

TO: SECRETARY OF STATE FOR BUSINESS, INNOVATION AND SKILLS
FROM: ALASTAIR MORDAUNT, DIRECTOR MERGERS, OFFICE OF FAIR TRADING

25 June 2009

ANTICIPATED ACQUISITION BY ATLAS ELEKTRONIK UK LTD OF THE UNDERWATER SYSTEMS WINFRITH DIVISION OF QINETIQ PLC.

A REPORT TO THE SECRETARY OF STATE FOR BUSINESS, INNOVATION AND SKILLS PURSUANT TO SECTION 61(2) OF THE ENTERPRISE ACT 2002

1. This report is made following the special intervention notice given to the Office of Fair Trading (OFT) on 15 May 2009 (the Notice) pursuant to section 59(2) of the Enterprise Act 2002 (the Act).

THE PARTIES

2. **Atlas Elektronik UK (AEUK)** is based in Newport, Wales, and is a subsidiary of Atlas Elektronik GmbH (Atlas Elektronik), a company incorporated in the Federal Republic of Germany. AEUK provides a range of products and services for defence applications.
3. **Underwater Systems Winfrith (UWS Winfrith)**, is a division of QinetiQ plc based in Winfrith, Dorset. It is a key supplier of research, advice, enabling technology, systems and support for a number of current and future maritime platforms for the UK's armed forces.

THE TRANSACTION

4. The proposed transaction would result in Atlas Elektronik, through AEUK, acquiring sole control of UWS Winfrith.

JURISDICTION

5. The above arrangements will result in the creation of a special merger situation for the purposes of section 59(3) of the Act in that:
 - a. no relevant merger situation has been created because of section 23(1)(b) and (2)(b) of the Act; but
 - b. a relevant merger situation would have been created if those enactments were disregarded;
 - c. enterprises carried on by or under the control of the UWS Winfrith division of QinetiQ plc will cease to be distinct from enterprises carried on by or under control of AEUK.
 - d. at least one of the enterprises concerned is carried on in the United Kingdom by or under the control of a body corporate incorporated in the United Kingdom; and
 - e. a person carrying on one or more of the enterprises concerned is a relevant government contractor within the meaning of section 59(8) of the Act (which has been confirmed to the OFT by the Ministry of Defence (MoD)).
6. In the Notice you stated that you believed that it is or may be the case that the national security public interest consideration specified in section 58(1) and (2) of the Act is, or may be, relevant to a consideration of the special merger situation concerned.
7. You may therefore make a reference to the Competition Commission (the CC) under section 62(3) of the Act or accept undertakings in lieu of such a reference under paragraph 3(2) of schedule 7 of the Act to address national security concerns arising from the merger provided that you believe that it is or may be the case that the conditions set out in section 62(3)(a) – (c) of the Act are satisfied.

SUMMARY OF THIRD PARTY REPRESENTATIONS

8. Following receipt of the Notice, the OFT has consulted and invited comments on the national security public interest consideration identified in the Notice. In response to the consultation, representations on national security issues were received from the MoD and a third party. These representations are summarised below.
9. The MoD's concerns arise from the fact that UWS Winfrith possesses unique capabilities that could not be replicated in other onshore capabilities operating in similar and analogous sectors without significant MoD investment. The concern is that following the acquisition, Atlas Elektronik might choose to

rationalise its defence activities with the potential consequence that these essential UK capabilities could either be run down, sold off or transferred abroad to be combined with Atlas Elektronik's other foreign based business activities. In addition, the move to ultimate control by a German parent company raises concerns for the MoD due to the potential for day-to-day management of programmes in support of the MoD being moved to Germany, and for application of German export control regulations to UWS Winfrith's output for the MoD. MoD consider that this would have profound implications for the UK's security of supply, as well as the timely delivery, of advice or systems, if UK information and technology were to be combined with foreign information and technology without UK knowledge or approval and/or MoD supply became subject to German export control.

10. In summary, for the reasons given, the MoD contends that the anticipated acquisition by AEUK of UWS Winfrith raises a number of national security concerns for the MoD. MoD has provided the following detailed assessment of how the proposed acquisition may impact on national security.

Impact on UK national security

11. The proposed concentration, although constituted via a UK registered company, AEUK, will effectively lead to ultimate control and ownership of UWS Winfrith passing to the non-UK company, Atlas Elektronik. MoD state that this means that the non-UK company will be able to influence UWS Winfrith in ways that could prejudice national security unless the MoD obtains statutory assurances over certain aspects of its behaviour. A failure to obtain statutory assurances and influence over ownership could put at risk the maintenance of strategic UK military capabilities, the protection of classified technology and information, and the independence and impartiality of research outputs and advice. It is in these three areas that MoD is seeking statutory assurances to protect the UK's national security.

