



Institut de Relations Internationales et Stratégiques

**INDUSTRIAL AND STRATEGIC
CO-OPERATION MODELS FOR ARMAMENTS
COMPANIES IN EUROPE**

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CHAPTER 1 : Germany

I. THE ECONOMIC AND INDUSTRIAL MODEL OF THE GERMAN DEFENCE INDUSTRY

The configuration of the German armaments industry and the rather particular place it currently occupies in the country's economy are shaped, above all, by the consequences of capitulation in 1945. Following the destruction and dismantling of all production capacity, the armaments industry was gradually rebuilt during the 1960s. Today, certain areas of production are even larger than those of the British and French industries. As a result of the collapse of the Soviet regime and unification, the military budget declined sharply and increased focus was given to civil technology. This focus has always been a characteristic of arms production in Germany¹.

The armaments industry was reconstructed differently depending on the sector concerned. In the aeronautics sector, where Germany had been a leader prior to the war, the industry was held back by the imposition of multiple international restrictions. Technological knowledge in this case was gained via participation in co-operation programmes. However, in the territorial industry and naval construction, German industrial companies were able to use their own skill and improve rapidly, without the need for external help.

One of the distinctive traits of German industry concerns the gradual development of an aeronautics and defence sector centring around Daimler-Benz. Since 1984, this group has acquired companies specialising in electronics (AEG, Telefunken, Siemens-Sicherungstechnik), engines (MTU) and in aeronautics (Dornier, Fokker, Messerschmidt-Bölkow-Blohm [MBB]) to form one single subsidiary, DASA. DASA has become national aeronautics champion, bringing together the largest companies of these sectors (apart from Dornier Luftfahrt GmbH, which was sold back to the American, Fairchild, in 1996 and Diehl whose subsidiary, BGT, specialises in missiles). DASA is, by a long margin, the largest supplier of the Bundeswehr (Tornado, EF 2000, Tiger, NH 90, etc.), however, thanks to

¹ For further information, see Joachim Rohde, "German Defence Industry and Defence Industrial Policy", ESAN-Projekt "Arms Production and Cooperation", Paper No. 10, SWP Ebenhausen, 1997, as well as "French-German Arms Cooperation : Issues and Perspectives", in : *Les relations franco-allemandes : état et perspectives*, IFRI reviews, No. 25, Paris, 1998, p. 69-108 ; see also *Military Technology*, Vol. XXII, Issue 2, 1999 : "Defence Procurement in Germany".

Airbus, it is achieving the greater part of its turnover in the civil sector. The other aeronautics companies are small and medium sized specialist suppliers.

A second sector of the armaments industry centres around naval construction. German naval construction generates a turnover of more than 10 billion DM, a third of which stems from the military sector. It is divided into two groups according to size. Firstly, the large naval construction sites of Howaldtswerke Deutsche Werft AG in Kiel (HDW), Blohm & Voss GmbH in Hamburg and the Thyssen Nordseewerke GmbH in Emden (TNSW), and secondly several average-sized companies such as Lürssen Werft GmbH & Co in Bremen (FLW), HDW specialising in non-nuclear submarines, Blohm & Voss in frigates, FLW in small surface ships and corvettes. All these companies are active exporters (HDW, TNSW and Ferrostaal in the German Submarine Consortium, Blohm & Voss, HDW and Thyssen Rheinstahl Technik in the German Frigate Consortium). Lately, naval construction has been undergoing considerable change : in 1995, Blohm & Voss and TNSW were restructured and recombined as a holding company, Thyssen Werften GmbH. Having sold 50% plus 1 share of HDW to Babcock Borsig at the beginning of 1999, Preussag is now about to give up the remainder of its stake in HDW to Celsius. Thus giving birth to a new German-Swedish construction company (HDW and Kockums Naval Systems) which will be the largest constructor of (non nuclear) submarines in the world.²

The territorial armaments industry is also undergoing restructuring. In view of the drop in military orders, companies in this sector have undertaken a major process of diversification over the past few years. At the same time, there is a strong trend towards concentration : following several mergers and take-overs, only three main players remain in the field of tank and armoured vehicle construction : IWKA AG (Henschel and KUKA), Krauss-Maffai Wegmann GmbH and MaK-Rheinmetall. Henschel and KUKA specialise in mechanised combat vehicles, Krauss-Maffai Wegmann and MaK in battle tanks. The fact that the latter were selected to manufacture GTK put pressure on IWKA AG to merge its activities with the winning team. If this merger goes ahead, there will be only one major German player which, thanks to its technological excellence, will probably assume the leadership of restructuring on a European scale. Due to its activities in the field of tanks, vehicles, canons and electronics, Rheinmetall will doubtless be the central focus of these developments.

² FAZ, 28.5.1999, S. 16.

Since its reconstruction began, the German armaments industry has remained largely private. The exception has been the major stake held by certain Länder (Bavaria, Hamburg, Bremen) in the capital of MBB, but this participation came to an end following the acquisition of MBB by Daimler-Benz (except for Hamburg, see below). On a federal scale, the State has never been a shareholder in the defence industry.³ The decision not to become involved as an industrial player reflected a widely held view in German society, but it was also intended to make it easier to transfer technology towards civil industry. From the 1950s and 60s onwards, the idea was to combine the defence and civil industries for the benefit of the economy overall.

Today, the influence of this idea is manifested in several characteristics of the defence industry structure : firstly, the majority of the main arms manufacturers also boast considerable civil activity. Even during the cold war, very few major defence companies generated more than 30% of their turnover with military activity. Only a few medium-sized industries (such as Wegmann and Diehl) and a good number of sub-contractors and suppliers are less diversified.

Secondly, the main players in the German armaments industry are all part of major industrial groups which are most active in the civil sector. This is the case both for territorial armaments (e.g. Röchling), naval construction (Thyssen) and aeronautics (DaimlerChrysler).

Thirdly, armaments companies have developed the same mode of governance as firms in other sectors. Legally, the majority are limited liability companies (GmbH), but there are also a few public limited companies (AG). While the structure and operation of AG companies are predominantly governed by law, the GmbH companies have a fair degree of freedom regarding their internal organisation. At the risk of generalising, certain characteristics can be highlighted, which are true for all companies :

a) Participation of salaried employees in managing companies :

Large German companies (more than 500 employees) have dual leadership. There is a Supervisory Board and a Board of Directors consisting of the company directors. The supervisory board monitors the management's activities and for certain important decisions

³ Up until 1992, the Federal State did however hold an indirect share of 20% via the Kreditanstalt für Wiederaufbau (KAW) in Deutsche Airbus GmbH.

holds a power of veto. The two boards are independent of each other because it is impossible for one person to be on both at the same time. In companies of more than 2000 employees, the supervisory board consists half of employees (personnel and union representatives), and half is appointed during the shareholders' general meeting. Nonetheless, the presence of employees on the supervisory board is tempered by the fact that the Chair of the board is always a shareholder representative and his or her vote is decisive in the event of a controversial decision.⁴ Nonetheless, employees are very much involved in the decision making process, both via the supervisory board and the board of directors. Furthermore, many German directors have often spent their entire careers with the company, having joined very young, which helps strengthen internal culture and ensures employees at all levels are taken into consideration. On the other hand, the need to reach a consensus with the employees can slow down the decision making process, thus depriving the company of a certain degree of flexibility.

b) The importance of banks :

Banks and companies traditionally enjoy a very close relationship in Germany. Banks act first and foremost as financial organisations. During the period between 1991 and 1994 for example, 83% of external funding for German companies was obtained via credit from banks. But banks are also major shareholders. It is estimated that in 1993, banks had majority control of at least 24 of the 110 largest companies and nearly 14% of overall company capital.⁵ These shares have often been acquired under extremely favourable circumstances in the first restructuring phase. Banks also wield influence over the decisions of companies via the voting rights bestowed by their clients who are shareholders (presuming agreement on their part). Thus, they must manage the shares that they hold on their clients' behalf because they are responsible for their depositors' savings. They make a considerable contribution to the merger-acquisition process, encouraging restructuring when they deem it necessary. Banks can also participate in shoring up companies in difficulty by increasing their share capital.

c) The presence of reference shareholders :

Compared with Great Britain or the United States, individuals and retirement funds in Germany hold a small percentage of the capital of companies listed on the stock exchange.

⁴ See Aktiengesetz, GmbH-Gesetz, 30. Auflage 1998, dtv, München 1998.

However, cross-holding of shares is abundant and the proportion of company capital held by shareholders is also considerably greater. At the beginning of the 1990s, the majority of AG companies in Germany had one reference shareholder who held at least 25% of the capital. The five largest shareholders held more than 40% of the capital of companies compared with a fifth in the US and a quarter in the United Kingdom.⁶

For German industry in general, globalisation has begun to profoundly modify some of these characteristics. Since the economic crisis of 1993 for example, the number of German companies listed on the stock exchange has continued to rise. Therefore, external funding is coming less and less from banks and more and more from capital markets where large institutional investors such as (international) investment funds become the major players.⁷ This has important effects on corporate governance. Once the financial markets become involved in power and control issues, the companies are obliged to implement practices that stem traditionally from the Anglo-Saxon model. From the companies' point of view, the share becomes a product that must be sold to the investors, and to do this, the creation of value for the shareholders, the famous *shareholder value*, is an absolute necessity. Company directors must report on their strategy and profitability and communication with shareholders takes on primordial importance. Investment bank analysts are demanding new transparency and are forcing companies to divulge much more information. The major investment funds thus become front-line stakeholders and directly influence the governance of the companies in which they hold shares. As a result, part of the control is moved outside the company.⁸

The majority of German armaments companies are not (yet) affected by these trends. They are GmbH companies and therefore not listed on the stock exchange. Among the main arms manufacturers, only Rheinmetall AG is listed, but it has a block shareholding (67.5% held by Röchling). The situation is the same for Thyssen Krupp AG, listed on the stock exchange and with a subsidiary in the armaments sector (in this case the reference shareholders are Krupp Stiftung with 16.75%, Thyssen Beteiligungsverwaltung and Thyssen Stiftung with 7% and 5% respectively, as well as Iran with 7.5%). This increased concentration of shareholders undeniably encourages internal monitoring. Bearing in mind the stakes in play, major

⁵ See OECD, "Germany", Economic Studies of the OECD, Paris 1995 ; Stephen Prowse, "Corporate Governance", in : Revue d'Economie Financière, No. 31, Hiver 1994.

⁶ Ibid.

⁷ Deutsche Bank, "Kapitalmarktstatistik", statistisches Beiheft zum Monatsbericht, May 1999

⁸ See Franz-Josef Leven, "Aktienkultur in Deutschland", in : Norbert Frei, Christoph Schlienkamp : Aktie im Focus (not yet published) ; Georg Weishaupt, "Vorstände kritisieren die Macht der Fonds", in : Handelsblatt, 10.5.1999, p. 37.

shareholders must take an interest in the companies they own, and cannot delegate all management responsibility to the managers. On the other hand, the existence of reference shareholders can mitigate the pressure for short-term profitability, and enable the directors to calculate on a long-term basis.

Despite the lack of direct pressure from the financial markets, defence companies have nonetheless had to undertake in-depth rationalisation since the beginning of the 1990s. In just a few years the armaments industry has shrunk dramatically, causing 140,000 out of 280,000 jobs to be lost. This consolidation demonstrates that private companies, listed on the stock exchange or not, cannot escape from the economic logic imposed by the reduction of defence budgets. Nonetheless, the more the large groups and their shareholders become international, the more they are obliged to ensure that their defence subsidiaries adapt as well to financial market requirements. Daimler Chrysler and DASA are a classic example of this.

II. THE GERMAN MODEL OF THE STATE-INDUSTRY RELATIONSHIP

The fact that the federal State is not a shareholder in defence companies does not mean that it does not have a role to play regarding these industries. On the contrary, as client, regulator and sponsor, its influence over the industrial and technological basis of defence is considerable. With the resources it has at its disposal, the German government follows an industrial defence policy that indeed has always been closely tied to the policy of forming alliances. During the cold war, Bonn considered co-operation on armaments issues above all as a political way of consolidating its integration into the Western camp and of strengthening the ties with its main partners. This perspective has not changed with the fall of the Berlin Wall. Even if financial logic is also pushing in this direction, Germany's current commitment to a European industrial and technological foundation and to transatlantic co-operation, is still largely spurred on by political considerations – to develop a European defence identity and maintain the cohesion of the Atlantic alliance.

At the beginning of the 1990s, the Federal governments industrial defence policy was, however, notable by its absence. Faced with budget cuts, the only instrument used by the *BMVg* (Bundesministerium der Verteidigung, ministry of defence) was to give up equipment procurement, leaving the companies alone to meet their fate. The result was a drastic shrinkage of the defence industry, with the elimination of 50% of the jobs. In 1992, it became

clear that Germany risked losing the heart of its defence industry if the process continued uncontrolled. In collaboration with industry, the government therefore initiated an analysis of the situation in order to define capacity and the minimal essential aptitudes. On the basis of this assessment, the procurement calendar was modified so as to maintain key R&D capacities and to stabilise the use of manufacturing capacity at a minimal level.

Since then, the objective of Germany's industrial defence policy has not changed. The preservation of key capacities despite budget constraints remains a priority. Of course, this policy aims to protect jobs and technological know-how. But just as important a reason is that these industrial assets are politically indispensable if Germany wishes to participate in the construction of a European armaments structure, considered as an integral part of a pan-European defence plan.

II-1. The State as Regulator

By law, the German government has very few instruments at its disposal for exerting any influence over the alliance strategies or commercial activities of companies. It does not hold any "*actions spécifiques*", or any other rights of this sort over these industries. Nor are there any legal restrictions regarding the foreign investment in the capital of German companies. Anti-trust laws do exist, but they do not play a major role at a time when the government is seeking consolidation.

However, major restrictions exist with regard to exports. Article 26, Paragraph 2 of the German constitution specifies that "war weapons shall only be manufactured, dispatched and sold with prior government agreement. The details shall be covered by a Federal law" This federal law is the *Kriegswaffenkontrollgesetz* (KWKG) of 1961. The KWKG includes a list defining the notion of "war weapons" and confirming that the production, holding and dispatching of a war weapon requires government approval. Under the KWKG, weapons manufacturers do not have the right to export. The export of weapons *may* be forbidden if, for instance, it would be detrimental to Germany's overseas interests. Exportation *must* be forbidden if the weapons risk being used for the purposes of a war of aggression. The conditions under which military equipment and dual-use technology can be exported are set out in the *Aussenwirtschaftsgesetz* (AWG). Unlike the KWKG, the AWG is based on the principle of free trade. The exporter must request a licence, but such a licence may only be refused if the security and overseas interests of Germany and international peace so require.

