
Completed acquisition by Babcock International Group plc of Devonport Management Limited

The OFT's decision on reference under section 22(1) given on 20 August 2007. Full text of decision published 3 September 2007.

PARTIES

1. **Babcock International Group plc (Babcock)** is an asset management business which manages fixed infrastructure in the rail, power networks, defence and nuclear sectors together with defence assets such as military aircraft, warships and nuclear submarines. Babcock owns the Rosyth Royal Dockyard on the Firth of Forth and manages the HM Naval Base Clyde at Faslane.
2. **Devonport Management Limited (DML)** was founded in 1987 to manage the Devonport Royal Dockyard as part of the UK Ministry of Defence's (MoD) reforms to introduce commercial management to its facilities. The Devonport Royal Dockyard was privatised in 1997, but the MoD retained a special share in Devonport Royal Dockyard Ltd (DRDL), which is otherwise wholly owned by DML. This special share grants powers to the MoD to intervene in matters affecting DRDL's ownership in light of Devonport's strategic importance. DML's UK turnover for the year ended December 2006 was £454 million.

TRANSACTION

3. Babcock acquired the entire issued share capital of DML from the existing shareholders. The transaction completed on 28 June 2007 and the statutory deadline for a decision on reference, as extended by virtue of a notice issued under section 25(2) of the Enterprise Act 2002 (the Act) on 12 July 2007, expires on 28 October 2007. The administrative deadline is 20 August 2007.

JURISDICTION

4. As a result of this transaction Babcock and DML have ceased to be distinct. The UK turnover of DML exceeds £70 million, so the turnover test in section 23(1)(b) of the Act is satisfied. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.

BACKGROUND

5. The Secretary of State for Defence presented to Parliament, in December 2005, the Defence Industrial Strategy White Paper (the DIS). One of the main conclusions of the DIS's maritime chapter is that restructuring and consolidation of the industry is likely to be necessary to improve performance and meet the MoD's needs. It also states that immediate measures are necessary to distribute the surface warship support workload in order to sustain key industrial capabilities.
6. [REDACTED]. The MoD said that, although DML was sold by competitive auction and the emergence of Babcock as the winning bidder was driven entirely by commercial considerations, the MoD established some 'minimum acceptance criteria' for the bidders.

RELEVANT MARKET

7. The parties are active in both military and non-military activities.

Non-military

8. In relation to their non-military activities, both parties have business related to commercial ships, rail and civil nuclear fields. However, their businesses are complementary rather than overlapping, and Babcock submitted it is not aware of ever having competed against DML in any of those fields. Although one third party raised concerns relating to conglomerate issues in the non-military nuclear field, the OFT did not find, and no third party could identify, any segments where the parties might have market power from which they could derive portfolio power.¹

9. Therefore, based on the evidence available, the OFT does not consider that it is or may be the case that the merger may result in a substantial lessening of competition in the non-military sector.

Military

10. In the military sector, the merging parties are active in the submarine and surface ships segments, as well as in the provision of equipment support and defence systems. Babcock segmented the military sector as follows:
- Submarines: (a) in-service support, (b) refitting, and (c) disposal
 - Surface Ships: (a) in-service support, (b) deep maintenance and refitting, and (c) design support
 - Equipment support
 - Defence systems
11. For all military overlaps, the MoD is the only customer of both parties, and it supported the delineation proposed by Babcock.
12. A third party suggested that submarine and surface ships in-service support should be considered together due to allegations relating to the possibility of cross-subsidisation. However, the scope for cross-subsidisation is considered under competitive effects and is not relevant to market definition. It has also been put to the OFT that 'submarine disposal' encompasses a number of different activities which could be further segmented. The OFT considers the precise area of overlap when assessing the impact of the merger on the submarine disposal segment.
13. Finally, Babcock submitted that defence systems comprise the supply of equipment for ships and submarines to be fitted either when the vessel is under construction or during the vessel's life as part of an upgrade package. A third party considered this to be an excessively broad category. However, it is not necessary to conclude on the market definition given that no respondents raised concerns or suggested alternative segmentations, and that the merger does not give rise to competition

¹ OFT *Mergers – Substantive assessment guidance*, para 6.1.

concerns in this segment in any case. Babcock is active in this market through its subsidiary Alstec, but its activities are focused on different areas than DML, and on the basis of the evidence available the OFT believes that these activities are complementary rather than overlapping. Therefore, this segment is not considered further.

