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Anticipated acquisition by BAE Systems plc of Detica Group plc

ME/3786/08

The OFT's decision on reference under section 33(1) given on 15 September 2008. Full text of decision published 25 September 2008.

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**PARTIES**

1. **BAE Systems plc** (BAE) designs, manufactures and supports military aircraft, surface ships, submarines, combat vehicles, radar, avionics, communications, electronics and guided weapon systems.
2. **Detica Group plc** (Detica) is a business and technology consultancy that specialises in helping clients collect, manage and exploit information. Its Government Division serves the intelligence, security and resilience communities in the UK and USA, and its Commercial Division works with a range of commercial customers in the financial services, telecoms, media and utilities sectors. Detica's UK turnover for the year ending 31 March 2008 was £161.5 million.

**TRANSACTION**

3. BAE has agreed to purchase the whole of the issued and to be issued share capital of Detica. The anticipated acquisition is subject to the City Code. It was cleared by the German Competition Authority, the Bundeskartellamt, on 26 August 2008.
4. The transaction was notified by way of a merger notice on 1 August 2008. The (extended) statutory deadline expires on 15 September 2008.

## JURISDICTION

5. As a result of this transaction BAE and Detica will cease to be distinct. The UK turnover of Detica exceeds £70 million, so the turnover test in section 23(1) (b) of the Enterprise Act 2002 (the Act) is satisfied. The OFT therefore believes 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 relevant merger situation.

## MARKET DEFINITION

6. The parties overlap in the supply of National Security and Resilience<sup>1</sup> (NSR) products and services to various departments of the UK Government. The parties also supply services to the Ministry of Defence (MoD): BAE are the MoD's largest single supplier of equipment, while Detica supply UK Defence Intelligence ('defence NSR') goods and services, as well as consultancy advice on non-NSR projects, to the MoD. There are no overlaps between the parties in relation to the activities of Detica's Commercial Division and therefore these have not been considered further in this decision.

### Product Scope

7. The parties submit that the relevant product market is the supply of NSR goods and services. They have identified four distinct segments within the overall NSR market:
  - **ICT Infrastructure** - The provision of IT hardware and associated infrastructure for communication, for example, emergency services' airwave communications network and the Government Secure Internet.
  - **Information Management** - Products and services related to the collection, management, processing, exploitation and distribution of data.

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<sup>1</sup> The NSR sector encompasses products and services supplied by the private sector to the Government (through various departments and agencies) to enable it to respond to national security threats and natural disasters that may impact on national safety, continuity and economic stability.

- **Product Integration** - The development and integration of specialist products that capture and process data, for example, sensor array processors, protocol-related products and services, and precise time and frequency equipment. Specific product technologies, for example, CCTV cameras, are used with other data processing and analysis systems to provide actionable data and alerts to security operators.
  - **Stand-alone Products** - This includes equipment such as scanning equipment used at border facilities, as well as vehicles for the emergency services.
8. Third party views broadly confirmed the parties' depiction of the product market. A third party competitor also felt that a distinction could usefully be drawn between consultancy services (for example, giving advice to Government agencies on procurement processes) and the provision of asset solutions.
  9. The parties have submitted that no one firm is active in all of the four main NSR categories outlined above, which suggests that, from a supply-side perspective at least, it is not easy to switch from one sector of the NSR market into another. A feature of the NSR market are consortia, put together for larger projects by 'prime' contractors, who in turn sub-contract certain aspects of the work out to other firms. The need to form consortia in order to meet the full range of the project requirements supports the view that supply-side substitution between different segments by individual firms is difficult. To the extent that individual firms are active in different segments, this appears more common among prime contractors than sub-contractors<sup>2</sup>.
  10. On the demand-side, the parties submitted that there are four broad Government customer groupings within the NSR sector:
    - **National Intelligence:** The primary aim is to deliver actionable intelligence on critical security issues.

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<sup>2</sup> Examples of prime contractors in the NSR sector include Raytheon, who prime on the UK Borders Agency's e-Borders programme.

- **Border Security:** This includes immigration-focused departments, such as Identity and Passport Services (IPS), and border protection agencies, such as the UK Border Agency.
- **Law Enforcement:** This covers police forces and other users of actionable intelligence, such as the Serious Organised Crime Agency (SOCA).
- **Critical National Infrastructure:** This covers all infrastructure deemed critical by the Centre for the Protection of National Infrastructure (CPNI) for example, transport infrastructure, utilities companies and communications infrastructure.