Exports to NATO member countries are, in theory, unlimited.⁹ Nonetheless, the manufacturer must firstly request a licence and prove that the weapons will indeed remain in the purchaser's country. For co-operation projects based on intergovernmental agreement, the conditions governing transfer and export are set out in the agreement protocols (MoU). The procedure becomes more complex for companies desiring co-operation without prior governmental agreement. In this case, the German company needs a licence to transfer equipment, unless it is only providing components or sub-systems which represent less than 20% of the whole weapon system. In principle, export to non-NATO member countries is forbidden, unless the vital interests of the RFA or the alliance require it. Employment-related issues should not feature among the considerations, and exports should not lead to additional production capacity. In 1982, the government specified that military equipment should not be delivered to regions where there is a risk of armed conflict.

Companies wishing to export weapons (under export licence) must request official authorisation from the *Bundesamt für gewerbliche Wirtschaft*, an agency reporting to the ministry of the economy (BMW_i). If it is not just a routine case, the opinion of the ministry of foreign affairs and the ministry of defence and (since the victory of the "red-green" coalition) the ministry of economic co-operation (BMZ) must be sought. If these opinions are divergent or if the case is a difficult one, the BMW_i calls on the Security Council, the standing members of which are the Chancellor and the ministers for the Economy, Finance, the Interior, Foreign Affairs and Defence. In practice, companies ask questions beforehand to ascertain their chances of success.

There is a long-standing debate over to what extent the export regulations put German industry at a disadvantage beside international competition. According to the companies, co-operation potential with European partners is also curbed by legal constraints. However, it is not the legal framework in itself that sets Germany apart from its main partners in this area, but the reticence shown with regard to using exports to strengthen the industrial foundations and pursue political objectives on a global level. The KWKG as well as the AWG leave the government quite considerable room to manoeuvre, and the way that the law is applied varies significantly depending on the sector. The naval construction sector, for instance, meets with little difficulty in selling its products on the world market and even benefits from political

⁹ A certain number of other countries such as, for instance, Switzerland, Austria, Sweden and Japan have the same status.

support in its export activities. As a result, it alone represents 50% of all military exports. As regards territorial armaments however, restrictions are more strictly applied. In the aeronautics sector, where practically all projects are carried out as part of European co-operative ventures, the export issue is resolved by the MoU which shares out the international contracts among the members, usually allocating the not too "sensitive" regions to German companies.

II-2. The State as Client

While the armed forces are responsible for specifying their needs, the procurement of weapons systems is the responsibility of civil bodies, namely the "armaments" section within the BMVg and the procurement agency (*Bundesamt für Wehrtechnik und Beschaffung*, BWB). The latter reports to the ministry and acts as a contractor to the industry.

The legal basis for awarding military equipment development, procurement and maintenance contracts is the *Verdingungsordnung für Leistungen* (VOL). According to the VOL, the contract needs, in principle, to be awarded following a call for tender. Under certain conditions however, the government can limit the bids or even dispense with the invitation to tender (*freihändige Vergabe*). Regarding armaments, the exception is however the rule. Here, more than three quarters of the orders are placed without competition. The explanation is simple : given the complexity of weapons systems, there are very few companies capable of carrying out such projects. The lack of competition is also shown by the type of contracts awarded by the BWB. Half of these are contracts at cost price, and even if the BWB awarded contracts at market prices, the actual prices are usually only calculated on the basis of the cost of comparable products – which, after all, leaves rather a lot of room for interpretation.¹⁰

As the government does not hold *actions spécifiques*, the awarding of contracts is its only tool for influencing industry restructuring. The decision to attribute the GTK project to Rheinmetall and Krauss-Maffai for example, was also intended to create a single industrial pole in territorial armaments. In the case of BAe's share in STN-Atlas, the government took advantage of its status of principle client to make it clear that the company must remain German in majority. This client influence diminishes, naturally, as soon as there is a

¹⁰ Reinhard Hild, Michael Breitenbacher, Bernhard Pieper : Die deutsche Luft- und Raumfahrtindustrie – Strukturanalyse und Handlungserfordernisse, ifo studien zur indusriewirtschaft, n° 52, München 1997, p. 132-137.

monopoly. The same thing happens if the economic weight of the bidder is significant enough to "dissuade" any "retaliation". This is the case for example for DASA, the parent company of which is all powerful both as employer and tax payer.

Current plans for the armed forces are based on five-year financing plans which are updated and adjusted each year in accordance with the real costs of the past year. The plans are drawn up by the Inspector General in collaboration with the leaders of the three armed forces and the "armament" and "budget" sections of the ministry. Then, they need to be approved by the minister and parliament. The *Bundestag* also decides how much of the budget is to be invested. Defence and budget commissions examine, on a case-by-case basis, the major procurement projects and must approve each procurement contract of over 50 million DM.

Current plans for the *Bundeswehr* emphasise mobility and the projection of forces. The territorial army includes transport helicopters (NH 90) and support helicopters (UHT), the new armoured transport vehicle (GTK) and a new artillery system (PzH 2000) as well as the modernisation of the Leopard assault tank and the development of a digitised C2 system. For the Air Force, the ATF is a priority, to which can be added the EF 2000 with air-to-air missiles of both short and medium range, as well as a cruise missile for the Tornado. Other programs are the development of MEADS (*Medium Air Defence System*), the modernisation of Patriot (PAC III) and SATCOM, a satellite communications system. For the marine forces, the plans include the acquisition of four F-123 frigates, three F-124 frigates, four 212 submarines, 15 130 corvettes, two refuelling ships, new maritime patrol aircraft and a new on-board helicopter.

In view of budgetary constraints, this programme seems very ambitious. The defence budget has diminished in real terms by more than 24% since 1991. With 1.53% of gross domestic product, Germany now spends less on defence than most of its fellow NATO members (2.29% on average), and this figure is continuing to drop. What is worse, R&D and procurement spending dropped from 15.3 billion DM in 1990 to 8 billion in 1994, to then stabilise around 8.5 billion DM. The invested proportion of the budget remains low (25.4% in 1999) and the objective of 30% by the year 2002 hardly seems feasible without restructuring the armed forces, the only way to make (even) more savings on operating and staffing costs.

As BMVg's main client, DASA was sharply affected by the budget cuts that caused, between 1990 and 1995, a more than 60% drop in procurement in the military aeronautics sector alone. During this period, DASA's situation was made even more difficult because the collapse of the military market coincided with the civil aviation market crisis. Since then, the situation has improved. Over the period from 1995 to 1998, DASA made a military turnover of 19.854 million DM, of which 5.248 million were for R&D contracts (BMVg exclusively) and 14.609 million for procurement and maintenance contracts (BMVg and foreign). In 1998, the BMVg dedicated 2.531 million DM to R&D, of which DASA received 1.483 million. DASA's turnover in the military field between 1995 and 1998 (in million DM) is shown below :

DASA's Turnover in Military-Related Business

	1995	1996	1997	1998	1995-98
Procurement & Maintenance (1)	3.404	3.840	3.468	3.887	Σ 14.609
Research & Development (2)	1.248	1.160	1.357	1.483	Σ 5.248
Total	Σ 4.652	Σ 5.000	Σ 4.825	Σ 5.380	ΣΣ 19.857

(1) National and international contracts combined

(2) BMVg contracts alone

II-3. The State as "Sponsor"

In Germany, the defence companies do not receive direct subsidies. However, the integration of civil and defence companies partly obscures the reality of the situation. To what extent, for example, does naval construction benefit from subsidies allocated to construction sites in general ? The same problem arises in the aeronautics and space sectors where the government subsidises civil research with two national programmes, the *Luftfahrtforschungs- und Technologieprogramm* and the *Raumfahrtprogramm*. (In the context of these programmes, the ministries of the economy and of research contribute up to 50% of the costs of a research project).

Total Federal Spending in the Aeronautics Sector

	1995	1996	1997	1998
1. All civil aeronautics projects	471	349	352	333
1.1 Research and technology (BMBF)	208	230	261	263
1.2 Research and development (BMW i)	142	98	35	30
1.3 Funding of the buyers' market (BMW i)	121	21	56	40
1.4 Risk of Airbus change (BMW i, end 1992)	-	-	-	-
2. Military projects	4,966	5,298	5,031	5,845
2.1 Research and Technology (BMVg)	253	263	235	291
2.2 Development (BMVg)	1,362	1,524	1,428	1,305
2.3 Procurement	1,501	1,741	1,613	2,559
2.4 Maintenance	1,850	1,770	1,755	1,690
3. Space	1,659	1,618	1,628	1,704
3.1 ESA (BMBF)	1,092	1,034	999	1,000
3.2 National programme, including DLR (BMBF)	491	517	451	445
3.3 Weather satellites, Eumetsat, ESA (BMV)	60	67	178	259
3.4 Telecommunications satellites	16	n.v	n.v	n.v
Total	7,096	7,265	7,011	7,882

*BMBF = Ministry of Education and Research,

BMW i = Ministry of the Economy,

BMVg = Ministry of Defence,

BMV = Ministry of Transportation,

BMPT = Ministry of the Postal Service and Telecommunications (the postal service was privatised in 1996)

During the period from 1995 to 1998, DASA benefited considerably from these programmes. Of the 600 million DM that the government contributed in the context of its *Luftfahrtforschungs- und Technologieprogramm* to the civil aeronautics industry as a whole between 1995 and 1998, DASA received 254.8 million. To which should be added the 238 million DM in assistance to the funding of the buyer's market for Airbus.

**Subsidies Received by DASA in the Context of the
Aeronautics Research Programme**

1995	1996	1997	1998	1995-98
42.9	73.4	77.6	60.9	Σ 254.8

* Approximately 8 million DM provided by BMWi, the rest by the BMBF.

During the same period, DASA received 396 million DM for its space activities in the context of the national programme and 3,749 million DM from the ESA programme, to which the federal government contributed 4,125 million DM.

**Subsidies Received by DASA in the Context of the
Space Research Programme**

	1995	1996	1997	1998	1995-98
Infrastructures	15	18	7	20	Σ 60
Satellites (*)	84	84	84	84	Σ 336
Total	Σ 99	Σ 102	Σ 91	Σ 104	ΣΣ 396

(*) average

Compared with that of its main partners, the Federal Republic's industrial defence policy is rather modest. As regulator, the State exerts considerable influence in the field of exports, but it does not participate in specifying the strategic direction of the companies at all. In this context, it is interesting to see that the plans for an EADC (*European Aerospace and Defence Company*) – as envisaged last year – would most likely give the German government more stakeholder rights than it currently holds in relation to its national industry.

As client and sponsor, the German State keeps its commitment to a minimum, even in the "strategic" sectors of aeronautics and space. It is true that the government has just decided to extend the civil research programmes, but the funding (600 million DM over five years) seems far from being assured. The disagreements between the federal government and the *Länder* over the distribution of costs on the one hand and the new strict budget plan of the Finance Minister on the other, are liable to bring the whole programme into question again. The awarding of some major contracts, Eurofighter and Tiger for example, provide a more solid basis for planning and establishing schedules for the companies. However, overall, the planned modernisation of the armed forces will still be difficult to fund. Given that the defence budget will be gradually dropping from 47.05 billion in 1999 to 43.7 billion in 2003, we are bound to see, in the coming years, an increasing gap between orders and available financial resources. The situation will doubtless become critical when several major programmes, such as the Eurofighter, the frigates or the PzH 2000 enter the manufacturing phase.¹¹ It would therefore come as no surprise if current programmes undergo further delays and cuts.

Budgetary constraints also weigh heavily on the government's ability to influence industrial restructuring. The Federal Republic's inability to participate in the Hélios and Horus programmes for example was a major factor leading to the failure of a planned Joint Venture project between DASA and Aerospatiale in the satellite field. Lacking golden share, on the one hand, and a structuring programme on the other, the companies follow their own industrial logic which does not necessarily coincide with the government's political aims.

¹¹ Franz-Josef Meiers, "A German Defense Review", unpublished manuscript.

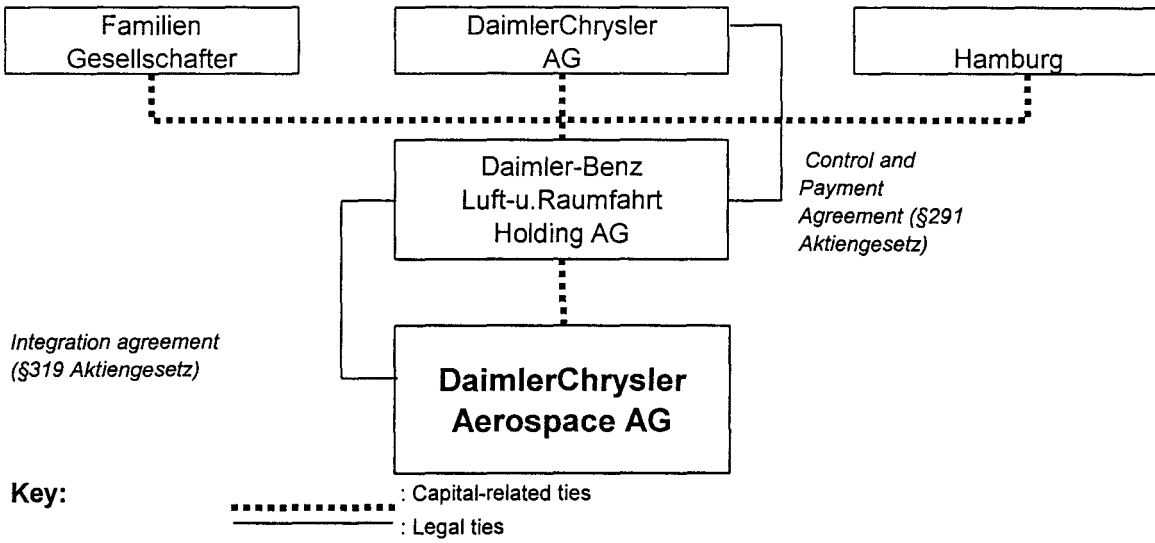
III. ANALYSIS OF THE STRATEGIES AND SPREADSHEETS OF THESE COMPANIES : THE EXAMPLE OF DAIMLERCHRYSLER AEROSPACE (DASA)

