

Completed acquisition by Babcock International Group plc of the Strachan & Henshaw Division of Weir Group plc

ME/3650/08

The OFT's decision on reference under section 22(1) given on 2 July 2008. Full text of decision published 3 September 2008.

Please note that square brackets indicate figures or text which have been deleted or replaced at the request of a third party for reasons of commercial confidentiality.

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, and defence assets such as military aircraft, warships and nuclear submarines.
2. The operations of the Strachan & Henshaw Division of Weir Group plc (S&H) are focused on the defence and nuclear sectors. In the defence sector, S&H's activities relate to weapons handling and launch systems for submarines. In the nuclear sector, S&H provides support services for nuclear power generation and the nuclear decommissioning sector. The UK turnover for S&H in the year ended 31 December 2006 was £43.2 million.

TRANSACTION

3. The transaction involves the acquisition by Babcock of the entire issued share capital of Strachan & Henshaw Limited (which has small subsidiaries in Canada and the US), and Strachan & Henshaw Australia Pty Ltd, which together comprise S&H from the Weir Group PLC.

4. Following a competitive bidding process, the parties signed a sale and purchase agreement and completed the transaction on 21 April 2008 therefore the statutory deadline for a decision is 20 August 2008. The transaction was notified to the OFT on 12 May 2008 and the administrative deadline for a decision is 8 July 2008.

JURISDICTION

5. As a result of this transaction Babcock and S&H have ceased to be distinct. The parties overlap in the supply of fuel route support services for the UK nuclear industry, together providing fuel route support services to all of the UK's seven Advanced Gas-cooled Reactors (AGRs). Therefore the share of supply test in section 23 of the Enterprise Act 2002 (the Act) is met. The OFT therefore believes that it is or may be the case that a relevant merger situation has been created.¹

MARKET DEFINITION

6. The parties are both active in defence and civil nuclear industries.

Civil nuclear sector

7. Between them, Babcock's subsidiaries Alstec and INS provide the following services for the nuclear sector:
 - dry storage of spent nuclear fuel
 - remote handling equipment (including nuclear fuel handling machines)
 - nuclear plant and equipment enhancement and refurbishment,
 - operations and maintenance support services for plant owners,
 - outage support services
 - decommissioning of redundant nuclear plant and waste management
 - support for fuel fabrication and spent fuel reprocessing,
 - nuclear decommissioning and waste handling, and
 - plant care and maintenance.

¹ [t]he share of supply test is not a market share test, thus the group of goods or services to which the jurisdictional test is applied need not amount to a relevant economic market. Page 13 OFT *Mergers – Substantive Assessment Guidance*. In determining jurisdiction, no demand and supply substitutability analysis is undertaken.

While S&H provide the following services:

- fuel route support services for the equipment it originally designed, and
- design and supply of the equipment for nuclear waste handling.

Resulting in an overlap in:

- nuclear decommissioning, and
- fuel route support services².

Defence sector

8. Babcock's subsidiary Alstec provides the following services for the defence sector:

- design, supply and maintenance of key nuclear reactor components for the Vanguard and Astute class submarines,
- design of the hydroplane and rudder actuators for Astute class submarines, and
- supply of automated materials handling systems.

Alstec has also been selected to supply automated cargo stowage and weapons handling systems for the CVF Royal Navy aircraft carriers.

S&H provides the following services:

- weapons handling and launch systems on all recent major UK submarine programmes
- in-service support to the Ministry of Defence (MoD) for the systems for the Trafalgar and Vanguard sub-marines which it supplied and which are still in active service

² Fuel route support services involve inspection, maintenance and repair of the equipment required to: (i) receive boxes of new fuel elements from the manufacturer, (ii) assemble new individual fuel elements into a fuel assembly that can be loaded into the reactor, (iii) transfer the assembled fuel assembly into the reactor, (iv) remove an irradiated fuel stringer from the reactor and transfer the fuel assembly to an irradiated fuel disposal facility, (v) dismantle the fuel assembly into its constituent parts in the irradiated fuel disposal facility, (vi) transfer the spent fuel elements into the cooling and storage ponds, and (vii) transfer the spent fuel elements into a flask for shipment to Sellafield.

