 – Partnering with Team CW. This approach has the potential to deliver the most coherent and most rapid industrial transformation of the UK CW sector consistent with DIS policy intentions. This will ensure the optimum level of sustainment possible, as efficiency will allow the greatest number of capabilities to be sustained, with rapid implementation minimising the risk of capability loss during the implementation phase. This option is judged to be able to provide the MoD with a framework to deliver sovereign CW capabilities through-life at best value for the tax payer. This option is recommended as the optimal solution.
- c. Option 3 – Selection of a Single UK Prime Contractor. While this option would provide a base level of sustainment it would be unable to encompass the full range of sovereign capabilities required under the DIS and DTS. On this basis the option is judged to be sub-optimal.
- d. Option 4 – Bilateral Partnering with CW Industry. This option would require the MoD to negotiate industrial transformation bilaterally with key companies. This is considered to deliver a sub-optimal approach as it would not provide a comprehensive or coherent sector transformation and would give five separate (but necessarily linked) arrangements would be particularly difficult for the MoD to manage. On this basis the option is judged to be sub-optimal.

10.1.2 In order to deliver the MoD's recommended option (Partnering with Team CW), it is judged that a PPEO from Chapters 1 and II of the Competition Act 1998 is required. It is the MoD's view that the anti-competitive practices needed would qualify for a PPEO on the grounds of national security.

10.2 Conclusion

10.2.1 The DIS specifically identified the need to retain UK capability in relation to CW. In particular it stated that "*The UK needs to retain the capability within industry to design, develop, assemble, support and upgrade complex weapons. Future demand and investment will not support the UK's current spectrum of industrial capability in the way it is currently provided from 2007 onwards.*" (DIS, B7.44)

10.2.2 Subject to a formal MoD business case being submitted, the MoD judges that Partnering with Team CW offers the most effective, sustainable and affordable solution to ensure that the necessary industrial transformation and

rationalisation of the UK CW sector is achieved, with the result that UK sovereign capability is retained, as required by the DIS. Critically, Team CW is the solution most likely to achieve the DIS outcomes in the timeframe needed to ensure sovereign capability is not lost. As stated in the DIS (para B7.51): “... *We will need to work fast, in conjunction with Industry, if we are to avoid seeing the UK industrial capability going into decline.*”

11. DECLARATION AND PUBLICATION

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

Signed The Rt Hon Des Browne

4th April 2007

**Rt. Hon Des Browne MP
Secretary of State for Defence**

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