Maintenance of strategic UK capabilities

12. UWS Winfrith is a key supplier of research, advice, enabling technology, systems and support for a number of important current and future maritime platforms for the UK's Armed Forces. These include: the Royal Navy's ballistic missile submarines which carry the national deterrent system; the Future Deterrent submarine (subject to final Government approval); the RN's current attack submarine fleet; its ASTUTE-Class of submarines being introduced into service; a number of current and planned surface warships including the Type 45 anti-air destroyer and the future surface combatant; and the RAF's and

RN's air-delivered sub-surface detection systems. The MoD state that it is essential for the protection of the UK's national security that the UK retain the capability, within the UK, to develop, operate and maintain platforms incorporating the underwater warfare technologies that UWS Winfrith provides, independently of other nations. Without retaining such capabilities within the UK, the UK will be unable to maintain the operational advantage that its Armed Forces gain from having unique, technologically-advanced equipment that is capable of performing alongside its allies but surpassing potential adversaries. UWS Winfrith is also involved in a number of highly sensitive programmes directly and indirectly supporting the defence administrations of close allies.

13. The MoD comment, that following the acquisition, Atlas Elektronik might choose to rationalise its defence activities with the potential consequence that these essential UK capabilities could be either run down, sold off or transferred abroad to be combined with Atlas Elektronik's other foreign-based business activities.
14. MoD therefore believes that it would be essential to obtain assurances from Atlas Elektronik that the capabilities that UWS Winfrith possesses in these areas would be maintained within the UK and neither run-down nor transferred abroad, following the acquisition, without prior consultation with the MoD.

Protection of technology and information

15. The capabilities described above are dependent, to differing extents, on classified technology and information. Aspects of the information are available only to UK nationals. The 'leakage' of such information or technology to the non-UK owners could directly prejudice the operational security and capability of the UK armed forces or those of any specified other nation that has agreed to share its sensitive defence information with the UK.
16. If UWS Winfrith, under the ownership and control of Atlas Elektronik, continues its involvement in such work, it would be necessary to ensure that such information was retained and protected within the UK. MoD considers legally binding undertakings from Atlas Elektronik (combined with an appropriate compliance regime) would be necessary to assure the UK government that sensitive information and technology is being adequately protected.

Independence and impartiality of research outputs and advice

17. A significant element of UWS Winfrith's output is research provided to the MoD, for eventual use in military systems supplied by defence manufacturers and systems integrators that are part of the UK's defence industrial base but have no connection with QinetiQ. UWS Winfrith also supplies advice directly to MoD acquisition teams at all stages of the acquisition cycle, from initial concept studies through to technology assessment, product development, equipment manufacture, in-service support and disposal. QinetiQ is not a major manufacturer or supplier of weapons systems and MoD was, therefore, able to have confidence in the independence and impartiality of its advice. This confidence was supported where necessary by a rigid Compliance Regime, ultimately controlled by the MoD and backed up by the Government's Special Share in QinetiQ, dealing with potential conflicts of interest.
18. UWS Winfrith's acquisition by a major manufacturer of underwater warfare systems may call into question the future independence and impartiality of the research output and customer support advice provided for MoD by UWS Winfrith. The benefits of MoD's investment in these areas could be called into question if there was a possibility that research outputs or advice were slanted towards Atlas Elektronik products or intended products; the level playing field in the limited UK supply side market for these products would also be affected.
19. MoD will seek to protect, to the greatest possible extent, the independence and impartiality of research outputs and advice from an Atlas Elektronik-owned UWS Winfrith by requiring the implementation of an appropriate system to compartmentalise activities and prevent conflicts of interest.
20. The third party commented that UWS Winfrith has performed underwater naval research for the UK MoD for many years. In this capacity UWS Winfrith had acted as an advisor and research agency to the MoD as well as a research collaborator with UK industry and so holds considerable information that is important to national security interests and the sustainment of UK sovereign sonar capability.
21. In the third party's opinion, the proposed transaction therefore raises national security and broader public interest issues and it has recommended that the following are addressed prior to any disposal of the UWS Winfrith business being concluded:
 - an assessment to be made of the original security undertakings given by QinetiQ at the time of its privatisation to determine their effectiveness

and to agree what enhancements are necessary in light of the proposed transaction;

- an audit to be performed of all core research data held at the Winfrith facility to identify what information is pertinent to national security and should therefore be excluded from the sale, transferred back to the MoD or protected in some other manner;
- a consultation with the members of the Osprey Consortium to agree how the current arrangements will need to change to reflect the fact that Atlas Elektronik is a direct competitor to some of its members; and
- suitable arrangements to be put in place to ensure that no conflicts of interest will arise for UWS Winfrith in its capacity today as an advisor to the MoD if it subsequently becomes part of a manufacturing organisation.