14. Based on the evidence available, the OFT believes that the market segmentation proposed by Babcock represents an appropriate framework within which the impact of the merger can be analysed.

Geographic market

15. The UK MoD is the sole customer of the merging parties. All services are rendered in Great Britain, where all facilities related to the services are located. Therefore, the geographic scope of the market is not wider than Great Britain.

HORIZONTAL ISSUES

Submarine in-service support

16. Babcock and DML are both active in the provision of in-service support for nuclear submarines. In-service support involves the regular maintenance and capability upgrades while a vessel is on active service. Babcock maintains that the location where in-service support is provided is currently defined by the class of the vessel and its home base. The MoD currently contracts in-service support of submarines at the respective home bases through the Warship Support Modernisation Initiative (WSMI).²
17. In establishing the counterfactual to assess the potential effects of the merger on customers (here, the MoD), the OFT considered, first, the extent to which there was pre-merger competition for submarine in-service support, and, second, the potential that for a procurement model featuring competition between multiple suppliers, or greater such competition, in the foreseeable future.

² These long term agreements were put in place in 2002 on a sole-source basis with the companies running the three UK dockyards, and operate on the basis of the three parties undertaking many of the day-to-day operational activities in the naval bases whilst the MoD retains overall control and ownership.

Pre-merger competition

18. The HM Naval Base Clyde, which is managed by Babcock, is home base to three classes of submarines: Vanguard, Swiftsure and Astute.³ The Trafalgar class is based in HM Naval Base Devonport, which is managed by DML. Due to technical, operational and nuclear regulatory constraints, the Vanguard class cannot operate from DML's naval base in Devonport. Therefore, as confirmed by the MoD, there is no scope for the MoD to switch naval bases and as a consequence there is no competition for in-service support of Vanguard submarines. For this reason, this class is not considered further.
19. In relation to the Trafalgar, Swiftsure and Astute classes, the MoD submitted that there are no fundamental impediments to flexing services from Clyde to Devonport and vice-versa. However, the MoD submitted that 'contextual' procurement drivers unrelated to the benefits of competing suppliers and the fact that in-service support for the Swiftsure and Trafalgar classes are covered by the WSMI substantially limits the scope for competition in this segment.⁴
20. The MoD submitted that, in view of the expensive assets involved in providing submarine in-service support, investment in facilities is carefully planned against future demand. For this reason, it is very rare that there is sufficient spare capacity at either Devonport or Clyde to allow Babcock and DML to engage in competition. The MoD also said that, even if there were sufficient capacity to generate competition, issues related to relocation of submarine staff for the duration of the service would complicate the switching of submarines, and as a consequence limit the potential competition for services. In 2007, the MoD did relocate a Trafalgar submarine from Devonport to Clyde: this was the first time a submarine relocation occurred since 1997. However, the MoD submitted that the rationale for the transfer of in-service support was to manage capacity and alleviate potential redundancies at Clyde between the decommissioning of one class of submarine and the commissioning of another. In other words, the decision to relocate was not taken to leverage the MoD choice of competing supplier, but was instead driven by wider MoD priorities.

³ This class is not in operation yet.

⁴ It is envisaged that the WSMI will also apply to the Astute class.

21. As noted above, in-service support for the Swiftsure and Trafalgar submarines is currently managed through the relevant WSMI agreements, which the MoD submitted constrains its ability to extract benefits from competition. This is because if the MoD wishes to (threaten to) switch from one base to the other, under the WSMI, the minimum committed resource level would still have to be funded, while the MoD would be paying for the additional resources to be secured at the alternative base. The MoD's ability to play off Babcock and DML against each other is therefore limited. Babcock believes that the MoD has the ability to move work between facilities, but this would be as a result of capacity and/or workload considerations and not in order to benefit from competition between the parties.