11. For defence NSR, as well as in the UK defence sector more generally, the MoD is the only customer.
12. The parties stated that the requirement for further integration across Government departments and agencies will lead to a more integrated approach to procurement in the future, and that therefore it is not necessary to segment the NSR sector by customer type. BAE also stated that the different Government customers have common key features to their approach to the NSR sector. For example, their generic demands are broadly the same (that is, they all need to capture, process and secure data in order to convert it into actionable intelligence), and they have similar (if not identical) procurement processes.
13. Some evidence from internal BAE documents appears to contradict this view. These state that the NSR sector displays 'greater diversity of customer and end user cultures' than the UK defence market, and a variety of procurement models. As a result it appears that, currently, no NSR supplier has a major contract in more than two of the four main customer groupings identified by BAE above.
14. A third party competitor argued that a convenient way of viewing the NSR market was to distinguish between 'civil' NSR (that is, with Government departments other than MoD as customers) and 'military' NSR, or rather defence NSR (with the MoD as the sole customer). It considered that the requirements of civil and defence NSR are fundamentally different. Indeed, it believes that civil NSR is by nature closer to civil law enforcement than

to defence NSR, and that the differences between civil and defence NSR at least partly explained BAE's difficulties in breaking into the former. As in the civil NSR sector, there is a distinction in defence NSR (highlighted by the MoD) between consultancy and the supply of solutions.

15. The parties have argued that the increasing adjacency of the NSR and defence sectors is making it easier for a defence contractor to enter the NSR sector. This may point towards considering civil and defence NSR as a single market, contrary to the view of the third party above.
16. The evidence as to whether the NSR sector constitutes a single relevant product market is mixed, with some evidence from the supply-side pointing to a much narrower market definition, and with some third parties pointing to the need to draw a distinction between civil and defence NSR. Although, it has not been necessary to conclude definitively on the appropriate product scope as no competition concerns arise whichever scope is adopted, the OFT has taken a cautious approach and considered civil and defence NSR separately in the analysis below.

### **Geographic Scope**

17. BAE submits that the relevant geographic market for NSR is at least UK-wide, and possibly wider, since a number of non-UK-based firms have successfully competed for NSR contracts in the UK. For the most sensitive contracts, companies require appropriately cleared personnel, meaning that they tender via UK-based subsidiaries.
18. Examples of foreign-owned firms winning significant NSR contracts include:
  - Raytheon<sup>3</sup> (US) won £500m e-Borders contract following competition with BT
  - EADS<sup>4</sup> (European consortium) won £200m FiReControl project

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<sup>3</sup> [www.bia.homeoffice.gov.uk/sitecontent/newsarticles/2007/bordercontrolsboosted](http://www.bia.homeoffice.gov.uk/sitecontent/newsarticles/2007/bordercontrolsboosted)

<sup>4</sup> [www.communities.gov.uk/documents/fire/doc/fcbusinesscaselondon.doc](http://www.communities.gov.uk/documents/fire/doc/fcbusinesscaselondon.doc)

- Computer Sciences Corporation<sup>5</sup> (US) won £140m managed services contract for UK Visas Overseas, and
  - National Identity Card framework<sup>6</sup> was awarded to a consortia led by five multinational firms: Fujitsu (Japan), IBM (US), EDS (US), Computer Sciences Corporation (US) and Thales (France).
19. Third parties generally corroborated the parties' arguments. One considered that whereas British firms used to have an advantage over foreign ones in securing British NSR contracts, this was no longer the case. Only one third party prime contractor felt that British firms had an advantage on some sensitive NSR projects which are given 'UK eyes only' status, which precludes foreign nationals from working on them.
20. In relation to the military sector, the MoD stated that it does not have restrictions on overseas bidders provided adequate national security safeguards are in place.
21. Although it has not been necessary to conclude as to whether the geographic scope is wider than the UK since no competition concerns arise under any definition, the OFT has taken a cautious approach and confined the competitive assessment to the UK.