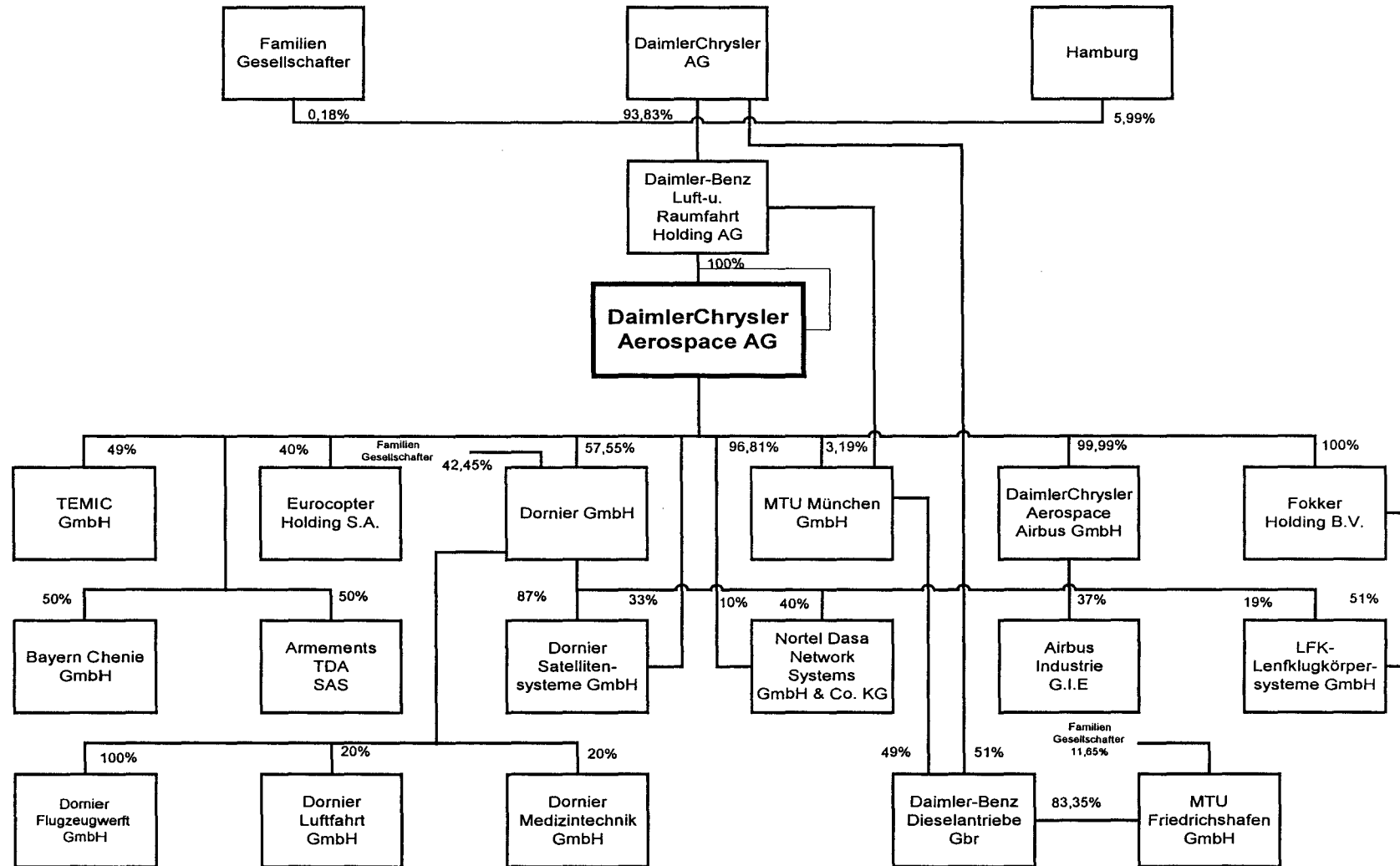
DASA is a conglomerate of around thirty companies divided into six sectors of activity. Three of these sectors are organised as subsidiaries (civil aircraft and helicopters, satellites, machinery), the other three as divisions (combat aircraft, space, and in part defence, infrastructure and civil systems). The latter three are not independent, and are directed by DaimlerChrysler AG. In legal terms, DASA AG, DaimlerChrysler Airbus GmbH, Dornier GmbH, Eurocopter GmbH and MTU GmbH constitute the DASA *konzern*.

DASA AG is both an AG company under German law, not listed on the stock exchange, and a subsidiary of the DaimlerChrysler group. Like Debis (services) and "directly managed shareholdings" (Adtranz, MTU-Diesel, TEMIC), DASA is part of the non-automobile section of the group. The ties between the parent company and its aeronautics and defence subsidiary are as much capital-related as contractual.

With a 93.83 % stake in Daimler-Benz-Luft- und Raumfahrt Holding AG, which possesses 100 % of DASA, DaimlerChrysler is by far the major shareholder (5.99 % of the Holding belongs to the city of Hamburg, 0.18 % to *Familiengesellschafter* (Blohm, Bölkow, Dornier and Messerschmitt-Stiftung). This share is the capital-related basis for DASA's domination by DaimlerChrysler.

Legally, DASA is an integral part of the holding company that was created in the 1980s to act as a common roof over the different aerospace and defence companies bought by Daimler-Benz. However, this holding company is now nothing but an empty shell, existing purely for tax reasons. Of more importance is the control agreement (*Beherrschungs- und Gewinnabführungsvertrag*) between the holding company and DaimlerChrysler. This contract both delegates management of DASA to DaimlerChrysler, and notifies DASA of its obligation to hand its profits over to DaimlerChrysler. According to German law, this structure is a *konzern* in which DASA is an affiliated group belonging to the parent company DaimlerChrysler.





Restructuring between 1995 and 1998

To understand DASA's current situation within DaimlerChrysler, we need to turn back to the restructuring undergone by Daimler-Benz under the leadership of Jürgen Schrempp in the years between 1995 and 1998.¹² From the beginning of his leadership, Schrempp – himself the former chief executive of DASA – had instigated a radical turnaround. Unlike his predecessor, Edward Reuter, who wanted to bring different areas of cutting edge technology together under a single roof (*Integrierter Technologiekonzern*), he decided to go back to the roots of Daimler-Benz, i.e. automobiles and transport. This new focus was above all evidenced by the merger of Mercedes Benz AG with Daimler-Benz Holding AG. (Formerly, the first had been one of the four legally independent entities covered by the common roof of the second).

The key word in the restructuring of Daimler-Benz was *Unternehmenswertsteigerung*. This concept is inspired by *shareholder value*, but is more extensive and comprehensive than the Anglo-Saxon model. Indeed, the objective was to attract investors, not by short-term financial success, but by improved competitiveness in the long term. To do this, Schrempp proposed to both rationalise the operations process, improve the quality and range of products, ensure employee consensus and perfect the workforce's motivation and know-how.

However restructuring began with the transfer of non-profitable activities. Following the *stop the bleeding* principle, Schrempp systematically assessed the activities of the group according to their profitability and their strategic value. Only those subsidiaries which via high returns and technological excellence would be able to achieve leading positions in the world markets were to stay in the group. The main victim of this portfolio balancing was AEG, a part of which was sold, the other part being integrated into the other subsidiaries of the group. The number of sectors of activity thus dropped from 35 to 23.

Even more important than spectacular sales figures were the internal changes to the Daimler-Benz group. Application of the US-GAAP to the annual reports of all subsidiaries provided more transparency, thus making it easier to gain access to the international financial markets and representing a decisive step towards the Americanisation of the group, indispensable for

¹² See Armin Töpfer, "Die Restrukturierung des Daimler-Benz Konzerns 1995-1997", Lüchtherhand, Neuwied 1998.

the subsequent merger with Chrysler. At the same time, a management level in the group was eliminated. The directors of activity sectors obtained greater room to manoeuvre, but became directly responsible for the management of Daimler-Benz with regard to strategy and results. Now it is not once a quarter but once a month that management requires an operations progress report. The ultimate objective set for each sub-subsidiary was to obtain a minimum of 12% Return On Capital Employed (ROCE) and to be among the most profitable bidders in its sector. To achieve this, the decision making and planning processes as well as the way work was organised were profoundly changed.

All these measures were also applied to DASA.

- 1) The portfolio was balanced. In 1995, a part of MTU as well as Temic Telefunken Microelectronic were transferred from DASA to AEG Daimler Benz Industrie to then merge with Daimler-Benz AG. At the beginning of 1996, DASA had finished subsidising its Dutch subsidiary Fokker, which then went into voluntary liquidation. A few months later, two of Dornier's sub-subsidiaries were sold : Dornier Medizintechnik, which no longer corresponded to the portfolio, and Dornier Luftfahrt GmbH, which was in the red.
- 2) A recovery package, "DOLORES" (*Dollar Low Rescue*), was set up to increase profitability. The aim was to reduce costs by 30% to remain profitable at an exchange rate of 1.35 DM to the American Dollar. The rationalisation measures were aimed at supplier contracts, the organisation of work and staffing costs. After an initial large cut in personnel between 1989 and 1993 (16,000 employees), a further 16,000 positions were suppressed in 1995/96. A third wave of cuts (18,000 jobs), scheduled for 1998/99, was only partially carried out, thanks to a significant market upturn.
- 3) The organisation and management of the subsidiary were restructured. With the dissolving of the "Aeronautics", "Space" and "Defence" branches, a management level was suppressed. The activities concerned were reorganised into sectors, directly answerable to the management of Daimler-Benz. The "Communications and Information Systems", "Sensor Systems" and "Missiles" branches were integrated into the new "Civil Systems and Defence" branch.
- 4) The accounting system was changed, each DASA subsidiary becoming responsible for its own financial results. Within the new group it is no longer possible to off-set the losses of one branch with the profits of another.
- 5) Another new feature is that DASA subsidiaries present their reports both to the Managing Director of DASA and to the functional central services of the parent company

("Management", "Finances/Controlling", "Research/Technology" and "Strategy/Development"). The latter support DASA's general management and participate, from the outset, in the strategic and tactical planning for DASA's subsidiaries. Having been jointly set by DASA's subsidiaries and management, the objectives for each subsidiary are then approved by the parent company's management.

The economic and financial situation

Financially, the restructuring of the group was a huge success. In 1995, Daimler-Benz recorded a deficit of 6.57 billion DM and for the first time in history, the shareholders did not receive a dividend. In 1996, Daimler-Benz made a profit of 1.29 billion DM, which increased to 5.79 billion in 1997. The merger with Chrysler opened up new horizons : the turnover in 1998 was 257.74 billion DM (+12%) and operating profit was 16.80 billion DM (+38%). The dividend of 4.60 DM per share is on a par with American levels and is well above average European returns. The financial markets honoured these results, and between 1995 and 1998, the share price rose from 64 to 180 DM. The value of the group thus rose from 34 to more than 100 billion DM.¹³

DASA's development is equally impressive. After the disastrous year in 1996 (losses amounting to 6.72 billion DM, largely due to Fokker), results have climbed steadily. Several factors have been at the root of such a recovery : the rapid expansion of the civil aviation markets, a favourable exchange rate with the dollar, but also, the positive effects of the restructuring measures. The key figures for DASA are shown below (million DM) :¹⁴

¹³ Rüdiger Liedtke, "Wem gehört die Republik", Eichborn, Frankfurt, 1998, p. 132-146

¹⁴ All figures according to the Annual Reports of 1997 and 1998.

Key figures by subsidiary and division

DaimlerChrysler Aerospace		Results		
		1996	1997	1998
DASA	Turnover	12,699	15,286	17,200
	Orders	16,658	19,399	27,000
	Research and Development	3,681	4,367	4,004
	Operating Profit	196	432	1,218
	ROCE	n.c	8.8%	18.7%
	Employees	44,174	43,521	45,858
Civil aircraft and helicopters	Turnover	3,501 and 1,102	4,758 and 1,212	5,800 and 1,400
	Orders	6,381 and 1,421	9,041 and 1,600	
	Research and Development	483 and 229	306 and 244	470 and 239
	Operating Profit	n.c.	n.c.	440 and 65
	ROCE	n.c	n.c	19.0% and 6.0%
	Employees	15,319 and 3,987	15,403 and 3,847	16,195 and 4,065
Combat Aircraft	Turnover	1,589	1,654	1,900
	Orders	1,152	1,964	
	Research and Development	403	407	425
	Operating Profit	n.c.	n.c.	160
	ROCE	n.c.	n.c.	65%

	Employees	5,567	5,640	5,913
Satellites	Turnover	1,183	1,450	1,300
	Orders	1,475	1,140	...
	Research and Development	851	1,503	1,040
	Operating Profit	n.c.	n.c.	23
	ROCE			8.5%
	Employees	1,648	1,623	1,652
Space Infrastructure	Turnover	1,012	1,105	1,130
	Orders	2,189	833	...
	Research and Development	708	720	628
	Operating Profit	n.c.	n.c.	100
	ROCE	n.c.	n.c.	45.0%
	Employees	1,919	1,946	1,990
Civil Systems and Defence	Turnover	2,747	2,841	3,400
	Orders	2,511	3,036	...
	Research and Development	631	861	901
	Operating Profit	n.c.	n.c.	90
	ROCE	n.c.	n.c.	6.0%
	Employees	9,254	8,724	9,109
Engines	Turnover	2,311	2,963	3,249
	Orders	2,127	2,703	...
	Research and Development	305	319	299
	Operating Profit	n.c.	n.c.	220
	ROCE	n.c.	n.c.	30.0%
	Employees	6,007	6,023	6,633

Thanks to its participation in many European programmes, DASA achieves 2/3 of its turnover via international co-operation. Its involvement in joint ventures such as Airbus and Arianespace also explain that the European Union is, with 50% of the turnover, the main market (Germany 28%, USA 16%, rest of the world 6%).

The rapid increase in civil aircraft contracts since 1995 has improved DASA's situation in general and increased the proportion of turnover related to civil activity (from 62% in 1996 to 69% in 1998). This development does not, however, indicate a withdrawing from the military sector. On the contrary, in the coming years, all subsidiaries concerned will be carrying out very important projects. The combat aircraft subsidiary has Eurofighter, Eurocopter has the Tiger and the NH 90, LFK has the Taurus and EURAAM programmes.¹⁵ Estimates of DASA's key figures for the next three years are shown below (million DM) :

¹⁵ Ibid.