Future competition

22. Absent the merger, this position is likely to prevail for the duration of the WSMI contracts expiring in 2009 and 2012, respectively; in the longer term, there may have been scope for competition between the parties when WSMI contracts come up for renewal. However, although the MoD has provided little explanation as to how it negotiates WSMI contracts, it declared that it has 'never competed a nuclear submarine project, nor [has] any current intention to do so.'
23. The MoD raised the possibility that, in the longer term, it could reconsider whether a programme of work within the Trafalgar class should be put to competition and whether more Trafalgar submarines should be based at Clyde. However, it also says that it would give weight to wider issues such as training, recruitment and crew accommodation benefits against the cost savings generated by competition.

Conclusion

24. The merger brings together the two UK suppliers of in-service support for submarines. However, due to the 'contextual' factors important to the MoD, as well as to the fact that these services are covered by WSMI agreements, the evidence before the OFT indicates that there was at best limited if any, competition between Babcock and DML pre-merger. In the long run, there could be scope for some competition between the parties when the WSMI agreements come up for renewal. However, this would only happen if the MoD were to choose to change the contractual

framework to pursue a competition-driven procurement policy for Trafalgar class submarines

25. The scope of future competition absent the merger is thus entirely in the hands of the only customer, as it depends on the MoD's policy. In relation to in-service support to submarines, the MoD declared that it regards competition to be ineffective as a tool to obtain value-for-money, and that it has no current intention of putting a nuclear submarine project up for competition.

Submarine refitting and deep maintenance

26. Refitting and deep maintenance involve mid-commission refurbishment, as well as refuelling in the case of current nuclear powered submarines. It can take from two to four years to complete.
27. DML is the only UK supplier of submarine refitting and deep maintenance because Devonport is the only facility in the UK licensed to carry out this work. Indeed, following the completion of refits in 2003, the facility at Rosyth (owned by Babcock) lost its nuclear licence. Babcock submitted, and the MoD confirmed, that it is inconceivable that Babcock or the MoD would fund the development of a refitting facility at Rosyth to meet modern safety standards.
28. The OFT therefore believes that the merger will not give rise to any competition concerns in relation to submarine refit and maintenance.

Submarine disposal

29. There are a number of nuclear-powered submarines stored afloat at Devonport (DML) and Rosyth (Babcock) that have had their nuclear fuel removed but are still waiting for final disposal. The market segment labelled 'submarine disposal' concerns the safe disposal of the submarines' reactor compartments (which remain radioactive), along with the remainder of the submarine.
30. The MoD is currently developing a project to manage submarine disposal named Interim Storage of Laid-Up Submarines (project ISOLUS). Although initially four different alliances were formed by players in the industry to compete for the project, some members of the industry later proposed to

the MoD that the project was taken forward by an 'industrial consortium in close partnership with the MoD'.

31. Babcock maintains that, from 2005, the MoD sought to move away from a competitive process, and that the MoD's preference is for a collaborative solution for project ISOLUS. However, the MoD maintains that it has not committed to any particular procurement strategy for the project ISOLUS, and that consultation is needed before a decision is made. Nonetheless, the MoD says it is not concerned about the impact of the transaction on submarine disposal.
32. The MoD considers that it is unlikely that submarine disposal activity would take place anywhere else but in the existing dockyards at Rosyth or Devonport, where the de-fuelled submarines are currently stored afloat. This is due to the costs of providing capability to conduct nuclear work, coupled with the difficulties involved in gaining public acceptance for a new facility. In addition, because Rosyth has been de-licensed to undertake nuclear waste management, and in view of the political difficulties surrounding the reversion of the de-licensing decision, the MoD believes that Devonport is the likely facility for dismantling under project ISOLUS. An additional benefit of selecting Devonport is that it would enable a better management of the volatile workload that that facility is likely to face due to a reduction in the submarine refitting programme. Nonetheless, the MoD stresses that this is subject to consultation with the industry and stakeholders. In correspondence with the MoD, industry members indicate that they consider Devonport to be the only 'realistic' site for submarine disposal activities.
33. In sum, the merger consolidates what are regarded to be the two only credible options for submarine disposal. However, the MoD regards Devonport as the likely solution for project ISOLUS for reasons unrelated to competition, which is also the opinion of industry members.
34. In essence, the question of whether there would be scope for competition for submarine disposal absent the merger is dependent on the MoD's policy. The MoD submitted that it wishes to develop a procurement solution for submarine disposal within the context of the DIS, discussed above, and said it is unconcerned about the competitive impact (if any) of the transaction in this sector. On the basis of all the available evidence the

OFT concludes that there is no realistic prospect that the merger materially affects competition in this sector.