## **HORIZONTAL ISSUES**

22. The parties overlap in the supply of NSR products and services to the UK Government. The NSR segment as a whole appears to be highly fragmented. Estimates provided by the parties, show that no firm has a market share greater than 5 per cent. The parties' combined market share for the NSR sector as a whole is approximately [less than 5 per cent] (increment [less than 5 per cent]).
23. If the Information Management and Product Integration segments of the entire NSR market (where the parties overlap) are considered separately, the combined market shares will be approximately [less than 5 per cent] (increment [less than 5 per cent]) and [less than 5 per cent] (increment

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<sup>5</sup> [www.computing.co.uk/computing/news/2184474/uk-visas-sign-140m-outsourcing](http://www.computing.co.uk/computing/news/2184474/uk-visas-sign-140m-outsourcing)

<sup>6</sup> [www.ips.gov.uk/identity/working-suppliers-framework.asp](http://www.ips.gov.uk/identity/working-suppliers-framework.asp)

[less than 5 per cent]) respectively and are not such as to give rise to horizontal competition concerns.

## **Civil NSR**

24. Third party competitors felt that Detica was stronger in civil, consultancy services for NSR, whereas BAE was stronger in the provision of solutions in defence NSR, and commented that BAE had rarely won civil NSR contracts. On this basis, competitors felt that the parties were not close competitors in civil NSR. Government customers also identified very specialist goods and services which Detica supplied them with, either directly or through consortia. These customers did not identify any overlaps between BAE and Detica even in any narrower categories within the NSR sector.
25. This was supported by bidding data provided by the parties: over the past three years, BAE had only bid for [ ] civil NSR contracts, while Detica had submitted in excess of [ ] competitive bids.<sup>7</sup> BAE and Detica had only submitted bids for the same project on only [ ] occasions, and even in these instances, the two companies were tendering for different roles.
26. In relation to consultancy work done by Detica, Government customers submitted that there were a range of other potential suppliers of these types of services. For example, PA Consulting and Fujitsu were both mentioned as able to do the same sort of work. Although BAE is also active in technical consultancy services<sup>8</sup> Government customers did not identify any overlaps between BAE and Detica.
27. Government customers submitted that some specialist technology Detica provide is unique, and irreplaceable in the short-term. One told the OFT that there would be 'some pain' involved if they had to substitute away from Detica.

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<sup>7</sup> Source: Internal Detica management systems, which the parties submit may not provide a completely accurate record of all bids or contracts.

<sup>8</sup> Technical consultancy focuses on specialised technical IT requirements for specific business areas and operations.

## **Defence NSR**

28. The MoD has submitted that BAE and Detica are not close competitors in relation to defence NSR products, and that its only concerns were vertical in nature (discussed further below), that is, related to instances where Detica was providing procurement advice on projects where BAE was bidding to be the supplier. It stated that there are other operators who supply it with defence NSR products and services. While it did submit that in some areas the number of suppliers was limited, overall it did not have any horizontal concerns in relation to defence NSR.

## **Coordinated Effects**

29. The merger will bring BAE into contact with [ ] through Detica's participation in a Government consortium headed by [ ]. This could provide BAE and [ ], both major defence sector prime contractors, with a forum through which to coordinate over MoD contracts, whether these are NSR-related or not.

30. In order for tacit collusion to be successful or to become more likely, the OFT considers that three conditions must be met or be created by the merger:

- a. the participants must have the ability to align their behaviour in the market
- b. the firms must have the incentives to maintain the coordinated behaviour, and
- c. the coordinated behaviour should be sustainable in the face of other competitive constraints in the market.

31. Key elements which allow firms to align in terms of coordination are market transparency, product homogeneity, stability and symmetry. Regardless of any symmetry between BAE and [ ], it is clear that the market for MoD wider defence contracts is not transparent (for reasons of national security). Neither is it characterised by product homogeneity, due to the wide range of products and services required. Accordingly, these particular features cast potential doubt over the parties' ability to coordinate their behaviour.

32. It is also doubtful whether the parties would have the incentive to maintain any coordinated behaviour. Defence contracts are heterogeneous in terms

of duration and value, such that if one of the parties diverges from the coordinated strategy in relation to a very large contract, the threat of retaliation over other, smaller contracts is unlikely to act as a sufficient deterrent.

33. In terms of the sustainability of the behaviour in the face of other market factors, the MoD, as a monopsony buyer, would have considerable capacity to disrupt any coordination between [ ] and BAE over wider defence contracts, for example by varying contract length, although this ability might be constrained if there were segments of the wider defence market where the alternatives to [ ] and BAE were limited.
34. Overall, the OFT does not consider that the merger will create or strengthen the likelihood of [ ] and BAE being able to coordinate over MoD contracts in the wider defence sector as a result of Detica's involvement on a [ ] consortium.