Projections for 1999-2001

DaimlerChrysler Aerospace		Results	Projections		
		1998	1999	2000	2001
DASA	Turnover	17 200	18600	19550	19950
	Operating Profit	1218	1040	1530	1460
	ROCE	18.7%	13.5%	19.0%	17.5%
Civil Aircraft	Turnover	5800	6500	7050	6900
	Operating Profit	440	400	800	650
	ROCE	19.0%	16.0%	30.5%	24.0%
Helicopters	Turnover	1400	1480	1550	1550
	Operating Profit	65	100	95	110
	ROCE	6.0%	9.5%	9.0%	9.5%
Combat Aircraft	Turnover	1900	1950	2075	2200
	Operating Profit	160	170	190	200
	ROCE	65.0%	38.0%	34.5%	35.5%
Space Infrastructure	Turnover	1130	1385	1350	1220
	Operating Profit	100	85	90	90
	ROCE	45.0%	31.0%	30.0%	28.0%

Satellites	Turnover	1300	1190	1095	1225
	Operating Profit	23	25	35	40
	ROCE	8.5%	10.0%	12.0%	13.0%
Civil Systems/ Defence	Turnover	3400	3600	3850	4350
	Operating Profit	90	170	220	290
	ROCE	6.0%	9.5%	14.0%	17.5%
Machinery	Turnover	3249	3315	3410	3500
	Operating Profit	220	220	230	220
	ROCE	30.0%	22.0%	19.0%	15.0%

*projections according to Capital, n°5/1999, p. 81

The ties between the parent company and the aeronautics subsidiary

Neither the restructuring of 1995 – 1998, nor the subsequent merger of Daimler-Benz and Chrysler changed DASA's legal status. The company is still an AG (public limited company), and its organisational structure is therefore determined to a large extent by German law. A board of directors is responsible for the company's operations. Its members are appointed and monitored by a supervisory board which consists of, in compliance with management equality, an equal number of shareholder representatives and employees. While the former are appointed by DaimlerChrysler, the latter are elected by the staff. There is also a General Assembly.

However, the fact that DASA is a subsidiary of DaimlerChrysler greatly influences how these bodies operate. The general assembly, for example, is not public and only takes "formal" decisions, such as to give full discharge to the board of directors or approve the annual report. The supervisory board is important in that it enables employees to participate in making company decisions. However, the majority shareholder has no need for it as an instrument of control because, as the parent company, it has other means of watching over DASA's operations.

In legal terms, DaimlerChrysler is governed by the control agreement (which is not public). This agreement comes with structural ties and a considerable number of key positions :

- The composition of DASA's supervisory board and board of directors and those of the holding company is identical ;
- The CEO as well as several members of DaimlerChrysler's board of directors (Strategy, Finance, Technology) are members of the supervisory boards of DASA and the holding company ;
- The CEO of DASA's board of directors represents the aerospace and defence sectors as a whole and is responsible for the activities of the different sub-subsidiaries. At the same time, he is a member of Daimler's board of directors and chairs the supervisory board of Adtranz, the railway subsidiary of DaimlerChrysler ;
- Generally, the exchange of directors between DASA and other DaimlerChrysler subsidiaries is encouraged (even if it is limited by the specific nature of DASA and by the difference in management salaries) ;
- DASA's general management is made up of members of its board of directors, the directors of its subsidiaries and divisions as well as two directors responsible for central services (Finances and Controlling, Strategy and Technology). The latter two are supported by the corresponding departments of DaimlerChrysler. The board of directors of DASA itself has only three members, and of these only one has functional responsibilities covering the whole of DASA (Personnel).
- While DASA's subsidiaries are responsible for R&D (relating to specific programmes), R&T (general) is centralised for the DaimlerChrysler group as a whole. DASA puts in requests for research to the "DaimlerChrysler Forschung" amounting to around 30 million DM per year. If the research could also interest the other subsidiaries of the group, the parent company subsidises the project with the equivalent sum. The objective is to create optimum synergy and to direct R&T towards the widest possible application.

Another important tie is that DASA's strategic planning is integrated into the planning of the parent company. It is divided into four stages, as for the other subsidiaries, which take place between March and June :

- Stage 1 : DaimlerChrysler's board of directors gives the overall guidelines for all the sub-subsidiaries (*Strategieforum*).

- Stage 2 : DASA's subsidiaries follow these guidelines to specify their own objectives and the resources to be used and policies to be followed to achieve these objectives. Then, these plans are brought into line with the others by DASA's general management.
- Stage 3 : the two co-CEOs and the directors of central services (Strategy, Technology, Finance) of DaimlerChrysler's board of directors, meet with the general management of DASA to discuss and decide upon the strategy and projects of each sub-subsidiary (*Strategisch-Wirtschaftliche Gespräche*, SWG).
- Stage 4 : the strategic plans of the different subsidiaries are integrated into the strategy of the group as a whole (*Konzernstrategieklausur*).

One of the essential characteristics of this process is the permanent co-operation between DASA's subsidiaries, DASA's general management and DaimlerChrysler's "strategy" management. This co-operation is ensured by means of a working group made up of strategists from the three levels. The group constantly monitors the development of strategic plans and thus guarantees that there is a permanent link between sub-subsidiaries, subsidiaries and the parent company.

Despite its legal stand-alone status, DASA is therefore closely tied to DaimlerChrysler. It is true that the specific nature of the aerospace and defence sector as well as the tradition of the original companies, still alive in the subsidiaries, give DASA a certain degree of autonomy. It does not mean that there are not many, strong, capital-related, contractual, staffing and organisational ties. Legally, DaimlerChrysler has the right to give instructions and have them executed. It is the parent company that takes the major strategic decisions, specifies profitability criteria, determines internal procedures and participates in its subsidiaries' planning. The objective is not, however, to be constantly interfering in DASA's daily operation, but to guarantee that its policy is appropriately in line with the group's philosophy.

For example, the principles for restructuring were the same in all Daimler's subsidiaries. For DASA, there was, nonetheless, a certain degree of flexibility allowing for the specific nature of its activity. The aeronautics subsidiary has, for instance, its own definition of the ROCE, and it still uses the ROCE in parallel with the new system, RONA (Return On Net Assets). Similarly, it is Daimler that set the objective of lowering costs by 30%, but it is DASA that drew up the corresponding restructuring plan (DOLORES), and DASA's subsidiaries that provided the details.

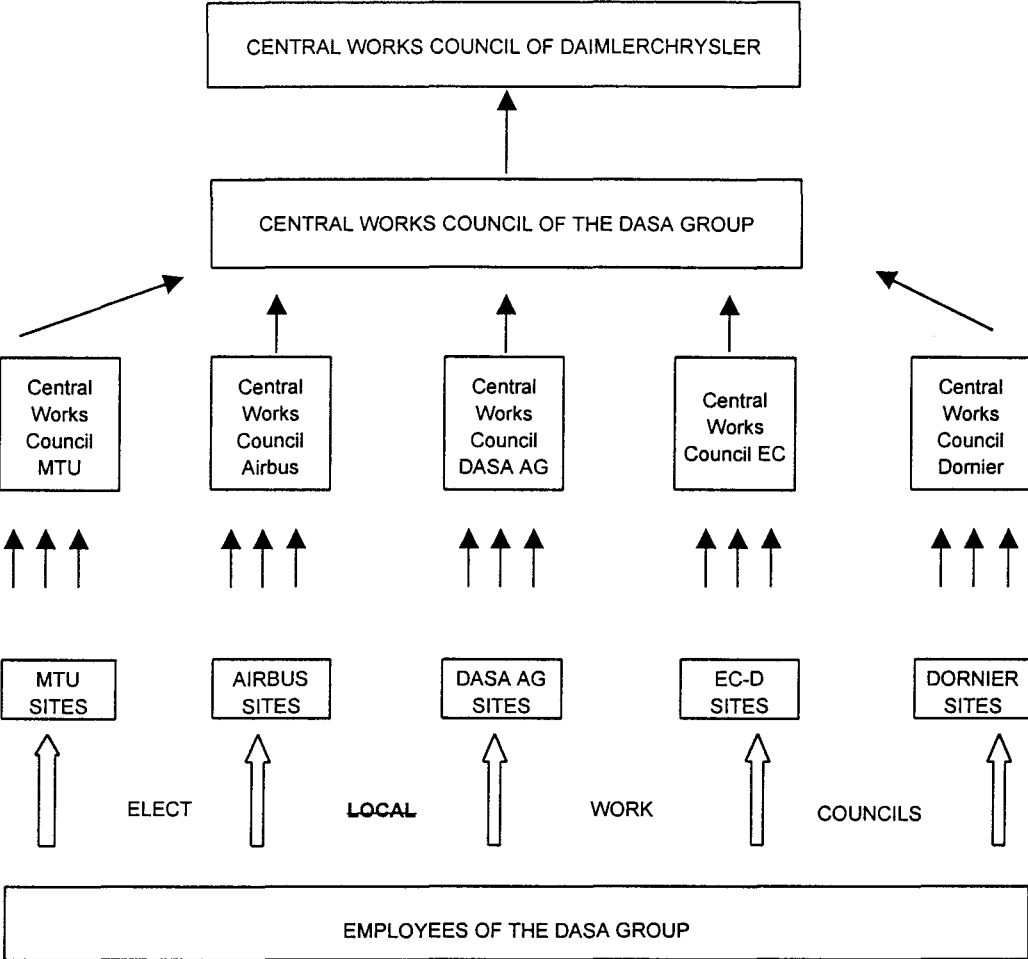
Furthermore, DOLORES is a good example of a certain "German" approach to restructuring, an approach which seeks, on the one hand, to maintain a consensus with employees, and, on the other, to safeguard long-term competitiveness :

- Despite considerable cost reductions, spending dedicated to R&D has remained relatively stable ;
- To avoid negative effects on the company's age pyramid, DASA endeavoured to avoid operating redundancies (*betriebsbedingte Kündigung*), but encouraged early retirement and redundancy packages for people who would leave voluntarily. Similarly, the company never reduced either its training activities or its recruitment of young executives and engineers ;
- Measures such as increasing flexibility of work hours, extending work hours without compensation and suppressing non-contractual services, were taken in close consultation with the works councils ;
- Sites that were not profitable enough (Laubheim, Speyer and Paisenberg) were not simply closed, but were restructured and transformed into independent SMEs.

Of course there were protests against DOLORES, but given the huge scale of restructuring, the degree of consensus between management and employees was quite remarkable. It is true that the stability of relations between management and employees is characteristic of the entire German economy. But, "social harmony" in defence-related industries in general, within DASA in particular, does however, display certain specific characteristics. Firstly, the rate of union membership is relatively low in this sector, which corresponds to the high proportion of engineers and executives among the employees.¹⁶ Secondly, German unions are still marked by a strong pacifist tradition, leading implicitly to a certain isolation of employee representatives in the sector from other union members. Mobilisation of the powerful IG Metall in support of Eurofighter, for example, was practically non-existent, despite the fact that several thousand highly-qualified positions were at stake. Conversely, the members of the affected works councils of DASA joined forces with management to put pressure on the social-democrat politicians.

¹⁶ Of the 45,858 employees of the *konzern* (Dasa AG, Dornier GmbH, Eurocopter GmbH and MTU AG), 13,833 exert industrial activities and 27,920 are non-manual employees. The rate of union membership among the former is 85% (IG Metall), that of the latter is only 10% (DAG).

The System of Works Councils Within DASA



The Dual Nature of a German-American Group

The question of whether DaimlerChrysler will be, in the future, a more American or more Germany company has given rise to much speculation. It is true that the United States represent the largest market for the new group (US turnover of 127.7 billion DM, in Europe it is 94.8 billion DM, and the rest of the world 35.2 billion DM).¹⁷ As regards the shareholders, the attempt to attract American investment has nonetheless met with failure. At the time of the merger, 44% of DaimlerChrysler's capital was held in the United States. Over the past twelve months, this percentage has dropped considerably. Today, 47% of the capital is held in Germany, 25% in the United States, 10% in other European Union countries, 5% in Switzerland and 10% in the rest of the world (including 7% in Kuwait). Therefore, there was a marked shift towards Europe and Germany.¹⁸ The withdrawal of American investors goes hand in hand with the departure of many of Chrysler's American directors. Thus, the so-called "merger of equals" now looks more like a hostile take-over of Chrysler by Daimler.

Nonetheless, regarding behaviour, the Americanisation of the group will probably continue and even accelerate with the absorption of Chrysler. The adaptation of management salaries to American levels, the introduction of English as the official language of the *Konzern* and the increase of the fixed profit margin (12% to 15.5%) bear witness to this. Shareholder value takes on even more importance, as shown by the large dividend per share (2.35 Euros = 4.60 DM) and the ambitious objective of increasing operating profit from 8.6 billion Euros in 1999 to 10 billion in 2000 and doubling turnover every ten years.¹⁹

The Americanisation of the group is also manifested in how it is governed. Since the merger, the German dual management system (supervisory board and board of directors) has been

¹⁷ Merger of Growth, Annual Report 1998, DaimlerChrysler.

¹⁸ There are many reasons behind this movement : considered to be a German company, (the headquarters is still at Stuttgart), DaimlerChrysler was not accepted on the American S&P 500 index. For this reason, the American funds that work on the basis of this index were forced to sell their shares. According to Goldman Sachs, this involved 47 million shares (4.7%). For their part, European funds had to buy 2.6 million shares to allow for the future weight of DaimlerChrysler in the European indexes. In the DAX for example, the share of this company alone represents 12% of the total values (compared with the 7% of former Daimler shares). In the EURO-Stoxx 50, the weight of the share has risen from 3.5% to 6%. In addition, the dividend from the new share, particularly large compared with European values, has attracted a large number of European investors. On the contrary, many American investors have been reticent with regard to the value of this company as it is much more complex than Chrysler, which was just an automotive manufacturer.

¹⁹ Handelsblatt, 1.4.1999, p. 14.

supplemented by a shareholders' committee, consisting of the two co-CEOs of the board of directors as well as the ten shareholders' representatives within the supervisory board. This committee is not covered by German law, but corresponds to the structures of American companies. Even if it cannot take decisions, it still holds a strong position. The shareholders' committee must monitor operations and advise the board of directors between meetings of the supervisory board (the former meets every two months, the latter every three months). It is clear that in such a system, the shareholders' representatives are in a much more advantageous position than the employee representatives. In other words, employee participation, a characteristic trait of the German model will continue by law, but in effect will have less value.²⁰

The Americanisation of the group was begun by Schrempp to prepare Daimler-Benz for globalisation. The capital markets for him were certainly a very important factor, but he was not pushed in this direction by investors. Firstly, he did not need pushing, because Schrempp is a wholehearted advocate of Anglo-Saxon methods. Secondly, the influence of American institutional investors over the group's governance remains smaller than was believed at the time of the merger. There are three main shareholders in DaimlerChrysler who hold 27% of the capital : the Deutsche Bank (12%), Kuwait (7%, managed by Dresdner Bank) and Kirk Kerkorian (4%), former reference shareholder of Chrysler. In addition to these, there are around 17,000 institutional investors and 1.45 million individual investors (of which more than 850,000 small shareholders) who hold respectively 49% and 24% of the capital. The largest proportion of the capital is therefore well dispersed, and there are very few institutional investors that hold more than 1% of the capital (AXA, DEKA, Dresdner Bank, Commerz-Bank). American investment funds together hold about 20% of the capital, but not one of them alone holds more than 1%.²¹ The merger therefore reduced the weight of the reference shareholders (Deutsche Bank and Kuwait held 24% and 12% respectively of Daimler Benz), without really changing the influences affecting DaimlerChrysler governance (or, for that matter, representation on the supervisory board).

