Written evidence submitted by the Ministry of Defence

Foreign Involvement in the Defence Supply Chain

The following submission of evidence to the House of Commons Defence Committee's Inquiry into Foreign Involvement in the Defence Supply Chain provides answers in response to the Terms of Reference outlined by the Committee. This memorandum has been prepared by the Ministry of Defence (MOD) and includes input from the Home Office, Department for Business, Energy and Industrial Strategy (BEIS), Cabinet Office and others.

Question 1 - What is the current extent of foreign ownership of the UK's defence and security sectors?

Defence

1. In Financial Year 2019/20, the MOD paid around 13,000 different organisations for goods and services.[1] They involve a wide range of different business sectors, including, for example, those providing construction, facilities and estates management, and IT. Many of the companies that play a critical part in the delivery of defence outputs obtain only a minority of their revenue from defence customers. Given this diversity, there is no single recognised definition of the 'defence sector', and there is no 'defence' category in the Standard Industrial Classification used for national statistics purposes. The majority of top suppliers to the MOD, by spend, are Public Limited Companies (PLCs), with a diverse international shareholder base, and shares being freely traded on the stock exchange. They therefore benefit from the ability to raise funding on global equity and capital markets. Many overseas domiciled suppliers to Defence have UK registered subsidiaries, which may be members of UK trade associations, and which contract directly with the MOD.

2. Ownership alone has not been the major driver in policy. The current approach continues to draw on the definitions set out in the 2002 Defence Industrial Policy, which described the UK defence industry as *"embracing all defence suppliers that create value, employment, technology or intellectual assets in the UK. This includes both UK and foreign-owned companies".*[2] It also stated that "*the UK defence industry should … be defined in terms of where the technology is created, where the skills and the intellectual property reside, where jobs are created and sustained and where the investment is made*". Focussing on the MOD's most significant suppliers (by spend), the attachment shows details for each company covering:

- Country of domicile;
- Key shareholders;
- Percentage of UK ownership of shares;
- Percentage of UK revenue.

3. This information has been collated from publicly available sources, which are especially pertinent for PLCs. However, information on companies that are privately held (which will be the case for many companies in the lower tiers of the defence supply chain) is not so readily accessible. It should also be noted that the available data for shareholder domicile may not include all shareholdings, and holding structures are subject to definition so it cannot be relied upon for accuracy.

[1] MOD trade and industry contracts 2020, published 17 September 2020
2 https://publications.parliament.uk/pa/cm200304/cmselect/cmdfence/572/57207.htm

4. Regardless of ownership, the MOD requires companies to have a robust regime in place to restrict access to classified information to appropriately cleared individuals. In addition, in a small number of particularly sensitive cases, the Government holds special shares for national security reasons in companies including: BAE Systems; Rolls-Royce Holdings; Qinetiq and certain subsidiaries of Babcock International.[3] The special share typically provides the Government with certain rights, including the ability to limit the ownership of a single foreign shareholder or foreign shareholders acting in concert; restrict disposals; and/or control the nationality of company directors.

5. Companies with a direct contract with the MOD are mandated to provide advance notification of any change of control. Upon notification, the Department will co-ordinate a due diligence exercise designed to establish whether the change creates concerns over security of supply, proximity risk, or other national security implications that need to be considered alongside any competition issues. In such cases, the Department can choose to transfer work to an alternative supplier.

6. Where foreign ownership does raise significant national security concerns, the Government has powers under the Enterprise Act 2002 (and will have under the proposed new National Security and Investment Bill) to block a transaction or to require statutory undertakings from the acquirer. Further details are set out in response to the Committee's subsequent questions. BEIS are continuing discussions with the Parliamentary Business and Legislation Committee on timings for Bill introduction.

UK Security Sector

7. There is no exclusive definition of the security sector, and as for defence, no Standard Industrial Classification, but it is generally taken to include critical national infrastructure protection; cyber security; policing and counter-terrorism; major event security; border security; offender management; and services including consultancy, training, guarding and risk analysis. 6,000 UK security companies are represented through their trade associations by RISC, the UK's Security and Resilience Industry Suppliers Community (and the UK's leading security industry alliance), which was founded by the trade associations ADS, techUK, and BSIA in co-operation with the Home Office in 2007. According to the Home Office, the wider UK security sector is extensive and diverse, with 95% of suppliers comprising Small and Medium-Sized Enterprises (SMEs). Foreign ownership in whole or in part can only be determined on a case by case basis.