- design and build of integrated waste management systems and counter-measure systems, and
 - services to the UK's Atomic Weapons Establishment which provides and maintains the warheads for Trident.
9. Babcock has submitted that the merging parties are not direct competitors and do not overlap in any segment of the defence market. However, they supply similar services and might be perceived to be potential competitors, particularly for weapons handling and discharge systems (WHDS). Babcock has been selected as supplier and systems integrator for the automated cargo stowage and weapons handling system for the new CVF Royal Navy aircraft carriers, while S&H has supplied WHDS for the UK's submarine programmes for the last 30 years. Babcock has submitted that the requirements of submarine WHDS are such that they cannot be considered to be part of the same market as the systems required for the new CVF, and that no existing surface warships have automated weapons handling systems.
10. The MoD agrees with the merging parties that the weapons handling systems on surface warships and submarines are different, and those developed by Babcock for the CVF would not be substitutable for those supplied by S&H for the Royal Navy's submarines. MoD has said that it could not have envisaged Babcock entering the market for WHDS for submarines (absent the merger) as it did not have a suitable design and the costs of producing it and having it qualified would have been prohibitive. Therefore the MoD would not have expected any competition from Babcock for submarine WHDS.
11. The MoD suggested that there was a potential overlap in munitions handling systems for the Royal Navy's surface warships as S&H offers this capability, principally for design, and Babcock has been selected as the supplier and systems integrator for the automated cargo stowage and weapons handling system for the CVF aircraft carrier. However, the MoD is not unduly concerned as such systems vary significantly from class to class of warship and, in any event, the MoD has said that it will not have any new requirement in this field for a number of years.
12. Overall, the MoD believes that this acquisition will not have a significant impact on competition in the weapons handling sector for neither submarines nor warships. In light of above, in particular the fact that the

parties are not potential competitors for submarine WHDS, and in relation to surface warship WHDS there is no current or foreseeable overlap between the parties, this sector is not considered further.

Nuclear Decommissioning

Product Scope

13. Decommissioning of a nuclear reactor involves three stages:
 - Stage 1: removal of fuel and coolant from reactors, post operational clean out, management of mobile radioactivity, and removal of non-fixed plant.
 - Stage 2: dismantling plant outside biological shielding.
 - Stage 3: removal of the remainder of the plant, returning the site to conditions where no significant radioactive hazard remains.

14. The Parties identified a number of competitors for the decommissioning market, including: AMEC, Bechtel, CH2M Hill, Doosan Babcock, Fluor, Nuvia, and Washington Group. The department for Business, Enterprise and Regulatory Reform (BERR) also confirmed that there was strong competition in the decommissioning market from companies such as AMEC, Bechtel, C2HMHill, Fluor and URS Washington.

15. The government is currently responsible for the decommissioning of nuclear power plants. BERR sponsors the Nuclear Decommissioning Authority (NDA) which administers the allocated budget. The total budget for the NDA in 2007/2008 was £2,472.3 million, of which £1,105 million was allocated to decommissioning and clean-up. The merged entity's combined revenue in decommissioning is £60 million. This gives the merged entity a 5.4 per cent share of the decommissioning market.

16. Given the size of the parties' combined market share and the large number of competitors it is not considered that the merger gives rise to a substantial lessening of competition in the market for nuclear decommissioning, and therefore this market is not considered further.