In this context, it is important to underline that DaimlerChrysler's reference shareholders are non-industrial financial investors. They monitor economic developments but do not interfere in strategic decisions. This constellation gives the board of directors and, above all, Jurgen

²⁰ See Holger Appel, Christoph Hein, "Der DaimlerChrysler Deal", DVA, Stuttgart 1998, p. 208.

²¹ Figures from DaimlerChrysler Investor Relations.

Schrempp, greater room to manoeuvre. The position of the German co-CEO is made all the stronger in that his American counterpart, Robert Eaton, had, from the outset, announced he would be retiring after two years. Schrempp can also benefit from a very good, long-standing personal relationship with Hilmar Kopper, who chairs both the supervisory board and the shareholders' committee of DaimlerChrysler as well as the supervisory board of Deutsche Bank.²²

The Strategy of DaimlerChrysler and its Subsidiary, DASA

Globalisation is still DaimlerChrysler's objective. The German-American merger has already made it possible to achieve the first objective, the parallel penetration of the American and European markets. The next step, conquering the Asian market, is proving to be more difficult. Following the failure of *rapprochement* with Nissan, DaimlerChrysler will probably develop its own automobile targeted at the Asian (and Latin American) market. The aim is to increase the Asian contribution to turnover from 4% today to 25% by 2010. At the same time, globalisation is still an objective with regard to investors. Seeming to have accepted the reticence of American shareholders, group's management is now hoping to attract more Asian investors.²³

For the moment, there is no indication that DaimlerChrysler could call into question its commitments in the aeronautics and defence fields. In fact, there is no reason for it to do so while DASA continues to produce good results. Nevertheless, the weight of DASA within the group has been considerably reduced by the merger. It only represents 7% of the group's revenues (83% vehicles). This marginalisation is also apparent in the fact that Mr. Bischoff does not sit on the Chairmen's' Integration Council which, consisting of 8 of the 18 directors, represents the hard core of DaimlerChrysler's management.²⁴

The fact that the group's leaders are currently studying the possibility of DASA entering the stock exchange shows that marginalisation of the subsidiary could lead to its emancipation with regard to capital. This would have a dual advantage : firstly, the parent company would

²² See *op. cit.* in note 15.

²³ FAZ, 10.5.1999, p. 19.

²⁴ Although the directors officially have all the same rights, the members of the council are *de facto* on a higher level in the hierarchy. They see each other more often (once a week, whereas the committee meets once a month), have access to more information and work on the key issues relating to the new group.

gain visibility and secondly, DASA would increase its strategic room for manoeuvre for future mergers, because mergers are sealed more by the exchange of shares than of cash.²⁵

Meanwhile, DASA is following the global guidelines of the parent company aiming for "profitable growth". For the aeronautics and defence subsidiary, these guidelines consist firstly of "organic growth" in the basic sectors and secondly, in developing new contracts. With the acquisition of Siemens defence activities (SI Sicherheitstechnik), DASA has significantly strengthened its position in the electronics field. In the future, it wishes to become more involved in space (communication and navigation by satellite, earth observation) and service activities (after-sales service, maintenance, modification). At the same time, DASA is trying to strengthen its presence on the world markets. It is participating, for instance, in the Brazilian contest to replace the F-X BR combat aircraft²⁶ and proposed to increase the proportion of its Asian contracts to 25% of the overall turnover.

From this point of view, DASA considers its participation in trans-national restructuring as a means, not an end *per se*. It is ready to merge with one or more partners – on the condition that such a marriage meets the economic and financial criteria laid down by DaimlerChrysler. Indeed, the favourable economic situation enables DASA to be on the lookout for a good occasion and not hurry integration into a multinational company.

Strategically speaking, the company now seems to be well placed for the next stage of restructuring. It remains to be seen if the parent company's strong base in the United States will help DASA to form a partnership with an American, but the German champion would certainly not hesitate if a transatlantic merger or acquisition became viable. In relation to its European partners, the merger with CASA significantly improved DASA's situation. Within the two main European projects, Airbus and Eurofighter, the new German-Spanish couple holds a key position. Whether restructuring takes on a more European or trans-Atlantic hue – the failure of negotiations with BAe, the absorption of CASA and moves towards Aerospatiale Matra clearly show that DaimlerChrysler would not allow its subsidiary to be a minor partner in future mergers.

²⁵ Ulrich Friese, Walter Hillebrand, "Lockruf der Börse", in : Capital 5/1999, p. 78-87.

²⁶ Paolo Valpolini : "Shark bites into fighter contest", Jane's Defense Weekly, 5-5-1999.

IV. STUDY OF AN ECONOMIC AND INDUSTRIAL CO-OPERATION MODEL WHERE A GERMAN COMPANY IS INVOLVED

IV-1. STN-ATLAS

STN-ATLAS Elektronik GmbH was created in 1994 by the merger of STN Systemtechnik Nord GmbH and ATLAS Elektronik GmbH. With a turnover of more than 1.2 billion DM (in 1997), it is one of the largest German companies in the defence electronics field.

STN-ATLAS is divided into four sectors of activity :

- Land- und Flugsysteme (Aeronautics and territorial systems),
- Naval Systems,
- Simulationssysteme (simulation systems),
- Marine Electronics.

Of these sectors, Marine Electronics has several distinguishing characteristics. Firstly, it is the only one to be organised as a subsidiary, and is therefore legally independent (in the form of a GmbH company). The other sectors are organised into divisions. Secondly, Marine Electronics generates – with 31% – the largest part of STN-ATLAS's turnover (Naval Systems 29%, Simulationssysteme 22%, Land- und Flugsysteme 18%). Thirdly, it is the only sector where civil activities exceed military activities.

**Distribution of Turnover between Civil and Military Activities in each
Division of STN-ATLAS :**

<u>Sector of Activity</u>	Proportion
Marine Electronics	80% : 20%
Simulationssysteme	40% : 60%
Naval Systems	10% : 90%
Land- und Flugsysteme	5-10% : 90-95%

Approximate figures according to estimates made by managers at STN

Until 1997, STN-ATLAS was part of a large construction site, the Bremer Vulkan Verbund. When it went under, the company was bought by a consortium made up of Rheinmetall, Badenwerk AG and British Aerospace. Soon afterwards, Badenwerk gave its share to Rheinmetall, which now holds 51% of the social shares.

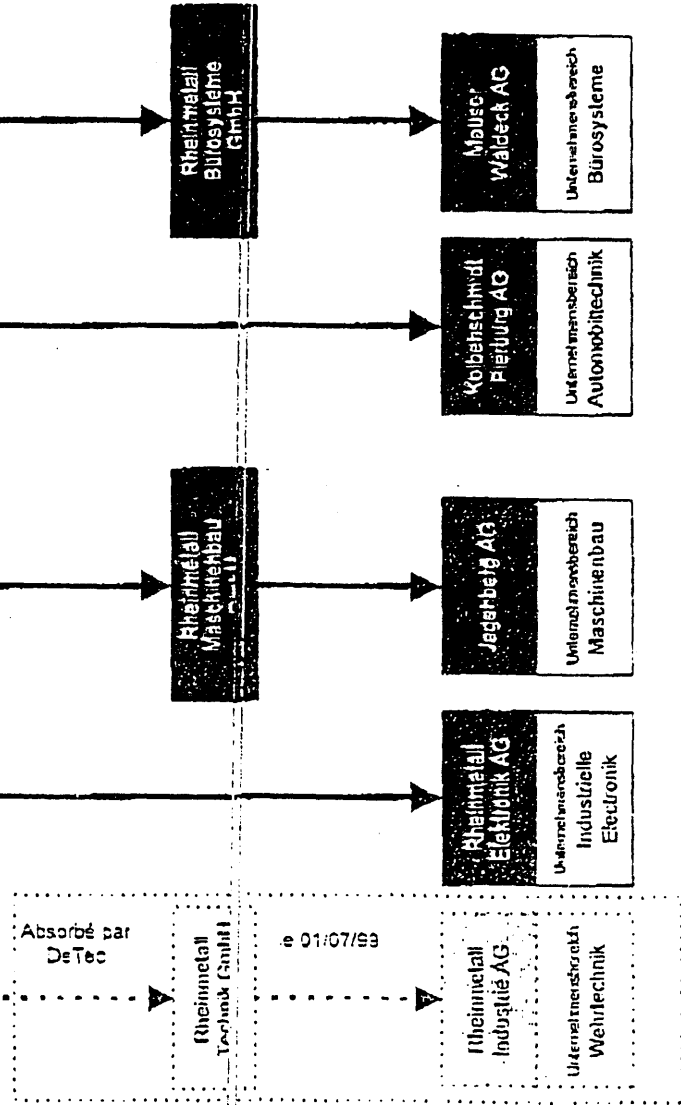
STN-ATLAS is not a joint venture, but a German company in which a British company has a large stake (49%). Rheinmetall is the majority partner and industrial leader and it alone specifies the strategy of STN-ATLAS. The latter is part of the Rheinmetall group, where it represents the "Defence Electronics" sector. As such, it is has been headed, since 1 July 1999, by a new holding company, "DeTec" (Defence Technology) which, at the same time, absorbed the activities of Rheinmetall in the territorial armaments sector (former "Defence Technology" sector).

For tax reasons, Rheinmetall holds its financial share through a holding company (STN ATLAS Holding GmbH). On the British side, the social shares are held by BAe Deutschland ; economic and industrial responsibility falling to the "Defence Systems" division of BAe in Farnborough.

Rheinmetall Industrie Verwaltung GmbH
65,6 % Aktienkapital

British
Aerospac

Rheinmetall AG



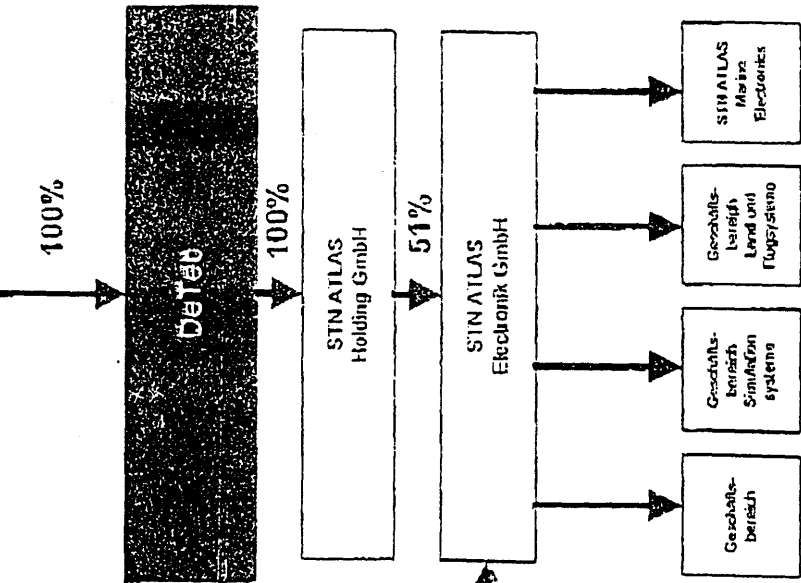
Majser
Wäldeck AG
Unternehmensbereich
Bürosysteme

Kolbenschmid
Pfeifung AG
Unternehmensbereich
Automobilttechnik

Jägerberg AG
Unternehmensbereich
Maschinenbau

Rheinmetall
Elektronik AG
Unternehmensbereich
Industrielle
Elektronik

Rheinmetall
Industrie AG
Unternehmensbereich
Wehrtechnik



100%

100%

51%

49%

STN ATLAS
Mezza
Electronics

Geschäfts-
bereich
Land und
Flugsysteme

Geschäfts-
bereich
SimAeron
systems

Geschäfts-
bereich

As the associate of a GmbH under German law, BAe benefits from patrimonial rights and administrative rights. The latter include the right to participation, information and opposition.

The chair of the BAe board of directors meets five or six times a year with his counterpart at Rheinmetall during STN-ATLAS associate assemblies. The Finance and Controlling Directors of the two associates also participate. The assembly takes strategic decisions of the company on a unanimity basis.

Within the STN-ATLAS supervisory board, two of the six associates' representatives are delegated by BAe : the director of BAe Defence Systems as well as the managing director of BAe Deutschland. BAe thus participates in all decisions submitted for approval by the supervisory board (such appointment of directors) and all decisions needing approval by both associates.

BAe does not have a representative on the STN-ATLAS board of directors. However, one of the three German directors is responsible, among other things, for relations with the British associate. He is employed by STN-ATLAS, but acts as interlocutor and "representative" of BAe's interests.

Each of the two associates monitors the accounts of STN-ATLAS, but they do not exercise this right in the same manner. While Rheinmetall acts more as a financial holding company, interested "only" in the overall results, the British associate demands detailed information on current business and the financial aspects of each project. Furthermore, Rheinmetall and BAe have different reference periods, which causes co-ordination problems with the accountants of STN-ATLAS.

While STN-ATLAS and the "Defence Technology" sector of Rheinmetall are industrial partners in several projects, co-operation between STN and BAe Defence Systems is limited to marketing for the moment. In this field, common organisations exist, responsible for overall co-ordination, the exchange of information on contracts and co-operation during exhibitions. Furthermore, a marketing expert from BAe is permanently based in Bremen where he acts as a focal point for the contacts at below-management levels. In certain cases,

STN-ATLAS and BAe Defence Systems co-ordinate their access to international markets, but there is no general sharing out of the world market.

However, there are many contacts in other fields which remain informal. The members of the research and development teams for example see each other irregularly, even occasionally, engineers exchange information on their basic research, but not on specific projects – which would indeed be forbidden by the national security regulations. These work contacts are increasing, but do not follow any pre-set agenda. Rheinmetall appears to be more active in this "spontaneous" *rapprochement* than BAe. This is not due to any difference in strategy, but to the administrative obligations to which the industrial leader is subject.

By committing to STN-ATLAS, BAe and Rheinmetall were pursuing the same overall strategy : to strengthen their capacity in defence electronics. However, there is a difference : while Rheinmetall was looking for a supplementary electronics component for its activities in territorial armaments, BAe wanted to invest in naval electronics, a field where it was not yet present. This situation has now changed. Since the absorption of Marconi, the British associate now has in its portfolio the very activities it wanted to "purchase" by participating in STN-ATLAS. It remains to be seen to what extent this change will influence BAe's strategy in relation to STN-ATLAS ; it is expected that in the future the British will be more interested in the territorial activities of the German company.