Question 2 - What has been the impact of the COVID-19 pandemic on the defence and security supply chain, particularly the finances of SMEs?

8. COVID-19 heavily disrupted global supply chains as countries introduced measures including manufacturing facility closures, export/import stoppages, workforce reduction and travel bans. The defence and security sectors are heavily reliant on global supply chains for raw materials and components, although many suppliers to the MOD have in place comprehensive business continuity and delivery assurance plans which meant they were comparatively well prepared to minimise disruption. Domestic defence demand has remained relatively stable throughout the pandemic, and defence suppliers continued working throughout the lockdown, maintaining critical services and production after appropriately adapting their working practices. For the broader security sector, the Security

[3] The Government retained 'special shares' when BAE Systems and Rolls Royce were privatised, which restricted share ownership by overseas investors to an aggregate of no more than 49.5% to protect national security. Considered overly restrictive, this was latterly removed from the Articles of Association of both companies, although a 15% limit on individual shareholding was retained to prevent outright control by a single foreign individual or organisation. An early requirement for all board members of BAE Systems to be UK nationals was also relaxed.

and Resilience Industry Supplier Community has reported that COVID's primary shock has been to supply chains rather than sales.

9. UK companies have significant global supply chains, which has generated challenges for the creation of finished products and the fulfilment of orders. According to material provided to the MOD by RISC in June 2020, some companies are reviewing their supply chains and seeking domestic alternatives for supply, potentially resulting in shortened supply chains and improved transparency. The international trend appears to be movement towards increasingly local supply chains, accompanied by the risk of protectionism, motivated by security, surety of supply and economic stimulus. The impact of such measures is likely to be exacerbated by pandemic-induced changes to many bilateral and multilateral relationships, including those relating to trade.

10. Companies globally are shoring up their inventories to reduce their reliance on 'just-in-time' supply chains. Many suppliers are now actively 'restarting' businesses as COVID-19 supply, demand and workforce impacts begin to reduce, and are adopting COVID-19 secure strategies (e.g. carrying out COVID-19 risk assessments; developing cleaning, handwashing and hygiene procedures; helping people to work from home; initiating two metre social distancing measures, where possible; and managing transmission risk.) Defence suppliers are presently mainly reporting unchanged, or an increasing capability to deliver defence outputs to the MOD, although the ongoing impact of Covid-19, in addition to planning for the end of the EU Transition period, are being considered concurrently in their supply chain and commercial risk analysis. Material availability is a key risk: lost manufacturing capacity within supply chains during Q1 and Q2 has resulted in some commodity scarcity, and resultant delivery risk. Increased costs incurred by defence suppliers that are related to COVID-19 are being reviewed by the MOD.

11. The pandemic has created financial challenges across the defence and security sectors, and liquidity and cash flow concerns continue, particularly for firms with exposure to the civilian aerospace sector or relatively high debt. Many defence and aerospace companies have introduced cash conserving strategies, for example suspending dividends, and reducing executive pay and pension contributions, and have arranged additional credit facilities. Targeted COVID-19 financial relief measures were undertaken by the MOD to support cash flow, maintain service delivery and retain staff within the defence supply chain. This has included forward ordering, prepayment, interim payments and payment on order rather than receipt, accompanied by strong guidance around the MOD's expectation that suppliers continue to pay employees and flow down funding to their supply chains. The MOD has made interim payments to Primes when requested, consistent with the guidance contained within relevant Defence Procurement Policy Notices. Primes have actively supported their supply chain in a similar way, responding to requests for financial and other assistance, which has ensured continuing cash flow through supply chains.

Question 3 - Under what circumstance will the Government currently intervene to prevent foreign takeovers in these sectors and what changes does the planned National Security Investment Bill make?