Surface ships in-service support

35. Babcock and DML, together with Fleet Support Limited (FSL), are active in the provision of surface ships in-service support. This segment involves fleet activities such as time engineering, facilities management, waterfront support, storage and transport. In-service support of surface ships is conducted at the ships' home base in one of the three HM Naval Bases - Devonport (managed by DML), Clyde (managed by Babcock) and Portsmouth (managed by FSL).
36. Babcock and the MoD agree that there is no competition for in-service support for surface ships because this service is covered by the WSMI contracts (as discussed above).
37. While in the short term the OFT believes that due to the current WSMI agreements there would have been at most limited if any competition between the merging parties absent the merger, there may have been scope for competition between the parties in the long term, when the WSMI agreements are up for renewal, as it is the case with submarines discussed above. However, the MoD has not indicated any intention to move away from its current policy of commissioning the provision of surface ships in-service support to the manager of each HM Naval Base. Clearly, competition would only have been introduced if the MoD decided to change its policy.

Surface ships refitting and maintenance

38. The assessment of merger effects in the supply of surface ships refitting and maintenance services may be split between two separate classes of vessels: (i) 'non-warship' surface ships and (ii) warships.

'Non-warship' surface ships

39. Refit and maintenance of non-warship surface ships represent a small proportion of the overall surface ships refitting and maintenance work carried out by the parties. A third party confirmed that there are a number of players active in this segment, including commercial ship companies,

and that the segment is competitive. In the absence of third party concerns or of any evidence before the OFT that the merger may cause competition concerns, the analysis will focus on refit and maintenance of surface warships.

Warships

40. Contracts for surface warships refits and maintenance were traditionally* tendered by the MoD via reverse auctions.⁵ Babcock said that, with only a very small number of refit packages being offered each year, most contracts were being taken at prices significantly below the cost of actually completing the tasks. The MoD [REDACTED] expressed concerns that competition would result in the demise or exit of one or more of the contractors.
41. In this context, and in view of the DIS, the MoD conducted the Surface Ship Support Study. This study concluded that the MoD should seek alternative ways of procuring in the warship refit and maintenance market in order to maintain suppliers' efficiency and avoid the loss of key capability and the collapse of the industry.
42. Following the outcome of the Surface Ship Support study, the Secretary of State for Defence announced in early 2006 the formation of the Surface Ship Strategic Alliance (SSSA) between the MoD and the three dockyard companies, Babcock, DML and FSL. A Competition Exclusion Order covering the SSSA was granted in April 2006.⁶ The SSSA is still subject to consultation and approval within the MoD and has not yet been implemented. However, a non-binding Memorandum of Understanding has been signed between the SSSA members and the MoD, surface warship refit work has been discussed by the potential SSSA members, and a work-share has been agreed.
43. Under the SSSA, the MoD will put together ships that are likely to require refits and offer the package to the SSSA partners. The partners agree the allocation of the vessels in that package on the basis of a defined formula

⁵ A reverse auction is a tool used in industrial business-to-business procurement. It is a type of auction in which the role of the buyer and seller are reversed, with the primary objective to drive purchase prices downward.

⁶ The Competition Act 1998 (Public Policy Exclusion) Order 2006, SI 2006/605.

and confirm this to the MoD. The MoD then contracts directly with each company.

44. Babcock submitted, and a third party confirmed, that there is no price benchmarking between SSSA members in order to allocate the ships.⁷ In fact, the MoD maintained that it scrutinises closely the prices and work estimates provided by the SSSA members and that, under the Alliance, all costs are open book and the MoD's audit group have full access to all cost data.
45. On the basis of the evidence available from suppliers and the MoD, the OFT considers that there is no scope for competition between the alliance members if the SSSA is in place. Indeed, the MoD expressly declared that it is contrary to its interests to sustain an auction model featuring rival bids, and has taken steps to undertake warship support on an allocated basis.