Finally, the pairing up that we are witnessing in the armaments industry is sometimes liable to call the activity-based joint ventures into question by in effect creating competitive strategies.

Indeed, the merger of BAe-GEC also made BAe a partner in two competing joint ventures in the sonar field because GEC-Marconi had its own joint venture with Thomson-CSF in this field : Thomson-Marconi-sonar.

As Thomson-CSF had pre-emptive rights in Thomson-Marconi sonar, the CEO of Thomson-CSF, Denis Ranque, asked the directors of BAe to take the side of Thomson-Marconi sonar threatening to withdraw from the JV in sonar with Marconi if they did otherwise.²⁷

IV-2. Eurocopter

Eurocopter's origins go back to 1985. At the time, Messerschmitt-Bölkow-Blohm (MBB) and Aerospatiale had created a consortium to develop the Franco-German attack helicopter, Tiger. However, it was an "empty shell" : a company with no employees which only existed for legal reasons, essential for managing certain business.

The group moved onto the next stage in May 1991, with the creation of a joint subsidiary, Eurocopter International. It took the form of an *Economic Interests Group*, responsible for marketing equipment manufactured on both sides of the Rhine throughout the world. However, the approach taken to create the group proved to be far from simple. Three years of work were required before Eurocopter International could be officially baptised. In addition to the many administrative contortions and struggles with bureaucracy, everybody's fears had to be allayed. Even more so considering that in the meanwhile, Daimler-Benz had taken control of MBB, and that, for one year, *rapprochement* was not the prime concern of Daimler-Benz's management.

Despite all these difficulties, the *rapprochement* did not end there. In order to strengthen co-operation, not only in the context of an economics interests group, but as a true company, DASA and Aerospatiale transformed Eurocopter into a public limited company. The signing of the development contract for the NH 90 made a large contribution to sealing the union that represented a desire for permanent co-operation. In agreement with the European Commission, Aerospatiale and DASA made the merger of their helicopter sector activities official on 1 January 1992. And Eurocopter was born.

Due to the lack of a joint European regulatory framework, the instruments of both German and French law were called upon in constructing the group. Thus a company governed by French law was created, Eurocopter S.A., which is controlled to a limit of 75% by a financial holding company, Eurocopter Holding, in which Aerospatiale holds 60% of the capital and DASA holds 40%. In addition, Aerospatiale directly holds 25% of the capital of Eurocopter S.A. Initially, Eurocopter S.A. had 100% control of three operational subsidiaries (EC France, EC Deutschland, EC International). These controlled another joint subsidiary,

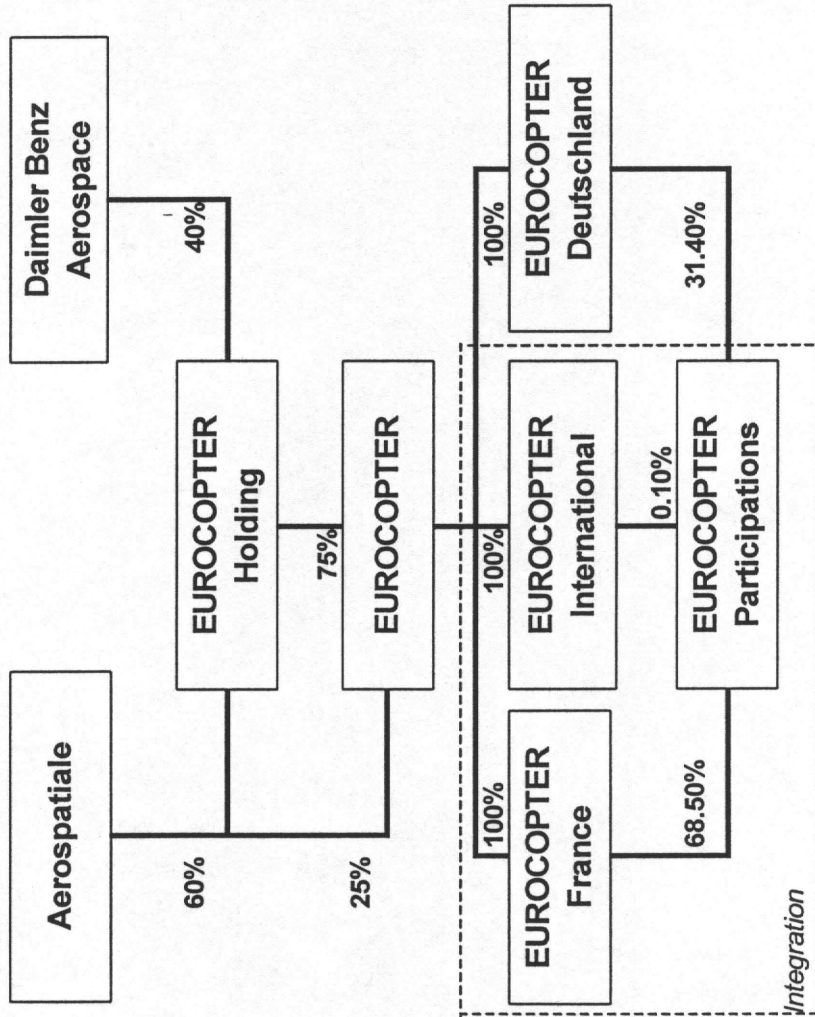
²⁷ Les Echos 18 August 1999

EC Participations. In 1997, this structure was significantly simplified : three of the subsidiaries (EC France, EC International and EC Participations) were integrated into a single entity, Eurocopter S.A., leaving just one subsidiary, EC Deutschland GmbH.

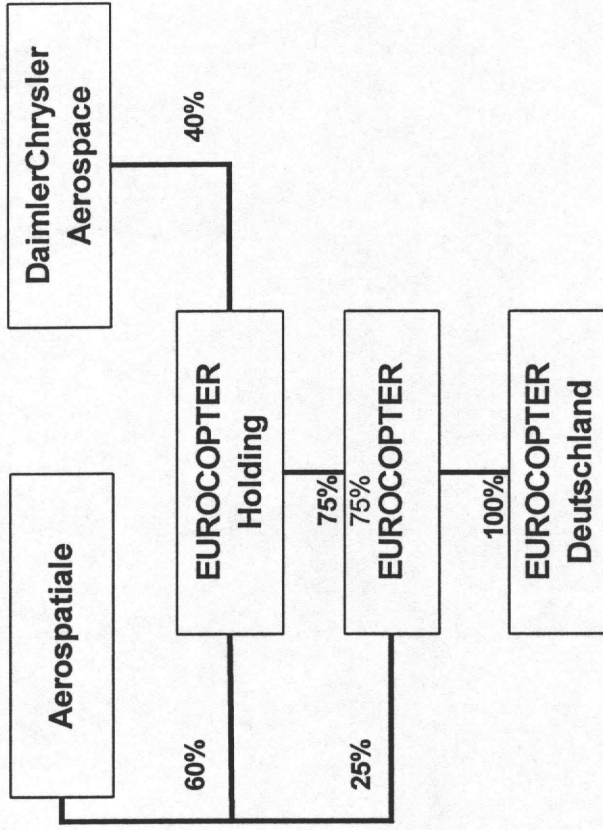
The three-stage system reflects the industrial and financial contributions of the two partners and follows the outline of their former "helicopter" divisions. The structuring by holding company is based on the principle that each partner structures the activity concerned by being a partner in a company under national law, then bringing it to a holding company created for the specific circumstances and governed by the law of one of the countries involved. In Eurocopter, several holding companies are used to settle dividend increases or power sharing issues. Assessment of the industrial capacities revealed a total of 80% in favour of Aerospatiale ; thanks to the payment of a further sum, DASA increased its share to 30%. To get even closer to a "politically correct" distribution of 50-50, the capital-related share of Aerospatiale had to be divided up (60% to the holding company, 25% to the public limited company). Therefore the dominance of Aerospatiale was mitigated at each level, and made the unanimity of strategic decisions (launch of new programmes, closure of sites, etc.) more "legitimate".

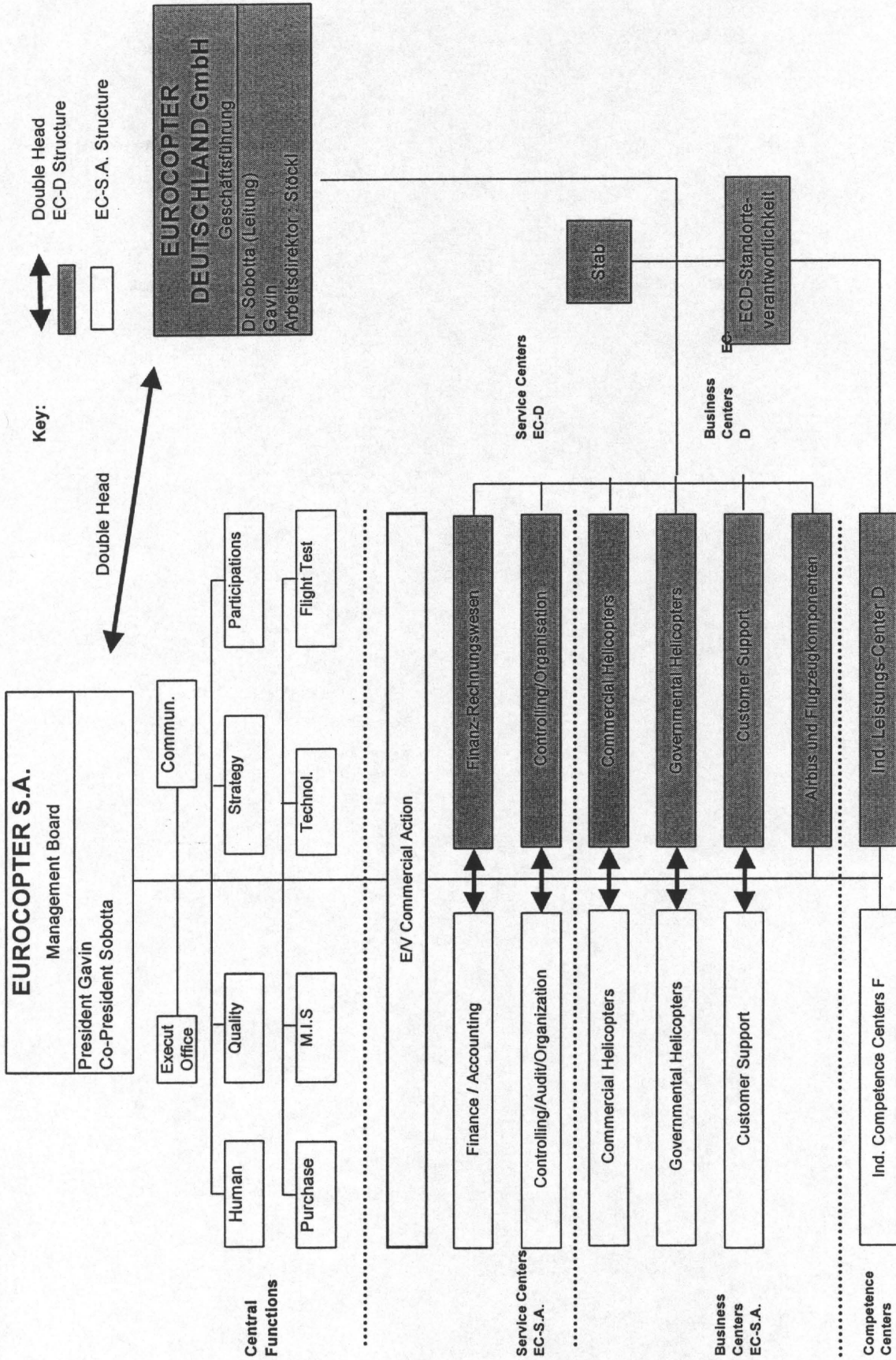
EUROCOPTER Organisation

Until 1996



Since 1997





In the French parent company, as in the German subsidiary, there is a dual management system (board of directors and supervisory board). Although there is a French majority on both boards, important decisions must be unanimous. For political reasons a difference was therefore drawn between voting rights and capital rights. Another Franco-German compromise is the structure of Eurocopter S.A.'s board of directors. The "cohabitation" of two CEOs is a solution halfway between the conventional French *société anonyme* (which just has one CEO) and the German *Aktiengesellschaft* (which has a collective board of directors).

The link between Eurocopter S.A. and its German subsidiary is personalised by the CEOs of the two boards of directors. The chair of one is vice-chair of the other and vice versa. At below management level, there is partial integration of positions. Eurocopter S.A. and Eurocopter Deutschland GmbH are set up according to the same structure with "service centres" and "business centres" and both companies have the same directors at the head of the respective centres. All these directors make up the executive board, which meets regularly and prepares the decisions of the board of directors. Given that these directors often meet in France, they are assisted by deputies who represent them in Germany during their absence. The exceptions are marketing – which is centralised at the parent company – and the Airbus profit centre of Eurocopter Deutschland, because the German subsidiary is the sole Airbus supplier within the group. The structure of the management bodies is organised both according to functions and to activities and products. This distinction corresponds to the major difference between civil and military clients. As regards distribution of positions, there is a French majority, corresponding to the proportion of Aerospatiale's industrial contribution.

While DASA and Aerospatiale specify the "major" economic and financial objectives, Eurocopter S.A. is responsible for strategic decisions regarding its products and contracts as well as daily operation. At this level, the different centres of the German subsidiary are as much answerable to the management of Eurocopter S.A. as to the French centres. This does not prevent DASA from still considering Eurocopter Deutschland as "a member of its family". Like the other subsidiaries of DASA, Eurocopter Deutschland must meet the economic objectives set by DaimlerChrysler. In addition, the German directors of Eurocopter are involved in staffing planning for DASA, and they also participate in the many working committees of the latter.

As regards employee participation, two systems coexist : half of the German subsidiary's supervisory board is made up of employees, only a third of that of the French parent company consists of employees. Another particularity of Eurocopter Deutschland compared with the French parent company is the *Arbeitsdirektor* (director of social and personnel affairs) who is a member of the German board of directors. Appointed by the supervisory board, he is a full member and participates in all decisions made by the German board of directors. However, he is actually primarily concerned with personnel matters. These differences reflect the differences in the two social and legal systems governing the various units of the group. The same applies to matters of pay and social services. For Eurocopter Deutschland employees these are controlled, in general terms, by DASA's collective agreement, for Eurocopter S.A. employees they are dependent on Aerospatiale's price scale. Nevertheless, the decisions of the parent company do, of course, directly affect Eurocopter employees. Therefore, the French unions made room for a representative of their German colleagues on the supervisory board of Eurocopter S.A.