Fuel Route Support Services

Background

17. The UK has 10 nuclear power plants operating a total of 19 reactors. Seven plants have Advanced Gas-cooled Reactors (AGRs), two, Oldbury and Wylfa, have an older type of gas cooled reactor operated by Magnox Electric, and one, Sizewell B, which has a modern pressurised water reactor (PWR). Oldbury and Wylfa are due to be decommissioned in the near future. While all the AGR power stations are due for decommissioning before 2025, the active life of the remaining power plants can be extended beyond the date of the planned decommissioning. All nuclear power plants apart from the two Magnox plants are owned by British Energy (BE).
18. Future new nuclear power plants are likely to contain water-cooled reactors of either the PWR type or the Boiling Water Reactor type (BWR). Neither party is a designer or supplier of these types of reactors. So far, three companies have applied for Generic Design Assessment (GDA) in the UK: GE-Hitachi, Westinghouse and Areva³. GDA is a pre-licensing process that any company aspiring to bid to build a nuclear power plant in the UK needs to fulfil.
19. A third party has submitted that six to eight new plants may be built in the UK between 2017 and 2022. According to this third party, a number of companies have expressed an interest in building or becoming a party to possible consortia owning new nuclear power plants in the UK, including BE, E.On, EDF, RWE, Iberdrola, Endesa, Vattenfall, and NOK.

Product Scope

20. As explained above, a fuel route for a nuclear power station includes all the plant and equipment used to:
 - Receive new fuel into the reactor building
 - Place the fuel into the reactor
 - Remove spent fuel and place it into cooling ponds, and

³ Atomic Energy of Canada Ltd also applied for GDA but later withdrew to concentrate on Canadian projects (see www.world-nuclear.org/info/inf84.htm).

- Place spent fuel into flasks for storage.

Fuel route support for AGRs is generally performed on a continuous basis when the reactor is at low power levels. Fuel route support services entail the provision of maintenance and upgrade services for the fuel route and the supply of spare parts for the fuel route equipment.

21. Demand Side Substitutes - The parties supply fuel route support services for the AGR reactors for which they were the original equipment manufacturer (OEM). AGRs are unique to the UK and each AGR is unique in terms of its specifications and design. This means that fuel route support services need to be tailor-made and require an understanding of the original design and access to the design's intellectual property rights.
22. Supply Side Substitutes – To date, the parties have only bid for fuel route services for the AGRs for which they were the OEM, and there have been no other bidders for these services in the past. Babcock argued that a non-OEM bidder would effectively need to reverse-engineer the fuel route equipment to enable it to supply the service. British Energy stated that it is extremely difficult to substitute the OEM supplier of fuel route services with an alternative supplier. This difficulty is attributed to the safety case⁴ implications, knowledge and experience of the OEM and the commercial costs of substitution. However, we note that in the case of the Dungeness B power plant, Babcock supplies the fuel route support services and S&H supplies spare parts for those services.
23. British Energy, the sole customer of the merging parties for these services, confirms the parties' view stating that it is unlikely to be economically viable for the parties to tender for fuel route support services for the equipment they did not originally design. BERR confirmed that new entry into the provision of fuel route support services for existing AGRs was unlikely.

⁴ When materials or equipment other than that approved for the original design is proposed for use the operator of the plant has to produce a safety case document for the Health and Safety Executive as part of the nuclear site license requirement. A safety case justification is required to ensure that there is no impairment to the safe operation of the plant as a result of any change to the design, materials, equipment, maintenance regime, operation or test procedures.

24. On the basis of the available evidence, it is likely that fuel route support services for individual AGRs should be considered as separate relevant product markets.

Geographic Scope

25. The parties argued that the market for fuel route services was at least Europe-wide. They refer to the European Commission's Decision in the Toshiba/Westinghouse merger⁵ where the Commission agreed that the market was likely to be global. The Commission reasoned that customers and sometimes also prime contractors organised world-wide tenders for larger components that needed to be replaced.⁶
26. The Commission's decision however, focussed on nuclear power plants, specifically PWRs and BWRs, concluding that the market for design, supply and maintenance of PWRs and BWRs was world-wide. By contrast, the focus in this case is on the provision of support services for nuclear power plants, namely fuel route services, moreover, the parties overlap in the provision of these services to AGRs, a type of power plant that is unique to the UK. Given these different focuses, the OFT does not consider that there should be direct read across between the two cases. In any event, there is no need to conclude on the geographic scope of the market as it does not materially impact the outcome of the case.