The appropriate counterfactual

46. Although in most cases the best guide to the appropriate counterfactual is the prevailing conditions of competition,⁸ it is necessary in this case to consider what the appropriate counterfactual is in view of the current stage of development of the SSSA.
47. Although the MoD made clear that the SSSA is currently in its exploratory phase and has not yet gained final approval, it also declared that it has moved away from using competition-enhancing tools to allocate or negotiate contracts for surface warships refitting and maintenance.
48. The MoD provided internal documents containing a summary of the range of options considered under the SSSA. One option is, obviously, full implementation of the SSSA. Two other options ('do minimum' and 'do minimum plus') are scenarios in which it is also assumed that there is no competition for refitting and maintenance. A fourth option would involve the reestablishment of competition in this segment.

⁷ Although a third party mentioned that prices are benchmarked against industry standards by the MoD, the MoD said that external benchmarking has not previously been undertaken due to the nature of the warship support market.

⁸ OFT *Mergers – Substantive assessment guidance*, para 3.23 and 3.24.

49. At this stage the OFT cannot determine the likelihood of each outcome. On the one hand the MoD maintained that it intends to submit a business appraisal by the end of the year and that it has not discredited other options to the SSSA (including the 'reinstatement of competition' option). On the other, consistently with the Surface Ship Support Study and the DIS, the MoD is adamant in saying that its level of demand can no longer sustain a competitive market.

Conclusion

50. The merger brings together two of the three suppliers of surface ships refit capability. However, there is currently limited or no competition in the market and this situation will be consolidated if the SSSA is approved in 2008 as forecast by the MoD. On the other hand, it is open for the MoD to decide whether to reintroduce competition in this field, and, in case it does, the loss of DML as an independent player would leave rivalry between two suppliers, rather than three. However, as considered above, the reintroduction of competition, although still in the MoD's range of options, would go against MoD policy decisions in this area taken in the past few years. On balance, it is the OFT's judgment that of the various scenarios, it is appropriate to attach little weight to the counterfactual scenario in which there is a reversal of policy towards 'winner-takes all' competition between three suppliers or more.

Surface ships design support

51. Surface ship design support encompasses the provision of design and technology services normally as part of the through life support of vessels such as, for example, the writing and provision of technical manuals.
52. The merging parties are both participants in the Design Support Alliance (DSA) with FSL, BAE Systems (Operations) Ltd and VT Integrated Services Ltd. The MoD submitted that the work-share is based on vessel class for each of the participating companies, and is not subject to competition. Babcock contended that it does not compete with DML in the supply of design support services in view of the DSA.
53. The MoD submitted that it does not have any competition concerns regarding the design sector, and that the DSA is providing better value for money than pre-alliance competition. The OFT therefore believes that there

was no competition in this sector pre-merger and none likely absent the merger.

Equipment support

54. Babcock submitted that the merging parties are active in the field of equipment support, a generic term that covers a wide gamut of services and equipment supplied as an adjunct to refitting and in-service support, both for submarines and surface vessels.
55. However, the merging parties' activities do not overlap, as they are active in different segments of the sector. Indeed, Babcock has no record of having competed with DML in relation to any equipment support contract with the MoD. In addition, Babcock submitted, and the MoD confirmed, that there are a large number of players active in this market. Babcock's and DML's combined share of supply of the overall equipment support market is [less than ten] per cent.
56. In view of the absence of third party concerns, the small combined share of supply of the merging parties, and the existence of a number of competitors in this market, the OFT considers that the merger does not raise competition concerns in relation to the supply of equipment support.

Barriers to entry and expansion

57. All industry participants that responded to the OFT confirmed that barriers to entry are high in all segments considered in the decision.

Buyer power

58. The ability of the merged entity to raise prices, decrease quality of service or retard innovation levels may be constrained by the countervailing power of buyers.⁹ However, buyer power is typically dependent on the availability of outside options should agreement fail to be reached. For the buyer, these are normally the threat to switch to an alternative existing supplier or sponsor new entry but could also encompass, for example, self-supply or threatened retaliation in other markets. However, high barriers to entry

⁹ OFT *Mergers – Substantive assessment guidance*, para 4.27.

make sponsored entry a costly and therefore unlikely option, as is self-supply.

