



The Spanish Defence Industry in the Face of Sector Consolidation in Europe

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Theme: This paper considers the need for a reformulation of industrial defence policy to enable the Spanish sector to adapt to a more integrated European market and to a new technological and strategic environment.

Summary: The Spanish defence industry has gone through a decade of strong growth, largely as a result of its participation in large-scale programmes for the procurement of military platforms. However, this growth model appears to have run its course and Spain's industrial sector must be adapted to an increasingly integrated European defence market and to the new strategic and technological demands of the Armed Forces. This reform will require that a strategy be developed for the participation of Spanish industry in the process of European consolidation, a revision of the Defence Ministry's current procurement policy, and a change in the sector's mentality and structure. All this should be reflected in a White Paper on the Spanish Industrial Defence Sector, prepared jointly by the Government and industry.

Analysis: These appear to be good times for the Spanish defence and security sector: total sales are now over €3 billion, having practically trebled in the past eight years.

Exports account for more than a third of total sales and have more than doubled in the same period to more than €1.3 billion a year. However, foreign sales have slowed down somewhat in recent years, in contrast to the strong growth in domestic demand.

Finally, employment has increased steadily, from 11,000 to more than 17,000 direct jobs. A large part of this has been highly skilled employment, resulting in a significant parallel increase in productivity.

However, not everything is bright on the sector's horizon. The growth in sales and employment is very closely linked to the development of the main arms programs, but most of these programs do not have much export potential, with the notable exception of the F-100 frigates. Spanish Defence Ministry financial projections also put in doubt some of the existing programs.

Furthermore, despite the growth seen in recent years, the size of the sector in Spain is very small compared with that of the largest countries in the Union, especially the United Kingdom, France and Germany.

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Finally, R+D+I spending in Spain is extremely low, particularly in the defence sector. The large amount of resources absorbed by the nine main arms programmes leaves very little margin to develop other programmes more closely linked to emerging technologies, especially in the field of information technology, electronic warfare, communications and intelligence.

Neither is this a homogeneous sector: The electronics subsector, for instance, has taken the lead in Europe in simulations systems and test banks, and is very competitive in radars, air control and other electronic defence systems.

For its part, the aerospace subsector has always been the mainstay of the Spanish defence sector and today it remains in the lead, both in sales and exports. However, its integration in a transnational company such as EADS has somewhat diluted its identity. The loss of control over the A-400M is a good example of how ground is being lost to France and Germany. However, this is now a consolidated sector that is on the rise and one that has a very solid industrial structure of small and medium-size enterprises. The aerospace subsector, meanwhile, is loudly demanding greater integration of the existing companies in order to consolidate sales volume and technological scale.

In the land-based sector, the Leopard and Pizarro programmes are currently at the forefront. The problem in this subsector is over-capacity on a European scale, also affecting Spain. We will have to wait and see whether there will be a move to remodel the sector on the expiration of the commitment by General Dynamics, owner of the main company in the sector, to keep open its facilities and maintain its workforce until July 2006. The lack of joint programmes, combined with the US capital invested in the company in Spain, could hinder its participation in a future process of European consolidation. In addition to Santa Barbara, there are other smaller but specialised and competitive Spanish companies in the field of explosives, arms and military vehicles.

The Spanish naval sector is also involved in a restructuring process. Following the bankruptcy of Izar, the newly created Navantia has taken over its portfolio of orders worth around €3.6 billion. The new company's lines of activity focus on naval construction (particularly military), although 20% of its work is in the civilian area. Its lines of activity will also include propulsion and energy, repairs and arms systems, all with a strong technological component, since the new company's more than 5,500 employees include a thousand working in engineering and R+D. Until the new company is fully up and running, it seems unreasonable to count on it to participate in any hypothetical European consolidation.

The growth model for the defence industry in the past decade seems to have run its course. Domestic demand is saturated to the point that the commitments taken on by the Ministry of Defence outstrip its medium-term financial capacity. Even if new forms of financing can be found to overcome this problem, the margin for setting up new programmes is certainly very small now. The programmes that have already been accepted are also generally very limited technologically, tending to be very mature systems with little export potential.

Furthermore, there is growing pressure to create a European defence market. This trend is developing at two levels: on the supply side, there is increasing sector consolidation. This is more advanced in the case of aerospace systems and is yet to be defined for the naval

and land-based systems. The demand side also shows incipient integration, both through action taken by the European Commission to make headway towards establishing a single internal market, and through the new European Defence Agency. For Spain's industrial defence and security sector, the creation of this European market is both an opportunity and a threat.