12. The Government recognises the benefits of an open economy and is keen to encourage inward investment. It recognises, however, that certain types of foreign investment into companies with sensitive technologies/capabilities or in parts of the UK's Critical National Infrastructure can raise national security concerns. The Government's existing powers to intervene in mergers and acquisitions are set out in the Enterprise Act 2002, with the related competition regime overseen by the Competition and Markets Authority (CMA). However, having reviewed these powers, the Government concluded that they needed to change in order to address the evolving national security threats the UK faces. The staged approach agreed was to introduce short-term amendments to the

Enterprise Act 2002 aimed at closing existing gaps, while preparing a new National Security and Investment (NSI) Bill to deal with the longer-term.

Enterprise Act 2002

13. Under the Enterprise Act 2002, in addition to the CMA's competition functions, the Government may intervene in merger transactions on limited public interest grounds relating to:

- National security (including public security);
- The stability of the UK financial system; and plurality and other considerations relating to newspapers and other media;
- The need to maintain in the UK the capability to combat and to mitigate the effects of a Public Health Emergency (introduced in June 2020).

14. Most decisions relating to public interest interventions are made by the Business Secretary. However, since 2010, those relating to the media, broadcasting, digital and telecoms sectors have been the responsibility of the Secretary of State for Digital, Culture, Media and Sport. By convention, the Defence Secretary provides formal advice if any of the transactions raise national security concerns for the MOD.

15. To intervene on public interest grounds, a Secretary of State must have *"reasonable grounds for suspecting that it is or may be the case"* that a relevant merger situation has been created or that arrangements are in progress or contemplation that would result in the creation of a relevant merger situation. A relevant merger situation occurs when:

- Two or more enterprises cease to be distinct; and
- The acquired company has a UK annual turnover of more than £70 million and/or the merger would result in the creation of, or increase in, a 25% or more combined share of sales or purchases in the UK (or in a substantial part of it), of goods or services of a particular description; and
- The merger has not yet taken place or has not taken place more than four months before the CMA was notified. If the merger took place without having been made public and without the CMA being informed of it, the four-month period starts from the time the merger was made public or the time the CMA was told about it.

16. With the rapid development of new technologies, there were concerns that smaller start-ups and university spin-offs would not be caught under the Enterprise Act 2002 thresholds, so in June 2018, the Government lowered the thresholds for intervention for transactions involving:

- Military and dual-use technologies;
- Quantum technology; and
- Computing hardware.

17. In June 2020 three further sectors were added to the list, as follows:

- Artificial intelligence
- Advanced materials
- Cryptographic authentication

18. In these cases, the turnover threshold is over £1 million and there is no requirement for an increase in share of supply (it is sufficient if the target has an existing share of supply of 25% or more of goods/services in the relevant sector).

19. Under the Enterprise Act 2002, the Secretary of State is also able to intervene in special public interest cases where the standard merger jurisdictional thresholds relating to share of supply and turnover are not satisfied. These include:

- Mergers involving certain government contractors or sub-contractors who may hold or receive confidential information or material relating to defence; and,
- Certain mergers in the newspaper and broadcasting sectors.

National Security and Investment Bill

20. The new investment screening legislation under the proposed NSI Bill is currently being finalised prior to its introduction to Parliament. It will introduce longer-term reforms and replace the national security screening regime under the Enterprise Act 2002 with a new regime that will address existing limitations relating to thresholds, process and scope, and will include powers of intervention that are not provided by the Enterprise Act 2002, which apply only when a *business* is being taken over. It will allow potential threats to our national security to be identified and addressed in a wide range of proposed business investments, whether in major infrastructure projects or small tech start-ups. The future National Security and Investment regime will be separate from the processes and practice of the CMA's mergers framework under the Enterprise Act 2002, divorced from competition regulation and run wholly by the Government.

21. The new regime is being designed to provide greater clarity, predictability and transparency, with strengthened protections that are justified and proportionate in light of the risks we currently face. It is likely to request that Parliament provides the Government with powers to act in the event of 'trigger events' in relation to entities and assets – covering a range of means by which a hostile actor can use an investment to acquire the ability to undermine national security. The trigger events are likely to include acquisitions of influence or control over an entity, including acquisitions of shares or voting rights above certain thresholds and the acquisition of assets. The Bill is also likely to request powers to allow the Government to call in transactions across the entire economy which may raise national security concerns, without being subject to a turnover threshold or share of supply test.