#### **Barriers to Entry and Expansion**

35. The parties submit that reputation, a track record for delivery for Government contracts (especially with regard to sensitive contracts within the NSR sector) and the necessary security clearances are necessary for a new entrant into the NSR sector. The parties believe that increased funding for NSR by the Government and enhanced demand for these products and services will provide further opportunities for new entrants, and allow established NSR suppliers to expand.
36. Third parties submitted that entry as a provider of solutions was harder than as a provider of consultancy services, since the necessary trust, understanding and capability took a long time to build. They also submitted that a firm entering as a prime contractor would have to do sub-contractor or smaller project work first, as a means of demonstrating competence in the NSR sector. [ ] was also cited as a lengthy process: a third party stated that achieving Detica's [ ] would take about two to three years.
37. The parties also argued that entry into the NSR sector by defence contractors would become easier over time, due to the increased convergence of defence and civil national security needs. However, third party views on the validity of this argument were mixed: one third party considered that defence and civil national security requirements 'should

never' converge, with different requirements characterising each. On the other hand, two other third party competitors both thought further convergence of the defence and civil NSR sectors could make entry easier in the future for a firm such as BAE.

38. In conclusion, assessing barriers to entry in the NSR sector is complex because it appears to vary significantly depending on the characteristics of the firm that is seeking to enter, and the work it is seeking to do. However, it has not been necessary to conclude definitively on barriers to entry to the NSR sector since no competition concerns arise.

### **Buyer Power**

39. The parties submit that the merged entity's behaviour will be constrained by the fact that the Government is a monopsony customer in the NSR sector. The parties contend that this is demonstrated by:
- its use of competitive tenders at the procurement stage
  - its ability to stipulate and govern design criteria for the products and services procured, and
  - its ability to designate particular suppliers as partners.
40. A third party competitor stated that consortia also offered an opportunity for Government purchasers to consolidate rates and reduce costs.
41. Competitors stated that there were only one or two suppliers for certain NSR products. One submitted that Detica was one of only two suppliers of [ ]. Those Government departments to whom Detica supplied very specialist technology observed that Detica was almost the sole supplier, and that it would be hard to find a replacement for its products.
42. Government departments we spoke to all saw themselves as possessing buyer power in the NSR sector, while the MoD saw itself as possessing buyer power specifically in the defence sector. However, it is not necessary to conclude definitively on the issue since no horizontal competition concerns arise.

## VERTICAL ISSUES

43. The MoD stated that there are instances where Detica might be advising MoD programme teams on projects where BAE is bidding to be a supplier. The MoD will therefore ask the parties to review their conflict of interest processes, in order to protect the competitive process and avoid perceptions of partiality. It felt that, despite its efforts to preserve Detica's impartiality post-merger, some companies could refuse to work with Detica post-merger given its connection to BAE, and that this would limit the MoD's supplier base in some cases.
44. A third party prime contractor submitted that Detica products are crucial to the functioning of many systems that it ran for clients.<sup>9</sup> It was concerned that the merged entity would seek to challenge Detica's existing relationships with prime contractors, and that it might 'walk away' from existing subcontract relationships, in order to free resources to act as a prime contractor on another project. Its concerns were echoed by a Government customer, for whom the prime contractor is a consortium leader with Detica as one of the sub-contractors.
45. The MoD's concern would appear to be one that is best resolved by Government customers themselves, if necessary through a review of their conflict of interest procedures. The concern of the prime contractor discussed in paragraph 44 above raises a potential refusal-to-supply scenario, in the event that the merged entity seeks to act as a prime contractor in the future, and withholds Detica's expertise and products from other prime contractors, both on existing and future projects.
46. On existing projects, the OFT does not consider that the merged company would have the incentive to withhold Detica's expertise and products, since this would affect its credibility with the same Government customers from whom it will seek to win future work.
47. With regard to future projects, BAE have submitted that they do not wish to act purely as a consultant or purely as a prime contractor in the NSR sector: instead they plan to have a flexible future strategy that is responsive to customer needs. If the merged firm was bidding for work as a prime contractor on a project where Detica's input was desirable, Detica

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<sup>9</sup>[ ]

would naturally form part of its consortium, rather than that of competitors.