Sector Consolidation in Europe

The new capabilities required of Europe's armed forces, whether in the framework of the Atlantic Alliance or of the European Union, present an enormous challenge to the defence industry. If Europe's armed forces are to overcome their current projection and technology deficit the sector will have to make a considerable effort to provide the increasingly complex and integrated systems they require. The lack of available budget resources will also force the industry to be increasingly competitive. The dynamism of the defence sector in the United States will make it necessary for the industry to reformulate its strategy, intelligently combining trans-Atlantic cooperation and competition as necessary.

It is clear that only very large companies will have the financial and technological potential to take on this challenge. The costs of research, development and production of the new systems will continue to rise and only companies with great technological potential and the necessary economic resources will be able to deal with the uncertainties that any new project entails. Only large corporations will have the capacity to offer comprehensive solutions to new defence and security needs.

This does not mean, however, that small and medium-size companies are going to disappear from the sector. On the contrary, large corporations will tend to subcontract an increasing number of components and services to outside companies, making the strength and quality of this network of SMEs crucial to assure the competitiveness of the sector as a whole.

To respond efficiently to this challenge it is essential for the companies in the sector to continue the consolidation process on a European scale, going beyond simple integration and rationalisation of the defence industries within each country. However, the progress being made with this process of consolidation varies greatly from one subsector to another.

The Aerospace Sector

This sector is undoubtedly the one that has made the greatest headway towards full consolidation on a European scale, although this does not mean that it has reached the end of the road. The creation of EADS is the best example of this process of consolidation. However, contrary to what many people think, EADS is more a starting point than an end in itself. Despite the integration of the national capacities of Germany, France and Spain, this new trans-European company lacks the size and leadership in the defence sector to enable it to compete globally with the big American corporations.

The essential problem is the growing imbalance in the weight of the company's civilian and military activities, to the point of preventing the company from being a leader in the defence sector. In 2003, civilian equipment –essentially commercial aircraft– represented 80% of its total sales and 90% of its profits.

Although the company is hoping to see growth in its military sales in the next few years, its weight in the defence sector is clearly insufficient to enable it to be a competitor in the

global market. While Boeing, the reference point among US companies, has defence sales of over €27 billion –more than half its total sales–, EADS sells only €8 billion in the defence area –only a fifth of its sales–.

It does not appear that this imbalance will be corrected in the short- or medium-term. For example, the choice of combat aircraft for the next generation of the EFA has not yet even been made. Also, the warm reception received by the US F-35 programme in several European countries (a programme now in a state of great uncertainty) highlights how difficult it is for a strictly European fighter aircraft to finally come into being. To complicate matters further, France's choice of the unmanned combat aerial vehicle (UCAV) prototype has been entrusted to Dassault. All this leaves EADS in a delicate position in its quest to become Europe's clear leader in defence systems.

One way EADS could overcome this weakness in the strictly military terrain would be to merge with Thales. There have been insistent rumours to this effect throughout 2004, but Thales' official strategy does not appear to include new mergers for the time being. Even if the French company did try to merge with another company, there are many candidates, such as the French shipyard DCN, the French company SNECMA and even the British multinational BAE Systems.

Another possibility that EADS has considered to raise its military profile would be to purchase the Italian company Finmeccanica. However, up to now this company has based its strategy more on alliances with US companies and on the creation of joint ventures with BAE Systems than on developing ties with EADS.

EADS is also cooperating ever more closely with the manufacturers of Russian military aircraft, but for the big European multinational this relationship is more complementary than exclusive.

The second big European company in the aerospace sector is the UK's BAE Systems. This company's growth model is completely different to EADS'. BAE has opted for vertical integration, so that every member company contributes a different kind of value. Its commercial approach is also much more American than European. BAE has thus managed to establish itself as the Pentagon's sixth biggest supplier, making it by far the most successful European defence company ever to enter this market.

The main dilemma now facing BAE is whether its strong presence in the United States could end up leading to a merger with one of the big US defence companies. There are various military, technological and political factors that could push the company in that direction.

In any case, all these movements will have little impact on the Spanish sector, which is highly focused on EADS. Likewise, all these possible movements will affect EADS only relatively, except for the possibility that the electronics company INDRA becomes involved in one of these deals, as has sometimes been suggested.