22. Like the statutory powers that it will replace, the NSI regime will operate alongside other tools to protect security, including export control, sector-specific regulation for critical areas and support to businesses from the Centre for the Protection of National Infrastructure and National Cyber Security Centre.

Question 4 - Are additional measures required to protect UK Defence and Security technological advances?

23. A range of targeted cross-Government mechanisms exist to protect UK defence and security technological advantages, and the MOD and partners take particularly careful measures to protect research and capabilities that would exceed analogous programmes in civilian sectors. Protection of defence technological advances is currently achieved through several mechanisms, which reflect the level of sensitivity and applicability. These include:

- Protective security. The MOD has established standards and procedures to implement external and internal personnel security checks and site/information restrictions to control access to sensitive technologies. As an example, the MOD has applied the Cyber Security Model (CSM) to protect information flowing down the supply chain since April 2017. This applies to all Electronic Information which is attributed to or could identify an existing or proposed MOD capability, Defence activities or personnel, and which the MOD requires to be protected against loss, misuse, corruption, alteration and unauthorised disclosure. The CSM process captures the supply chain and defines risk-based proportionate controls these suppliers should have. A programme of work is ongoing to apply this retrospectively to contracts let prior to April 2017.

- Intelligence. The MOD's community of technical and intelligence experts can monitor scientific and technological developments within academia and industry as well as actions taken by hostile actors to develop their capabilities or attempt to steal/compromise those of the UK.

- Legislation. The Government can access legal powers to intervene on research licensing, export controls, foreign investment and patenting where there are concerns around the sensitivity of the technology in question. The amendment to the Enterprise Act 2002 introduced earlier this year, to include certain emerging technologies, provides an example of the Government enhancing its ability to track and protect emerging technology sectors whose development could have future defence and security implications.

- Outreach. The MOD works closely with other government departments where there is mutual interest in a technology and the need for a shared understanding of the threats and opportunities it presents. The Department is also closely engaged with the academic and private sectors through various networks whereby the MOD can provide support and advice on protective measures applicable to research and development undertaken with external partners.

- Targeted financial support. The National Security Strategic Investment Fund (NSSIF) supports long-term equity investment in advanced technologies that contribute to the UK's defence and security sectors. It supports private sector-led investment by increasing the amount of early stage venture and growth capital available to innovative, high potential UK technology companies. NSSIF aims to attract venture and growth capital into investment strategies that support the UK's defence and security sectors (12 areas of technology interest are published), resulting in an increased flow of private investment into these technology areas. NSSIF operates both through investment in Venture Capital Funds whose investment strategies align to the UK defence and security sectors and through acquiring direct equity stakes in advanced technology firms. Funding for NSSIF was increased from £85 million to £135 million in the 2020 Budget.

24. We recognise that while there are measures in place to protect UK defence and security technical advantages, they will need to evolve to meet future challenges. A flexible and forward-looking approach from the Government will require enhanced cross-Government collaboration and relationships with external parties, to allow for better co-ordination and a cohered understanding of the benefits and challenges of protecting the UK's technological development base, whether from a defence and security, civic or economic perspective. In order to consider how to address the challenges and maximise potential opportunities, the MOD is currently leading a cross-Government review of the UK's Defence and Security Industrial Strategy (DSIS), the findings of which will be considered alongside the broader Integrated Review. DSIS has yet to conclude and therefore decisions have not yet been made on whether the review will result in the pursuit of alternative approaches in particular areas.

Question 5 - How does the UK's regime compare internationally and what can the UK learn from its allies?

25. The UK Government is determined to ensure that the UK continues to benefit substantially from open trade and remains one of the foremost destinations for inward investment. However, the Government also recognises the potential national security risks posed by certain types of foreign investment. Technological, economic and geopolitical changes mean that reforms to the UK Government's powers to scrutinise investments to better protect national security are needed. Table 1, below, offers an outline comparison of current international investment screening regimes by country, that includes the type of regime, notification requirements, associated thresholds and the length of any retroactive application of powers after an event has taken place.