48. With regard to future projects where the merged entity was not bidding for work as a prime contractor, it is unlikely that it would have the incentive to withhold Detica's input from other consortia, as this would involve foregoing potentially considerable amounts of revenue. Furthermore, while one prime contractor, whose views are outlined above, appears to indicate that Detica is indispensable to certain existing project consortia that they are currently part of, the views of a second third party prime contractor confirmed that this is not always the case. It submitted that the participation of Detica in their consortium in no way guaranteed their success. This was confirmed by the Government customer, who submitted that the participation of Detica was important, but not essential, to the consortium's success. The second prime contractor did not feel that the non-availability of Detica as a consortium member post-merger would prevent it from bidding successfully for future work.
49. It therefore appears that while Detica goods and services may be indispensable to some current projects on which they work, this is not always the case. It also appears that, in the future, even if the merged entity were to withhold Detica's input from other consortia, other prime contractors would be able to find ways of overcoming the non-availability of Detica for involvement in future projects. Additionally, the combination of very large, well resourced, prime contractors and potentially powerful Government purchasers should be sufficient to ensure that competition for future projects is not distorted.

### **Portfolio Issues**

50. A third party competitor suggested that the merger would give BAE a far larger pool of [ ] personnel than it currently had, and that this would give it a significant advantage over other firms. However, this point was not raised by other third parties. Additionally, no other third parties have suggested that the success Detica has enjoyed in the NSR sector is due simply to the fact that large numbers of their staff are [ ], rather than to their expertise or to the quality of their products. For BAE this is even more unlikely to be the case, since it lacks Detica's track record in the NSR sector, and must convince customers that it represents a viable proposition in the sector post-merger.

## **THIRD PARTY VIEWS**

51. Third parties' comments have been discussed above. In general third party competitors supported the parties' arguments that BAE's presence in the NSR sector was very limited, and that the activities that it does have do not bring BAE into direct competition with Detica. There were conflicting views from third party prime contractors concerning the possibility that the parties might withhold Detica's goods, services and expertise from prime contractors on current and future projects.
52. A third party competitor stated that in one specialist product area (not one within the NSR sector), Detica's only competitor was [ ]. It felt that competition in relation to this technology would be dampened post-merger by the fact that BAE is a major customer of [ ] (on the basis that [ ] would not want to upset relations with BAE), which could have cost implications for the supply of certain items of equipment for a Government [ ] programme. However, this concern was not advanced by the Government department in question. Furthermore, [ ] is owned by [ ]: since BAE's business does not make up a significant proportion of [ ] revenue, it is unlikely that the merger will have any significant impact on [ ] strategic behaviour as suggested by the third party.
53. Third party Government customers were not generally concerned by the merger, but were keen to seek assurances of Detica's commitment to existing contracts.

## **ASSESSMENT**

54. This merger brings together a large defence contractor and a much smaller firm specialising in NSR products and services. Competition between the parties is extremely limited with, over the last 3 years, BAE only bidding for [ ] pieces of work in the NSR sector, while Detica entered over [ ] bidding competitions over a similar period. And in addition for the projects where BAE bid that also saw bids from Detica, the parties were bidding to work on different parts of the programmes. Third parties have confirmed that BAE and Detica are not close competitors, either in the civil NSR or defence NSR sectors. Thus, this case raises no competition concerns of a horizontal nature.

55. Third parties raised vertical concerns about the merger generating potential conflicts of interest, in particular that the deal might lead to situations when Detica gives client-side advice to customers regarding a project where BAE is bidding to be the supplier. However, the Government customers we spoke to were confident that they would be able to resolve any problems of this nature through their own procedures to guard against conflicts of interest.
56. A third party prime contractor was also concerned that the merger would affect Detica's commitment to its work as part of an existing consortia working for a Government customer. Again, the Government customer in question submitted that they could guard against this happening themselves. A decline in the quality of Detica's work on existing consortia post merger may also be unfounded given evidence from BAE internal documents that show a recurrent concern to preserve the value of Detica post-merger.
57. Another concern raised by some third parties was that in the future BAE would seek to withhold Detica's products and services (some of which are currently almost unique) from third party prime contractors seeking work that BAE itself wishes to tender for as a prime contractor. For this to be a concern, we would have to be confident that (a) BAE did seek to position itself as a prime contractor in the short term, and that (b) no other firm could develop products to compete with Detica's. Given lack of certainty about either of these, this theory of harm is speculative, and lacks any evidence to support it.
58. Consequently, the OFT does not believe that it is or may be the case that the merger may be expected to result in a substantial lessening of competition within a market or markets in the United Kingdom.

## **DECISION**

59. This merger will therefore not be referred to the Competition Commission under section 33(1) of the Act.