59. Given that the merger creates a monopoly in the supply of services to submarines, the threat to switch to another existing supplier can be ruled out, in relation to submarines (although the threat was not credible even before or absent the merger, as discussed above). Although FSL is an alternative supplier for surface ships, there are difficulties associated with wholesale switching of the MoD's needs, which have been explored above.
60. Ordinarily, absent credible threat of sponsored entry or self-supply, buyer power lacks validity as a countervailing argument in a merger to monopoly case. However, the defence industry is extraordinary in that the purchaser is a monopsonist, and there is no realistic prospect of other potential buyers that could conceivably suffer adverse merger effect. The post-merger outcome is therefore a bilateral relationship between a monopsonist purchaser and a monopoly supplier. While Babcock maintained that the MoD is a powerful monopsonist, able to exercise strong control over its suppliers it did not supply historical evidence in support of this proposition.
61. Nevertheless, the MoD does not believe that the transaction will reduce its buyer power or its negotiating strength. The MoD submitted that it is a sophisticated buyer and that it is confident in the efficacy of its negotiation mechanisms to ensure that contracts in the areas affected by the merger represent good value for money. Indeed, it seems logical that having access to alternative sources of negotiation strength is a requisite for the adoption of alternative approaches to procurement that exclude competition. Among other aspects, the MoD declared that it has well-established processes for non-competitive pricing; that existing contracts include mechanisms to control price increases or quality reductions; and that it can use the DRDL special share if Babcock's influence or control threatens the UK's strategic interests. In relation to surface ships, the MoD also contends that work could be passed on to FSL and to other industry players that choose to enter that market.
62. In addition, the MoD has established Heads of Terms with Babcock that will lead to a legally-binding agreement in 2008 which the MoD believes will allow it to apply pressure to rationalise facilities and personnel across sites. The Heads of Terms also deals with costs savings that will be achieved by Babcock and shared with the MoD. According to MoD these

are in the region of at least £[REDACTED] per year from 2011/2012 onwards.

THIRD PARTY VIEWS

63. The MoD is the only customer of the merging parties and supports the merger. Its views on specific topics have been dealt with throughout the decision.
64. A number of competitors to the merging parties were concerned that the merger would lead to conglomerate issues and allow cross-subsidisation between submarines and surface ships. These issues have been dealt with within the wider assessment of whether the merger leads to the creation or strengthening of market power. Given its findings described under the headings horizontal issues and assessment, the OFT has insufficient basis to conclude that the merger gives rise to material non-horizontal issues.

ASSESSMENT

65. The parties overlap in a number of naval services, and in all of them the MoD is the only customer. The white paper on defence industrial strategy, DIS, favours consolidation of the naval industry and the substitution of tendering and other competition-based tools by other negotiation mechanisms for certain industry segments relevant to this merger.
66. The merger does not raise any competition concerns in relation to equipment support, submarine refitting and deep maintenance and surface ships design support. In equipment support, a number of competitors remain in the market, the combined share of supply of the merging parties is very small, and no third party expressed any concerns. In relation to submarine refitting and deep maintenance, DML was already the monopolist supplier, and therefore the merger does not lead to an increase in market power. Finally, there was no or limited current competition in surface ships design support since all work is shared under the DSA according to criteria unrelated to competition, and therefore the merger cannot lead to a lessening of competition.
67. The OFT believes that there was very limited, if any, pre-merger competition in relation to submarine in-service support and disposal and to

surface ships in-service support and refitting and maintenance. Submarine and surface ships in-service support are covered by WSMI agreements, and as a consequence work is allocated according to the vessel's home base rather than according to competition criteria. Submarine disposal works are currently on hold, pending definition of Project ISOLUS. Finally, the MoD has moved away from competition for surface ships refitting and maintenance since 2005**, when it started to explore the possibility of forming the SSSA.