Table 1: Comparison of International Investment Screening Regimes

Country	Type of Regime	Notification Requirements	Thresholds	Retroactive period[4]
UK (Enterprise Act 2002)	Competition regime with specific public interest tests	Voluntary	£70 million and 25% share of supply (with the exception of the 6 sectors identified in paras 16-17 for which lower thresholds apply).	4 months
Australia	Public interest	Mandatory for foreign government purchases	Thresholds normally vary depending on individual trade deals, but have been temporarily lowered to AUD$0	3 years for a divestment order. 6 years for a civil penalty
Canada	Economic and national security	Mandatory	If a new business is started or if a stake of 50% or above is taken. Some sectors (health and critical goods) have a temporary 0% threshold due to COVID	2 years
United States	National security	Mix of voluntary and mandatory for certain sectors	No threshold	No limit
France	Public order, public safety and national defence	Mandatory for certain sectors for non-EU members	Acquisition of over 10%	5 years

[4] Retrospective periods are not directly comparable. Some date from the close of the transaction. The Enterprise Act 2002 timeline starts when HMG finds out about the transaction.

Country	Type of Regime	Notification Requirements	Thresholds	Retroactive period[4]
Germany	Public order and security	Mix of voluntary and mandatory for certain sectors	Defence and sensitive sectors – mandatory with lower thresholds (10% share) The rest of the economy is voluntary with a 25% share threshold	5 years
Italy	Strategic assets in defence and national security	Mandatory for specific sectors	The aggregate Italian turnover of all undertakings concerned exceeds EUR498 million. The Italian turnover of each of at least two undertakings exceeds EUR30 million. Temporary thresholds of 10% or above for non-EU entities	5 years
Japan	National security The maintenance of public order The protection of public safety The smooth management of the Japanese economy	Mandatory for certain sectors	Acquisition of 1% or more	Limitless

Future Legislation

26. The proposed NSI Bill will strengthen the Government's existing powers to scrutinise and intervene in business transactions to protect national security, and to provide companies and investors with the certainty and transparency they need to do business in the UK. In addition to planned legislative changes, the Government is accelerating plans to build new capability and capacity to assess economic interactions which affect our national security. This includes not only potential threats arising from hostile foreign investment, but also wider challenges such as changes in corporate governance, research and innovation agreements and joint ventures. The content of the NSI Bill has not yet been finalised, but it is anticipated that enhanced powers under the NSI Bill will bring the UK more closely into line with the approaches of close allies. The UK is not alone in making changes to its foreign investment screening arrangements. Many like-minded partners have strengthened their own investment screening regimes, including the US, Australia, Japan and some European governments.

Learning from Allies

27. The UK can and does learn from our allies, with whom the Government works closely on Foreign Direct Investment protection. The development of the NSI Bill has included scrutiny of the regimes applied by others and related experiences. BEIS has engaged extensively with other countries, particularly our Five Eyes partners, throughout the policy development process. The earlier Green and White Papers noted the approach of our allies to investment screening which the Government has sought to build upon in the forthcoming reforms.

28. The supply chains for UK defence capabilities and those of our primary international partners are often closely aligned, especially where companies have a global network or presence. We recognise that adversaries and competitors may seek to identify key elements within related supply chains and to exploit them to access critical technologies that in turn could be used to undermine our existing military advantage. The UK MOD has relationships with counterparts in the Defence departments of several allies, supporting the sharing of information and best practice in a defence and security environment that is characterised by rapid change and shared threats and risks.

30 September 2020

Attachment:

Top defence suppliers (by spend) - ownership summary - August 2020

UK Government Investments

Top defence suppliers (by spend) - ownership summary

August 2020

Disclaimer

UK Government Investments

The data presented in this document has been sourced primarily from Capital IQ as well as some company-sourced information.

Geographic ownership data for investors is established at ultimate parent level (e.g. for UK funds with US-based parents, the public ownership data will appear as US public holdings). Additionally, not all shareholder locations are disclosed.

Whilst directionally useful, the geographic ownership information provided by Capital IQ may therefore <u>not be relied upon for accuracy</u> and may not match company-sourced information.

