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MARKET-SENSITIVE

NBPM.

PRIME MINISTER

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PROPOSED MERGER OF GEC AND PLESSEY

The Director General of the Office of Fair Trading has recommended to Leon Brittan that this proposal should be referred to the MMC.

In our view, this is the right course to follow. The merger is so significant, and would diminish competition in so many important markets that it requires proper examination.

GEC has argued that there is a critical size which electronics firms have to achieve to be competitive internationally, in respect of research and manufacturing cost; and that a merger with Plessey is necessary to achieve this. GEC can also point to the need to rationalise the two companies' capacity to product electronic exchanges (System X).

If the merger only concerned the two companies' telecoms interests, the DG of the OFT judged that there might not be a need for a reference. Although the two dominate the UK telecommunications markets (together they account for 80% of public switching equipment, 60% of private switching equipment, 30% of telephones and key systems, 60% of transmission equipment), BT has shown itself robust in its willingness to look abroad (eg, to Thorn Ericcson). The crux of the matter is the two companies' dominance of defence

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electronics markets, where importing is not an easy option (we import only 10% of our defence equipment) because of patriotic sentiment, concerns about retaining important technologies, and, of course, powerful industrial lobbying (which the merger could only intensify). GEC and Plessey account for over one third of the entire defence electronics equipment budget of £3.3 billion. Together they supply around 90% of MoD's underwater systems, 80-90% of the radar, and 50-60% of combat radios.

With level real defence expenditure from now on, MoD will need to secure keener prices for its equipment to meet the Soviet threat: MoD need alternative bidders to achieve this. Ferranti, Racal and Thorn are also significant competitors, but for major electronics projects, MoD will look to GEC and Plessey to take the lead in offering alternative technical solutions to defence problems. Under Peter Levene, the proportion of new MoD orders which is obtained by competition has risen sharply (from 47% in the half year to October 1984 to 70% in the corresponding period in 1985). Peter Levene is rightly concerned that GEC and Plessey remain independent so that he can sustain the policy.

There is, therefore, a judgement to be made. The arguments have not yet been examined fully. GEC has asserted, but has not demonstrated, that acquisition of Plessey will add to our industrial strength. It is not clear, for example, why merging the two companies' research will improve their performance. There is some value, as GEC acknowledge, in

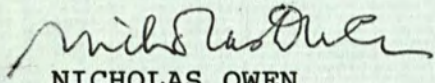
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retaining independent centres of research. No one would recommend merging the laboratories of Oxford and Cambridge. Neither company is without its faults. GEC seems unable to deliver working systems to the MoD on time, or to cost. It seeks easy pickings in protected markets, and is reluctant to take technical risks in competitive markets, even with its £1.5 billion cash mountain. Is GEC really qualified to remedy the deficiencies of Plessey? It will be argued by GEC that, in the international league of electronics companies, both companies are minnows, but will the marriage of two minnows produce a salmon? That question, surely is the task of the MMC.

Leon Brittan ought, and probably will, accept the advice which Gordon Borrie has offered him.


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