68. The OFT therefore believes that, due to the virtual absence of pre-merger competition in those segments, the merger does not eliminate material competition.
69. Nor does the merger reduce the scope for potential and future competition in those markets. Competition in submarine and surface ships in-service support would only have been reintroduced if the MoD decided to change its policy of commissioning the services to the manager of each HM Naval Base according to the vessel's home base irrespective of competition considerations. However, the MoD has not indicated any intention of doing so, and it has expressly declared that it does not intend to tender nuclear submarine projects.
70. In relation to submarine disposal, the MoD is considering a wide range of issues to decide where project ISOLUS will be carried out. If the MoD does not change its views (and the OFT has not received any evidence of indications that this is likely) that the decision on the site for project ISOLUS will take into account factors not affected by competition, it is irrelevant whether the Devonport and Rosyth facilities are managed by the same undertaking as they will not be in competition for the project.
71. The reintroduction of competition into surface ships refitting and maintenance is related to, but not dependant on, the future of the SSSA. If this alliance is implemented as expected, there will continue to be limited or no scope for competition in this market. However, even if the SSSA is aborted, the MoD may still choose to maintain the status quo, namely the situation in which firms do not compete for the provision of services. Nonetheless, the OFT recognises that the MoD may theoretically choose to re-implement competition in this market, even if it goes against the direction of its recent policy for this segment, although it attaches little weight to this scenario occurring in the foreseeable future.

72. In sum, the prospects for actual and potential competition absent the merger pre-merger are limited in both the supply of submarine in-service support and disposal, surface ships in-service support and refitting and maintenance. There would only have been scope for future competition between the parties if the MoD reintroduces competition in these sectors.
73. Moreover, the MoD maintained that there are a number of negotiating tools available that enables it to obtain the best value for money in negotiations with suppliers in these specific sectors even in the absence of competition, and that the merger will not cause any detriment to its negotiation power. While as a general matter the OFT is sceptical that mergers to monopoly do not reduce the negotiation power of even a monopsonist, the OFT has no evidence in this case that would contradict the MoD's own judgment of its position.
74. Overall, the impact of this merger on the relevant markets appears to be limited. While the merger clearly reduces any existing and potential future rivalry between the parties, the scope of such rivalry appears limited under the MoD's current procurement policy agenda and, in any event, the prospects for injecting or reducing supplier competition into the procurement process is largely driven by the MoD's judgment about its own best interests on behalf of the UK taxpayer, which limits the potential for merger effects compared with non-military markets. Indeed, the MoD actively supports this transaction as favourable to its interests, taking the view that it will be better off, rather than harmed, and that it can protect its position on account of its value-for-money procurement strategies.
75. While rivalry will be weakened by the merger to the extent it would exist without the merger, the OFT's Guidance notes that a substantial lessening of competition arises only where the OFT expects that a merger's weakening rivalry *'to such an extent that customers would be harmed'*.¹⁰ It is therefore doubtful, in the OFT's judgment, that there is a realistic prospect of a substantial lessening of competition in the relevant markets, and that a duty to refer arises.
76. Finally, even if the OFT were to conclude it was under a duty to refer, the OFT has a discretion not to make a reference on the basis of customer

¹⁰ OFT *Mergers – Substantive assessment guidance*, para 3.7

benefits. The MoD, the sole customer, has expressly taken the position that it supports the transaction because it will benefit from it, and not only in strategic or 'contextual' terms, but also strictly in terms of value for money. These value-for-money benefits have also been quantified as arising through the merger: through the Heads of Terms signed between Babcock and the MoD it is agreed that, because the merger allows Babcock to operate in a more cost-effective manner, Babcock intends to provide the MoD with cost savings of at least [REDACTED] per year from the financial year 2011/2012 onwards. It might be the case that any detriment loss of competition would be outweighed by the benefits that would be passed on to the MoD. Although in the overwhelming majority of cases the customer benefits exception is subject to strict evidentiary standards due to information asymmetries and the speculative nature of such claims, in this case such claims are endorsed by the only customer: in other words, the MoD's express belief is that it will be better off in procurement cost terms with the merger than without. These exceptional circumstances make it appropriate to invoke the customer benefits exception in the event that the OFT were otherwise under a duty to refer.

77. Consequently, the OFT does not believe that there is a realistic prospect of a substantial lessening of competition giving rise to a duty to refer; in any event, if such prospect were realistic, the OFT would be minded on the unusual circumstances of this case to exercise its discretion in favour of the customer benefits exception to the duty to refer.

DECISION

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

Notes:

- * The MoD clarified that tenders were only used latterly and until 2006.
- ** The MoD clarified that the correct year is 2006, after the Competition Exclusion Order was granted.