Top defence suppliers (by spend)[1] - ownership summary

UK Government Investments

Company	Domicile	Key shareholders	% UK ownership[2]	% UK revenue
BAE Systems		Asset managers including BlackRock (13%), Capital Research & Management (7%) and Vanguard (5%)	44%[3]	20%
Babcock International		Asset managers including Standard Life (8%), Invesco (7%) and UBS (6%)	27%	67%
Rolls-Royce Holdings		Asset managers including Capital Research & Management (8%), Harris Associates (7%) and Causeway Capital (6%)	22%	11%
Airbus[4]		Capital Research & Management own 11%. SOGEPA own 10.9%, KfW 10.9% and SEPI 4.1%, which are holding companies for the French, German and Spanish governments respectively	1%	n/a
Lockheed Martin		Asset managers including State Street (15%), Vanguard (8%) and Capital Research & Management (7%)	3%	n/a
General Dynamics		Asset managers including Longview (11%) and Vanguard (7%)	4%	n/a
Leonardo		The Ministry of Economy and Finance in Italy owns 30%, and asset managers such and Blackrock hold small stakes in the company	3%	10%[5]
Ferrovial S.A.		Rijn Capital BV is the major shareholder owning 20%. Menosmares, S.L.U. owns 8% of the company	2%	7%[6]
QinetiQ Group		Asset managers including Schroders (9%), Majedie (8%) and BlackRock (7%)	47%	69%
DXC Technology		Asset managers including Vanguard (12%), BlackRock (8%) and Glenview (4%)	1%	14%[7]
Boeing		Asset managers including Vanguard (7%), BlackRock (6%) and State Street (5%)	1%	n/a

Source: Capital IQ unless stated otherwise (please refer to the disclaimer on page 2).

1. As provided by Defence Economists
2. Please note that not all shareholder locations are disclosed, so whilst this is directionally useful, it may not be relied upon for accuracy
3. Source: BAE Systems website (as at 21 July 2020)
4. Airbus SE is a European public company, with its HQ in The Netherlands. It is listed in France, Germany and Spain
5. Source: Leonardo 2019 Annual Report
6. Source: Ferrovial 2019 Annual Report
7. Source: DXC Technology 2020 Annual Report

Top defence suppliers (by spend)[1] - ownership summary

UK Government Investments

Company	Domicile	Key shareholders	% UK ownership[2]	% UK revenue
Leidos Holdings	US	Asset managers including Vanguard (11%), BlackRock (6%) and JP Morgan (6%)	3%	n/a
Thales S.A.	France	The French State owns 26% of the company and Dassault Aviation owns 25%	3%	7%[3]
KBR	US	Asset managers including BlackRock (11%), Vanguard (10%) and MFS (6%)	4%	n/a
Innisfree Group Ltd	UK	Private company primarily held by pension funds and insurance companies	70%	n/a
Serco Group	UK	Primarily asset managers including Majedie (10%), BlackRock (9%) and Fidelity (8%).	79%[4]	41%
Jacobs Engineering Group	US	Asset managers including Vanguard (11%), State Street (7%) and BlackRock (6%)	6%	n/a
BT Group PLC	UK	Deutsche Telekom AG owns 12% and BlackRock owns 5% of the company	29%	85%
Interserve PLC	UK	Private company – delisted in 2019	n/a	78%
Raytheon Technologies	US	Asset managers including Vanguard (9%), State Street (8%) and BlackRock (7%)	4%	n/a
Infrared Partners	UK	Private fund with limited disclosed information[5]	n/a	n/a
Terra Firma Holdings	UK	Primarily held by fund of funds and pension funds based in the US and UK	17%	n/a
Fujitsu Limited	Japan	Asset managers including Ichigo Trust (7%) and BlackRock (6%)	2%	n/a

Source: Capital IQ unless stated otherwise (please refer to the disclaimer on page 2)
1. As provided by Defence Economists
2. Please note that not all shareholder locations are disclosed, so whilst this is directionally useful, it may not be relied upon for accuracy
3. Source: Thales investor presentation (2019)
4. Source: Serco corporate responsibility report 2019
5. Limited public information as it is a fund (private company)