Originally, the German subsidiary specialised in the manufacture of light equipment, and the French subsidiary in equipment weighing over 3.5 tonnes. However, this distribution of work proved to hinder industrial integration and so was abandoned. The objective now is to create skills centres and achieve reciprocal dependency. However, even in the civil sector, it remains difficult to integrate the whole cycle from development to after-sales service. Cross-border consolidation is fraught with national considerations, often relating to employment, and each of the two units still maintains all their technological capacities. For new products, the greatest workload falls to the unit that is leading the programme, even if *strictly* economic logic calls for different distribution. While technological specialisation is progressing gradually, the other fields are already consolidated. Eurocopter has already integrated marketing as well as sales, is gradually rationalising the product range and is organising bulk purchasing. The exchange of experience between the two competitors is also an advantage, a difficult one to gauge, but nonetheless an important one.

In the military sector, the industrial organisation of the Tiger and the NH 90 has, in the event, been largely integrated into the "normal" structures of Eurocopter S.A., even though the two stand-alone subsidiaries (Eurocopter Tiger GmbH and NH 90 Industries) are legally responsible for the programmes. For the Tiger and the NH 90, workloads had already been distributed even before the creation of Eurocopter. Therefore, in both cases rationalisation is

limited by certain regulations under the agreement protocol, requiring, for instance, two assembly lines for the Tiger.

According to the German directors, Eurocopter's integration has always depended upon the quality of relations between the parent companies. DASA and Aerospatiale are partners in specific sectors when they act as shareholders in joint companies, but they remain rivals in the overall restructuring process. This competition could cause their strategic interests to diverge, which could, in turn, have a negative impact on the joint company.

Interference by the shareholders is, of course, closely associated with the joint company's degree of independence. In fact, the independence of Eurocopter depends not only on shareholder approval regulations, but also on the identity of the company developed by the joint venture. The more the directors and employees identify with the new company, the more room to manoeuvre with regard to the shareholders. For an integrated company like Eurocopter, which is meant to be a permanent structure, the development of such an identity is essential. At executive level this has already happened, but in general, the staff continues to identify with "its" national unit. Therefore staff exchanges across the borders are still very limited.

In this context, it has been generally recognised that the human factor is a decisive factor in the success of any international merger. Paradoxically, the higher the degree of integration of an international company, the greater the issue of national and corporate cultural differences. While setting up a joint management system is difficult, it is even more difficult for individuals of different nationalities and professional origins to work together within a new organisation. Eurocopter is therefore a "social laboratory" which could provide valuable experience for future mergers between national champions.

CHAPTER 2 : SPAIN

I. THE ECONOMIC AND INDUSTRIAL MODEL OF THE SPANISH PUBLIC SECTOR

Spain's current government is stepping up the restructuring and privatisation of public companies. A modernisation programme, presented in 1996, aims to improve the financial performance of public companies and privatise them over the next few years. This policy reflects the idea that government control has led to reduced efficiency for the economy and that the budgetary spending it generates is too great.

I-1. Main Characteristics of Public Sector Companies

Spanish public companies are governed by a whole series of organisations²⁸. Until September 1997, industrial companies in the red were grouped together within the *Agencia Industrial del Estado* (AIE), while those in the black were directed by the holding company SEPI (*Sociedad Estatal de Participaciones Industriales*). Other major public companies are controlled by the Ministry of Finance (*Direccion General del Patrimonio del Estado* (DGPE)) and its agency responsible for privatisation (*Sociedad Estatal de Participaciones Patrimoniales* (SEPPA)), or are public entities with the status of public organisation. Public companies that provide public services report to the ministry concerned. Finally, regional and local administrative bodies have also created public companies that they control directly.

This constellation of public companies includes companies that belong to very diverse sectors and the financial situations of which vary considerably. This is also the case in most other countries.

Bearing in mind the high capitalistic intensity of a great number of public companies, productivity was, quite naturally, higher than in the private sector. However, public companies benefited much more than the private sector from aid in the form of operating subsidies or capital grants and were comparatively more indebted. If we divide public companies up according to the organisation controlling them, high productivity can be noted

²⁸ A company is considered to be public by the Spanish authorities when :
- the government directly or indirectly holds at least 50% of the capital, or

for those companies covered by the SEPI. However, even these companies, which benefit from considerable government assistance, had a lower rate of profitability than in the private sector.

Having been over indebted for a long time, and in view of profitability problems, the Spanish aerospace industry is maintained by State financial support for a sector it has always deemed strategic. Sole shareholder of CASA and majority shareholder in the capital of Indra and Iberia, the SEPI is the financial instrument for the government's policy of support.

I-2. There are not many public sector companies and they are becoming fewer

Over the past few years, the number of public sector companies has fallen, due to an increase in the rate of privatisation. This rate of privatisation is now more rapid than in a great number of other European countries. In 1996 and 1997, the State gave up its residual shares in the telecommunications company (Telefonica) and its subsidiary specialising in international calls, the petroleum company (Repsol), the gas company (Gas Natural), the iron and steel industry (CSI) and the aluminium manufacturing company (Inespal). It also gave up a part of its shares in the electricity company (Endesa) and in the second largest telephone operator (Retevision). Furthermore, it plays little part in banking and insurance.

While the public companies controlled by the central government were gradually restructured and privatised, those controlled by territorial communities seem to be multiplying at a great rate. The number of these public companies rose by 45% between 1990 and 1996.

I-3. Assistance for public companies

Operating subsidies and capital grants awarded by the State to public companies averaged around 1.5% of the annual GDP between 1987 and 1996. This figure is well below the total assistance given to public companies because it does not include contributions in own funds and debt cancellation.

- the government does not hold a majority share, but effectively controls company operation.

The State also assists public companies by more indirect means, particularly by taking charge of commitments arising from early retirement schemes and redundancies and by acting as guarantor for loans, particularly in the case of companies or entities that are in debt.

The monopolistic environment in which certain public companies operate and a policy of budget transfer have not encouraged the control of labour costs. Salaries seem too high in the public sector.

I-4. A new policy with regard to public companies

In June 1996, the government announced an ambitious programme to modernise State-controlled enterprises, the aim being to guarantee the future viability of this sector and, as a result, maintain its employment levels. This modernisation programme is based on the two following principles :

- Separate management and ownership of public companies in order to improve restructuring and privatisation operations,
- Modernise with transparency, this commitment led, in particular, to the creation of an organisation responsible for assessing the equity and transparency of privatisation (*Consejo consultativo de Privatizaciones*), and
- Among the acceptable financial offers, give preference to those that will create investment and maintain employment. The privatisation programme plans for public companies to be privatised as soon as possible.

This new strategy allows for the great disparities among public companies as regards their financial situations and the competitive environment. This is why public companies are divided into several categories, for which a specific calendar and approach have been drawn up in line with their performance and competitive environment.

I-4-a. Consequences for employees

In addition to reducing transfers to public companies, measures have been taken to control salary costs. In a context of a wage freeze for civil servants in 1997, the government tightened up the salary standards applicable to companies controlled by the State and, for the first time, tied salary increases to improvements in productivity. More specifically, actual salary increases were dependent upon increases in productivity in profitable companies. The ceiling on overall salary mass increase had, however, been set at the official rate of inflation predicted for 1997 (2.6%).

As regards companies running at a loss, the total salary mass was frozen in nominal terms in 1997. The salary standards for 1998 are less restrictive. There will not be a rise in salaries in real terms, but there will be nominal increases dependent upon productivity gains.

I-4-b. Monitoring the competition

To implement its new strategy with regard to public companies, the government is now envisaging other modifications to the policy of competition. It will involve more effective action and greater independence for the organisations responsible for monitoring competition.

The current system consists of two levels :

The *Servicio de Defensa de la Competencia*, which is an integral part of the Ministry of the Economy, and an independent body, the *Tribunal de Defensa de la Competencia*. The *Servicio*, acting as its own boss or, more and more, in response to complaints from private individuals, decides which affairs require an inquiry to be opened and brought before the *Tribunal*.

I-4-c. Shareholders

The shareholders of newly privatised public companies reflect the efforts deployed by the government to give small shareholders more influence. During recent privatisation operations, around half the shares on offer were reserved for small individual investors who were able,

furthermore, to acquire the shares for a lower price than other potential buyers. To have an even more diverse range of shareholders, international institutional investors were recently offered a high percentage of shares. Despite all these efforts, major banks also obtained a significant stake in companies that had just been totally or partially privatised. These companies themselves wove a network of crossed shareholdings leading to close relationships between vertically connected sectors.

As a result, two banking groups still play a pivotal role in the capital structure of these companies. The first is the Banco Bilbao Vizcaya (BBV)/la Caixa and the other the Banco Central Hispano (BCH)/Banco Santander.

This situation can be explained by the traditionally close relations between banks and industry, which is supposed to create captive markets for the banks. The shrinking of banking margins on loans over the past five to ten years has also given banks added incentive to take a stake in industrial groups. The privatisation of monopolistic industrial sectors offered the banks an attractive new source of investment. The *Cajas* (regional savings banks) followed the banks' example and were able to invest heavily in these companies. The regulations encourage such initiatives, granting financial incentives to acquire significant share packages.

Despite efforts to achieve a diverse range of shareholders, the ties between banks and industry remain strong. This type of structure is reminiscent of the one that exists in Germany for example. This system of corporate governance is supposed to offer the advantage long-term relations creating a stable environment for the directors, which is auspicious for long-term investments. Banks are thus in a better position to monitor the situation, because they would be acting as both lender and major shareholder.

Nonetheless, this formula presents certain disadvantages : companies with inter-connected interests are not motivated to compete with each other on linked markets. Crossed shareholdings can also create systemic risks damaging the liquidity of the stock market and making shares less attractive for foreign investors.

Despite everything, a fair balance could be achieved if small shareholders continue to be encouraged and if access remains open to foreign institutional investors. But in Spain, shares with specific rights which enable the government to retain significant control over the main

strategic decisions, particularly for major cession of shares, can still hamper the entry of new investors and mitigate the threat of a take-over – which affects management effectiveness.

This practice is the opposite of that in many countries, which tend to encourage shareholding by institutional investors independently of banks, and foreign investment, which can also come with technological know-how and strengthen the rights of minority shareholders.

SUMMARY

Definite progress has been made recently in the restructuring and privatisation of state-controlled enterprises. The government's ambitious programme aimed at ensuring the financial independence of public companies and privatising any remaining public companies by the end of this century should significantly lighten the load that has previously put such a strain on the budget. Over the past decade, the total funding requirements of public companies covered by the State's budget have represented a high proportion of the debt accumulated over that period. Estimates attribute a quarter of governmental debt to public companies.

Thanks to progress made thus far and the measures still to be implemented, Spain should be well ahead of many other European countries in its reform of the public sector. Action taken to promote competitiveness and efficiency in sectors previously dominated by public companies will now be a determining factor in this reform effort. Revenue stemming from privatisation has lightened public debt. Between 1996 and 2000, income from privatisation could increase public revenues to the order of 4% of GDP.

If the reforms are implemented rapidly, the expected profits will be forthcoming and Spanish companies will leap ahead of their European and other world market competitors.

II. THE SPANISH MODEL OF STATE-INDUSTRY RELATIONS

II-1. Building the Spanish Model

Similar to the French model, and to a lesser extent the Italian one, the Spanish model of State-Industry relations is very progressive.

The Spanish armaments industry has evolved in different ways throughout the twentieth century.

Historically, the first third of the century was the golden age of the Spanish defence industry. In 1935, it was a leader on the international stage. After the civil war, a period of reorientation began. From 1935 to 1970, national industry went through a serious crisis. American aid in the name of military co-operation made up for these hardware restrictions. Apart from a few rare exceptions, national production ground to an almost complete halt. But in 1971, the military grants law gave rise to ambitious programmes : Baleares Frigates, construction of AMX 30s and of Northrop F-5s under licence.

In 1981, the defence industry employed 57,000 people and its exports were worth 1.5 billion French francs.

Ever since that period, Spain has considered co-operation in the armaments field and the purchase of military equipment to be the way to reconstruct a defence industry fabric. The "fair return" policy makes it possible to provide this country with real technological capacities, compensation is systematically requested for foreign orders.

This policy has been faithfully followed until the present day. This explains why negotiations for Spanish entry into the OCCAR are so difficult. This country considers that the rule stipulating that "fair return" must be applied to several programmes over a several-year period, cannot apply to them because Spain considers that its technological and industrial capacities are superior to its relative weight in the European defence industry²⁹ .

In the years following the new golden age of the early eighties, the Spanish armaments industry again met with difficulties. Although companies' turnovers were continuing to rise, profitability was not forthcoming and the government was forced to inject capital into

²⁹ La industria de defensa en España. Revista española de defensa numero 129 September 1998.

companies in difficulty on numerous occasions. In the nineties, this industry also suffered from severe defence budget cuts. The number of jobs in the armaments industry plummeted.

Today, this industry employs slightly less than 25,000 people for a turnover of just under 2 billion Euros. The Spanish themselves recognise that they are at a lower level than France, the United Kingdom, Germany and Italy in the European armaments industry. However, they also consider that this industry has a role to play in safeguarding Spanish security, that it will generate employment and particularly high technology employment. It is this last factor that largely explains Spain's interest in this industrial sector.

Furthermore, although this industry has not made specific moves to diversify, neither is it totally dependent on military activity because civil production represents 40% of the turnover of Bazan (naval sector), 64% of the turnover of Indra (defence electronics) 58% of the turnover of CASA (aeronautics) and 50% of ITP.

II-2. The State as Client

The drop in the Spanish defence budget is all the more significant in that during the cold war this country did not make any particular defence efforts in this field. From 1.7% of GDP in 1990, the defence effort dropped to 1.1% of GDP. The drop in investment credit during this period was 41%, a figure greater than in the UK or France, but lower than that of Germany. As in France, Italy and Germany, the drop in investment credit was able to occur during the fiscal year, a practice which helped unravel the organisation of the defence industry a little more. Spanish defence credits are now stabilised and are concentrated on three equipment programmes for the Spanish armed forces, that are also fundamental for the defence industry : the combat aircraft, Eurofighter, the combat tank Leopard 2 bought from Germany, and the frigate, F-100. Efforts were even made to increase research and development spending by awarding interest-free loans from the ministry of industry.

The ministry of industry also participates indirectly in the defence effort by financing research programs, particularly for the combat aircraft, Eurofighter.

Although total defence credits remain a very modest sum, the Spanish State is, however, pressing hard to help its industry profit from technology and work-load transfers by means of compensation tied to purchasing or industrial co-operation.