The Naval Sector

The European naval sector is still moving towards consolidation on a national basis. Until the process is complete in each country, it is unlikely that a more ambitious project will be undertaken on a European scale. Germany has recently seen the creation of European

Marine Systems, integrating almost all the country's military shipyards. The new company will have sales of €2.2 billion and around 9,000 employees. Its creation puts Germany in a very good position to lead a process of European integration, but its managers are not planning to do so in the short term.

For its part, France has a plan to reduce its overproduction and increase the competitiveness of the DCN shipyards. The French government often speaks of consolidating the naval sector on the same model as EADS in aerospace. In addition to the big German company, this would also include the Italian company Fincantieri and the Spanish company Navantia, formerly Bazan. An alternative to this merger, however, would be a more vertical integration with Thales (also French), though this option would seem to be weakened by rumours of a merger between Thales and EADS.

A process of national consolidation is also underway in the UK. This process, however, depends on the British government's commitment to develop a 15-year building plan for the Royal Navy to provide the necessary stability on the demand side. It seems very unlikely that this new company will take part in a more ambitious consolidation process on a European scale.

The model for a possible European naval consolidation has therefore been neither decided nor defined. There is room for the EADS model of horizontal integration or, on the contrary, a model of vertical integration that would associate Germany's European Marine Systems or the French DCN with BAE Systems, Thales or EADS, to provide greater capacity in electronics. In any case, such movements seem very unlikely in the near future. However, through its new company, Navantia, Spain could play a relevant role in this process.

The Land-based Sector

The land-based arms sector is the one in the worst position to face the consolidation process. Multinational cooperation programmes in this subsector have not only been less numerous and relevant, but there is also great capacity for overproduction in practically every country.

For the moment, all that is sure is that consolidation is underway at the national level: in the UK after the acquisition of Alvis by BAE; in Germany, where the sector is larger, the process has not yet begun, but there is great pressure on the government to definitively force a merger of the main companies, following the example of the naval subsector; in France, there are plans to reduce GIAT's large excess capacity, but this is a complex process that will take a long time to complete. Until these national processes are successfully completed it will be difficult to address the necessary consolidation at the European level.

Further complicating this process is the American presence in the land-based sector, especially after the acquisition of the Spanish company Santa Barbara by General Dynamics. This presence makes Spain's likelihood of participating in a hypothetical European consolidation in this subsector more remote.

Towards a Single Market?

On the supply side we have seen that there is a trend toward increasing consolidation of the sector on a European scale –a slowly advancing process not lacking in difficulties–. On the

demand side, too, there is a trend towards greater integration through a common procurement policy. However, the difficulties involved in integration on the demand side are even greater.

Nonetheless, it is unquestionable that the political will exists in the European Union to make headway towards the creation of a single defence market. There are three reasons for this single market to exist: first of all, the European defence industry can only be competitive at the global level if there is such a single market; secondly, the European defence industry can only satisfy the need for materiel under the new Common Defence and Security Policy if it is truly competitive in technological and industrial terms; finally, the distinction between defence technologies and strictly civilian technologies is increasingly tenuous. This means that in the long term, civilian and military markets will increasingly interfere with each other.

Various instruments have been created to try to stimulate the common defence market, although to date most multilateral initiatives have been promoted outside the framework of the European Union itself. Such is the case of the Letter of Intent signed by the six main European arms producers in 1998, which in 2001 became a Framework Agreement with the standing of an International Treaty. This Letter set out to stimulate the creation of a single market by creating a set of conditions in its signatory countries, such as secure supply, harmonised export procedures, secure information, treatment of technical information and harmonised military requirements.

For its part, the OCCAR, an organization that originated in a Franco-German agreement in 1993, has set out to create a common structure for managing military programmes. In 1996, Italy and the UK joined, followed by Belgium in 2003 and Spain and Holland in 2004. The great novelty of OCCAR is that for the first time the principle of fair return has been abandoned. According to this principle, every country participating in a programme has the right to an industrial share equivalent to the percentage it has contributed financially to the programme. This principle led to great rigidity in the management of programmes and made them significantly more expensive. However, ending it may give an advantage to the countries with the most technologically advanced sectors, to the detriment of the least advanced. To a great extent, this explains Spain's delay in joining the organization and the suspicion that it still raises in some Spanish industries.

Although Article 296 of the Treaty establishing the European Community provides a safeguard for the defence sector in the Common Market, the European Commission has in fact had something to say about this issue. In recent years, the Commission has issued three statements on the defence market: the first in May 1996, the second in November 1997 and the third in March 2003.