22. MoD has noted above that UWS Winfrith has strategically important capabilities within the UK, in terms of current front-line capability, nationally sensitive research, emerging capabilities and emerging enabling technologies. Some of these capabilities are dependent on highly classified technology and information, much of it only available to UK nationals. In the context of the third party concerns above, MoD has commented:

- QinetiQ will, post merger, continue to be obliged to meet the security requirements place on it by HM Government. UWS Winfrith, post merger, will separately be obliged to comply with the Government's Security Policy Framework in undertaking classified business for the MoD and other HM Government customers. Additional security requirements may be imposed by foreign governments that place classified business with UWS Winfrith in respect of information they entrust to the company. Compliance with these security requirements will be audited by the MoD prior to completion of the transaction, and periodically thereafter, and will be a pre-condition of such business continuing.
- QinetiQ is undertaking a detailed and comprehensive exercise to audit, prior to completion of the transaction, all information and data held at UWS Winfrith and to verify, including with the owners where such material is owned by 3rd parties, whether it should be included in the sale, retained, returned or reallocated, or otherwise disposed of.

- MoD has discussed with the members of the Osprey consortium, an industrial grouping for sonar design, how the work MoD currently has under contract should be continued following the sale of UWS Winfrith, and the options for replacing the consortium approach once the present contract expires in 2010.
- The acquiring parties have undertaken to agree a compliance regime with the MoD, prior to completion of the transaction, to mitigate conflicts of interest and this will be enshrined in any undertakings.

Undertakings in lieu

23. Given that Atlas Elektronik is a non-UK company, the MoD believes it would be necessary to establish special security arrangements to ensure that the UK's national security interests are being adequately protected post merger. The aim of these arrangements would be to satisfy the MoD that sensitive information could not be passed to foreign nationals without the MoD's express approval and that the MoD would be informed before UK military capability was adversely affected, enabling it to take appropriate action.
24. The MoD consider that the most effective means of achieving these arrangements would be to seek appropriate undertakings from AEUK and Atlas Elektronik as part of the regulatory consideration of the merger.

CONCLUSIONS ON NATIONAL SECURITY CONSIDERATIONS

25. The OFT is not expert in national security matters and therefore merely summarises here representations made by the MoD and a third party.
26. The MoD and a third party have identified national security concerns arising from the transaction which relate to the maintenance of strategic UK capability, the protection of technology and information and the independence and impartiality of research outputs and advice. If you believe that it is or may be the case that the creation of the special merger situation may be expected to operate against the public interest, you may either make a reference to the CC under section 62(3) of the Act or accept undertakings in lieu of such a reference under paragraph 3(2) of schedule 7 of the Act.
27. The draft undertakings in the attached appendix are intended to remedy, mitigate or prevent the particular effects adverse to the public interest identified by the MoD which may be expected to result from the creation of the

special merger situation concerned. Specifically, the undertakings seek to address the three areas of concern identified above.

28. AEUK and Atlas Elektronik have confirmed to the MoD that they are willing to sign the undertakings in the form attached in the appendix.

CONCLUSIONS

29. The OFT advises you that it is or may be the case that arrangements are in progress or in contemplation which if carried into effect will result in the creation of a special merger situation for the purposes of section 59(3) of the Act.
30. It appears that this transaction raises national security concerns identified by a third party and the MoD in submissions to the OFT. If you believe that it is or may be the case that as a result of this transaction a special merger situation will be created, that the national security consideration specified in the Notice is relevant to the merger, and taking account only of the national security concerns raised, and the creation of the special merger situation may be expected to operate against the public interest, you may make a reference to the CC on such public interest grounds, or accept undertakings in lieu of such a reference. The MoD has prepared undertakings, to be accepted in lieu of reference to the CC, which it believes are the most effective means of remedying the national security concerns it and the third party have identified.
31. AEUK, Atlas Elektronik UK (Holdings) Limited, and Atlas Elektronik have confirmed to the OFT (and MoD) that they are prepared to give the attached draft undertakings. However, this does not fetter your discretion in determining whether to accept the proposed undertakings in their current form, or in a modified version, if found appropriate following public consultation.



Director
Mergers
25 June 2009