HORIZONTAL ISSUES

27. The parties have a 100 per cent share of fuel route support services for all AGRs in the UK. However, Babcock has argued that the merger will not lead to a substantial lessening of competition in the provision of fuel route support services for AGRs or any other services. Their argument was three-fold:
- Firstly, the parties provided fuel route services for those fuel routes for which they are the OEM. As a result there was no competition pre-merger that could be lessened as a result of the merger. This is in line with the OFT's proposed product market definition in this case. Babcock explained that the price of fuel

⁵ Case No. COMP/M.4153 – Toshiba / Westinghouse, decision of 19 September 2006

⁶ Op. Cit. para 44.

route support services was set competitively as part of the initial bidding process to build the original equipment.

- Secondly, Babcock suggested that fuel route support services were tendered as part of a wider bundle of services and that the sole purchaser, British Energy, was able to exercise countervailing buyer power.
- Thirdly, Babcock pointed out that the existing AGRs were soon to be decommissioned and that they would be replaced by PWRs and BWRs for which the merging parties were not OEMs. In the future, the merging parties would be consigned to the role of a subcontractor to Areva, GE-Hitachi and Westinghouse.

28. The sole customer of the merging parties in this market segment, British Energy, has not raised any concerns about the merger. On the contrary, it expects that the merger will lead to efficiencies and lower prices. British Energy confirmed that prices for fuel route support services had been set competitively when the contract for the original equipment was tendered.

29. Although one potential competitor suggested that the merger between Babcock and S&H might reinforce the two players and transform them into a stronger competitor, it was not concerned about the merger.

Barriers to Entry

30. The parties and all third parties agreed that barriers to entry into fuel route support services for AGRs were very high.

Buyer Power

31. Babcock submitted that prices for fuel route support services were set at a competitive level when the contract for the initial equipment was tendered. This was confirmed by British Energy. These services are re-tendered every five years, with British Energy using Open Book contracts⁷ for fuel route support services, with uplifts to the value aligned to British Electrotechnical

⁷ Open Book contracts are where the price is agreed to cover the contractor's costs plus some element of profit. So that only genuine and sensible costs are included, the open book agreement allows for these costs to be examined in order to satisfy the person letting the contract that they should be included within the total contract cost.

and Allied Manufacturers Associations (BEAMA) and National Agreement for the Engineering Construction Industry (NAECI) indices. Following the merger, it is British Energy's expectation that costs for fuel route services would go down as the parties optimised the two suppliers, ALSTEC and S&H.

ASSESSMENT

32. The parties are active in the defence and civil nuclear industries, and primarily overlap in the supply of fuel route support services to the UK's AGR power plants.
33. While the parties have a 100 per cent share of fuel route support services for AGRs in the UK, Babcock argued that the merger would not lead to a substantial lessening of competition as each party only provides support services for those fuel routes for which they were the OEM. The parties have submitted that as each AGR is unique in terms of its specifications and design this means that fuel route support services need to be tailor-made and require an understanding of the original design and access to the design's intellectual property rights. Anyone other than the OEM would be required to reverse-engineer the support services to enable them to be carried out correctly, and given that AGR technology is being phased out, albeit over a number of years, and replaced by either PWR or BWR powered plants such steps were not commercially viable. [].⁸
34. Given this, the OFT believes that the provision of fuel route services to individual AGRs should be considered as separate relevant product markets. Further, the OFT does not consider it plausible, absent the merger, that Babcock and S&H would have entered each other's market by bidding for fuel route support services on AGRs for which they were not the OEMs, and, for the same reasons, entry by other companies such as Areva, GE-Hitachi and Westinghouse is equally unlikely.
35. Any new generation of nuclear reactors are most likely to be based on a water reactor, PWR or BWR, rather than the AGRs that the parties provide support services for. Water reactors are the norm outside of the UK, and

⁸ British Energy, the sole customer, commented that due to the OEM intellectual property rights and the knowledge and experience of the merging parties switching to a third party is not technically or commercially viable.

the parties will face competition for future contracts from a number of worldwide competitors.

36. In the light of the above evidence, the OFT does not believe that the merger will lead to a substantial lessening of competition in the provision of fuel route support services for AGRs.
37. Consequently, the OFT does not believe that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

DECISION

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