In the first statement, the Commission addressed a double challenge: the sharp fall in the demand for defence products and the need to create a European identity for security and defence. The Commission expressed its concern over the fact that only 3%-4% of systems were procured within the Community, while 75% were imported from the United States. It also reported that the increasing fragmentation of the sector was reducing its competitiveness.

In its most recent statement, the Commission said that the consolidation achieved by the sector in recent years, as well as the boost given by the European Security and Defence

Policy, make it essential that EU policy on defence equipment be more coordinated. In the Commission's opinion, the ad hoc agreements signed by some European countries require 'the support of a more coherent global framework that provides greater legal security and attracts the participation of a greater number of member states'.

As a continuation of this last statement, the Commission recommended the preparation of a Green Paper, which was finally approved in September 2004. The paper establishes two basic options for achieving greater market unity: either the Commission prepares a Statement establishing the criteria for deciding when the exception established in the Treaty establishing the European Union can be applied to the production of defence products, or else the Commission proposes a Directive to coordinate the procedures for defence procurements in those cases in which the exception in EC Article 296 is not applicable, or even in all cases, if certain member countries voluntarily opt for this.

Through the creation of the European Defence Agency, efforts that until now have been made in other multilateral forums to develop a single defence market and to consolidate the sector, are now being dealt with at the European Union level. The Agency therefore represents a new and highly significant boost in this area.

Officially known as the European Armaments, Research and Military Capabilities Agency, the European Defence Agency was finally included in the constitutional treaty that is now in the ratification process. Article III-311 of the Treaty establishes that this body will be open to all member states who want to join and will be attached to the Council of Ministers. However, participation in the Agency and in all its projects is voluntary, so that the number states actually involved will be fundamental to the success of its initiatives.

Many voices express significant scepticism regarding the practical effects of all these initiatives. It is true that procurement policies remain in the hands of the national defence ministries and it does not seem that this is going to change in the short or medium term. However, it is also undeniable that the creation of the Agency could give a new boost to the harmonisation of requirements and the development of a common R+D+I policy for the defence and security sector, which would have a considerable impact on the future orientation of arms systems and on the rationalisation of capabilities in the framework of a Common Defence Policy. The ambition and speed with which these goals are achieved will depend on the dynamics of the Agency itself, but the sector should be prepared to operate in a context that will necessarily be more integrated.

Conclusion: In terms of its defence industry, Spain is a middling power in the European Union. This implies that, whereas the main European industrial powers, such as Germany, France, Italy and the UK have taken a position in favour of a single European defence market, the Spanish position ought to be more balanced in order to protect the country's growing domestic defence sector, which is still far smaller than those of its larger European partners.

Spain must therefore define what role it wishes to play in this process of consolidating the sector on a European scale –a process that appears inevitable in the medium and long term–. In this regard, the experience acquired by Spain's CASA in its integration in the big aerospace consortium EADS is positive in many ways; however, it should also prompt us to reflect on how to defend more efficiently Spanish national interests in the framework of these large transnational companies. These lessons are necessary in order to tackle other

processes of consolidation in the naval, land-based and electronics sectors. Furthermore, the EADS model need not be imitated by other subsectors; all options should be explored. Protecting our industrial fabric of small and medium-size industries in the sector should certainly be a priority.

Spain has traditionally been one of the members of the EU to most strongly support a common defence policy and, as part of this policy, a growing integration of demand. Spain has not only participated in most of the big pan-European arms projects –the EF-2000, the A400M, the Tiger and the Meteor, among others– but has also been part of the main multilateral initiatives –LoI and OCCAR– and was the first to promote what is today the European Defence Agency. Spain’s goal now is to try to safeguard its industrial and defence interests in the increasingly multilateral framework it has helped create.

Spanish industry must redefine its strategy for growth and must focus on participating in a European market that is certainly much bigger than the small domestic market, but is also much more competitive. This strategy necessarily involves greater specialisation, consolidating technologically rich niches and developing a better policy for transnational alliances.

For its part, the Ministry of Defence should refocus its procurements policy towards the programmes that most contribute to developing an industry that is technologically more advanced, more innovative and more competitive in this European framework. By making this contribution, the Spanish government will also be helping to bring about a necessary transformation of the country’s military capabilities to adapt them to the new global strategic context. All this should be reflected in a White Paper on the Spanish Industrial Defence Sector, prepared jointly by the government and by the industry itself.