One of the many examples is the Leopard 2 for which the territorial armaments company, Santa-Barbara, became a true partner of Krauss-Mafei, the tank designed by the Germans being manufactured in Spain. Similarly, the Cougar helicopter manufactured by Eurocopter was only chosen by Spain in exchange for the delivery to France of seven CASA CN 235 military transport aircraft.

II-3. The State as Shareholder and Regulator

Historically, it is clear that the Spanish State is very directly involved in its armaments industry. As a result of this involvement, the Spanish State is the main shareholder in this industry and all the companies still have a status of public company. However, this situation is changing.

Although the armaments industry continued to develop from the beginning of the eighties, it was at the cost of major losses which the public shareholder had to cover. Between 1989 and 1995, the State had to contribute 335 million French francs (around 50 million Euros) in subsidies to Spanish companies.

In this context, the arrival in power of a liberal Government has doubtless accelerated a Europe-wide movement of government withdrawal from the armaments industry.

This policy was developed in a more global context, in which the Government adopted a programme to modernise public enterprise which was approved by the council of ministers on 28 June 1996.

This modernisation programme was applied in the armaments field by the *sociedad estatal de participaciones industriales* (SEPI) which is the company that manages the public shares held by the Spanish State in the armaments industry.

The model of corporate governance shows that the SEPI plays a very important role with regard to Spanish armaments companies, more important even than that played by the IRI with regard to Italian armaments companies.

Whereas the IRI manages a very large number of public shares and has a formal control function in the running of Finmeccanica, the SEPI demands a clear role in the management and strategy definition of Spanish defence companies.

This role is formally specified in the relationship between the SEPI and armaments companies.

Indeed, it is the SEPI that appoints the CEO's of armaments companies.

However, once the appointments have been made, the SEPI again intervenes in company management and strategy. Indeed, just under the President of the SEPI, are two managing directors, responsible for managing armaments industry shares. The first deals with the defence electronics and aeronautics sectors, and the second with the territorial armaments and naval construction sectors.

The role of these two directors is very important, because they sit on the boards of directors of these companies and are responsible for approving a certain number of decisions :

- approval of investments above a certain amount ;
- approval of the business plan ;
- approval of increasing subsidiaries' capital.
- approval of new programmes.

Therefore, it can be said that these two managing directors fulfil an executive function.

Finally, the SEPI is principally responsible for preparing the privatisation of the armaments industry.

In order to prepare for such action, the SEPI has adopted a policy of acquiring the companies in which it managed shares, to restore balance and gradually minimise and eventually stop the practice of granting balancing subsidies. Today the SEPI can boast that it has succeeded in putting at least the aeronautics and defence electronics sector into order ; the companies in this sector are even making a profit now.

The SEPI is answerable to the ministry of industry and therefore would presumably receive orders regarding policy mainly from this ministry.

III. ANALYSIS OF CASA'S STRATEGY AND BALANCE SHEETS

CASA's heritage is gradually diminishing (drop of 23% between 1992 and 1997). Since 1996, CASA – doubtless to improve its situation with regard to third parties – chose to reduce its share capital by 20%.

In 1992, CASA's results were in the red. After a spectacular recovery in 1993, the company was once again making a profit, which kept rising steadily. Profits rose six-fold between 1993 and 1998.

III-1. Asset Evolution

III-1-a. Fixed Assets

The relative proportion of fixed assets is diminishing. Investments in corporeal assets necessary to industrial activity are low.

However, the increase in long-term financial fixed assets (shares in the group's companies and subsidiaries) is constant, because financial investments tripled between 1992 and 1998. Nonetheless, a slight fall-off in financial assets can be noted in 1998.

This reveals a tendency on the part of CASA to favour financial investment rather than activity development itself. This choice to invest in financial assets rather than manufacturing equipment is indicative of the company's external growth strategy.

It should be noted, however, that although shares enable a company to control another one, the risk run by this parent company is not limited to the share value alone, but includes the risk of insolvency of the subsidiary.

Other financial assets (shares in other companies) have followed the general downward trend.

Development in R&D investments can be noted, with a more than 36% increase between 1992 and 1998.

III-1-b. Current Assets

This consists of all assets that are not intended to remain forever in the company, i.e. stocks, accounts receivable, VMPs and liquid assets.

The total sum of current assets dropped by 12% between 1992 and 1997, but experienced a sharp upturn in 1998 (+ 25% between 97 and 98).

The reduction in stocks and accounts receivable reveals CASA's management's desire to improve the running of the company. Good management of stocks makes it possible to reduce operational costs and following up on creditor client payment enables CASA to honour its commitments to suppliers. Indeed, a company relying on loans will suffer greatly from the interest payments.

VMPs (securities, shares and bonds acquired by the company to create short-term direct revenue or added value. They can be considered to be liquid assets), are the exception in the general downward trend shown by current assets, having skyrocketed over the past six years. These major investments even doubled between 1996 – 1997 and 1997 – 1998. This confirms the importance given to the company's financial policy.

III-2. Evolution of Liabilities

III-2-a. Fixed Capital Assets

A drop of 20% in share capital can be noted from 1996 in comparison with the years between 92 and 95. In theory, this reduction is due either to reimbursing the contributions of associates, or to a decision by the associates who consider that the capital is too high in relation to volume of activity and by decreasing it wish to improve the financial situation of the company with regard to third parties.

From 1992 to 1997, shareholder equity increased by 50 %. This is thanks to very good results achieved since 1993, and to savings set aside since 1996.

- Current liabilities hold an important position which increased steadily until 1998 They may have been over-valued to cause an underestimation of the result, or else to counteract the financial difficulties of the subsidiaries.

Current liabilities are intended to be used if ever current assets are unavailable. These current liabilities are set aside even before the results are established. Therefore, they reduce profits before any risk has actually occurred. No doubt shares in the subsidiaries do not give the results expected and CASA prefers to set aside reserves to compensate for poor performance by the subsidiaries.

- Investment subsidies increased by 19 % between 92 and 98.

- The proportion of medium and long-term debt has diminished considerably. It represented 61% of fixed capital assets in 1992, by 1998 it only represented 16%. In 1992, loans from credit establishments represented more than 62% of all financial debt and 38% of fixed capital assets.

In 1998, the proportion of this long-term debt was 9% of all financial debt and 1% of fixed capital assets.

The proportion of all financial debt corresponding to loans from credit establishments is as follows :

1992 : 62% 1993 : 57% 1994 : 46% 1995 : 35% 1996 : 22 % 1997 : 5%
1998 : 9%

The proportion of fixed capital assets corresponding to loans from credit establishments :

1992 : 38% 1993 : 31% 1994 : 21% 1994 : 4% 1996 : 5.5% 1997 : 6%
1998 : 1%

These elements contribute extremely important information on the financial management of the company. Indeed, minimising the use of this type of loan enables interest charges to be dramatically reduced.

However, an increase in borrowing by the subsidiaries and companies in which it hold shares can be noted, particularly since 1996.

The proportion of total financial debt corresponding to this debt :

1992 : 5% 1993 : 8% 1994 : 8.5% 1995 : 10% 1996 : 28% 1997 : 31%
1998 : 34%

The proportion of total fixed capital assets corresponding to this debt :

1992 : 3% 1993 : 4.5% 1994 : 4% 1995 : 4% 1996 : 5.5% 1997 : 6%
1998 : 6%

Indeed, this change in borrowing by the subsidiaries gave the group more flexibility in reimbursing the loans, particularly as regards negotiating the payment dates in accordance with results.

III-2-b. Short-Term Debts :

In percentage terms, commercial debt has notably increased. In 1998 it represented 43% of total liabilities whereas it only represented 33% in 1992. But in absolute terms, a regular drop in commercial debts can be noted until 1996, with an upturn in 1997 and 1998.

CASA's efforts to honour its commitments to its suppliers fell off sharply in 1997 and 1998.

Indeed, commercial debts represent the main (despite the fact that they are diminishing) source of short-term financing (sort of "free credit" granted by CASA's suppliers) because they represent between 80 and 75% of short-term debt.

Generally speaking, it can be said that CASA is working hard to bring its level of debt under control, because all financial and commercial debts are dropping significantly.

CASA needs to preserve its image of a healthy and well-managed company because financial institutions will loan more money to a company that is not too far in debt.

III-3. Breaking even :

Independently of the quest for profitability which is the very reason for its existence, the company must ensure its durability and stimulate long-term growth by reinvesting in fixed assets. The company must spend a certain amount of money, which it cannot postpone. It offers credit to its clients, and in return, the suppliers agree to delayed payment. The company must therefore, in its operating cycle, spend before earning. While awaiting incoming payment, outgoings continue. These can only be covered if the company has sufficient working capital. Therefore, there is a permanent net funding requirement.

The working capital is the excess of stable resources (or fixed capital assets (shareholder equity + long and medium term debt)) over fixed assets. In other terms, it is the percentage of fixed capital assets which is allocated to financing the operating cycle (current assets).

The first point to be made is that CASA's working capital is positive. This means that one of the fundamental financial rules is being followed : indeed, all permanent employees (fixed assets) are financed by stable resources. The excess is used to finance current assets.

CASA's working capital dropped by 14% between 1992 and 1997 but it returned to 1992 levels in 1998. However, the total working capital is only significant when compared to the net funding requirement. It can be noted that the working capital is lower than the net funding requirement in 1992 and 1993, indicating that the company cannot meet its commitments, due, in particular, to major creditors.

Balance was restored in 1994-95 and 96 because the working capital was exactly equal to the net funding requirement. This meant that the fixed assets and the working capital necessary for the company to run properly were covered by stable capital. The profits

which tripled in 1994 and which have continued to increase (12.5% in 1995, 16% in 1996 and 45% increase between 1996 and 1997) contributed to this financial balance. In 1998, the working capital greatly exceeded the net funding requirement, due to the increase in commercial debt.

IV. STUDY OF MODELS OF ECONOMIC AND INDUSTRIAL CO-OPERATION WITH SPAIN.

As the Spanish armaments industry is fairly small, and the decision has just been made to privatise it, no real economic co-operation exists yet between the Spanish armaments industry and other European industries.

The armaments industry in this country does, of course, participate in the conventional armaments co-operation programmes initiated by the States such as the Helios satellite or the Eurofighter combat aircraft. Similarly, co-operation can be established on a case-by-case basis for export programmes such as the sale of Scorpene submarines to Chile, or Bazan co-operates with the French naval constructor, DCN. Finally, the Spanish armaments industry is systematically involved in purchases by the Spanish armed forces of foreign military equipment.

The only major example of association with a foreign industrial partner concerns Indra Systemas in the defence electronics field, resulting from a joint venture between Taneo and Thomson-CSF, created in 1995.

IV-1. Indra systemas : individual case or precursor to the Spanish model of European grouping ?

In this joint venture, Thomson-CSF held 33%, and the Spanish State the remaining 66% via the SEPI. Rather than joint venture, it was therefore more appropriate to talk of opening of capital by seeking a reference industrial partner, which was Thomson-CSF. The particularity of this JV is that it was originally created between two public companies, but since then Thomson-CSF has been privatised, as was Indra in March 1999.

However, the privatisation of Indra in March 1999 dramatically changed the distribution of capital. Thomson-CSF was asked to reduce its stake to 10.5%, in particular by selling some of its shares to the Spanish banks Caja Madrid and Banco Zaragozano. In addition, with privatisation, 65% of Indra's shareholding was planned to be reserved for Spanish investors. In the end, the Spanish government decided to retain a golden share in Indra systemas for a duration of five years, which may be extended by two years.

In an initial analysis it can be supposed that the Spanish State was fairly cautious in tackling the privatisation of Indra systemas, retaining numerous means of control over the future company

- the French reference industrial shareholder only holds 10.5% of the capital,
- one of the shareholding banks holds an equal percentage,
- the shareholding is averagely diluted, and Spanish investors remain the majority,
- the Spanish government decided to retain a golden share.

An interview held with the director of shares of the SEPI, Pedro Castro Borrego, sheds some light on the choice made by the SEPI. Apparently, the analysis of the experiment led by the Spanish with Thomson-CSF since 1995 seems to be mitigated. The SEPI has been well aware that there is some disappointment with the industrial partnership provided by Thomson-CSF. The amount of technology, investment and workload transfer proffered by Thomson-CSF seems rather insufficient, and this is, no doubt, the reason steps were taken to in advance to balance the privatised company's shareholder power and provide protection against possible withdrawal by Thomson-CSF.

The importance of this example should be put into perspective while at the same time, it should be used to draw certain conclusions regarding Spain's immediate concerns.

It should be put into perspective in that Indra systema's share distribution model is not likely to prevail for all Spanish industry. According to comments made by SEPI directors, it appears that the choice is dependent on the economic conditions, that there is no typical doctrine for privatising the armaments industry, but that many decisions are taken on a case-by-case basis in accordance with various factors. It is the analysis of these factors that will influence the decision making.

The factors taken into account to determine the type of privatisation process chosen are both endogenous and exogenous.

There are three endogenous factors :

- The number of employees in the company liable to be privatised and where these employees are located.
- The technological skills already acquired by the company to be privatised.
- The overall character both in terms of high technologies and number of jobs in the sector to be privatised.

There are four exogenous factors :

- the workload provided by the company that will be the reference shareholder ;
- the technology transfers envisaged ;
- the market share contributed by the company that will be the reference shareholder ;
- overall analysis of the global and European context of the sector in which the restructuring is taking place.

IV-2. Analysis of the role of the different factors governing restructuring

Employment would appear to be a very important endogenous factor for Spain. This small player in the armaments field understood that its companies would be "wooded" by larger ones, be they European or American, and that full advantage should be taken of the situation.

At this stage, an initial turnaround in Spanish strategy appears. In sectors which appear to be of the future, both in terms of high technology and market share, and where Spain considers it has technological prowess, the European groups seem to be favoured. This is the case for defence electronics and aeronautics. However, alliance with the United States does not seem to be excluded when European prospects seem fraught with risk, and Spanish skill seems limited. Thus the SEPI has not excluded the possibility of choosing General Dynamics as a partner for Santa Barbara in the territorial armaments field.

The form privatisation takes also depends on the sector concerned. If the Spanish company's technological capacity is minimal, and if their contribution in terms of market share is negligible, then the search will be for a company interested in buying the Spanish company, the choice being in favour of the one that brings with it the greatest workload and market share. This is again the case for territorial armaments. It is fairly unlikely that under these conditions the Spanish government will opt for retaining a golden share in the territorial armaments company, Santa-Barbara.

However, the more the sector is considered to be technologically important, future provider of high-technology jobs and market share, the more the Spanish government will be tempted to retain decision-making power in the context of European grouping and restructuring. For the moment, this policy is illustrated by Spanish attachment to unanimous decision making for launching programmes and distributing workload among the different States that participate in Airbus, and even though the Spanish are making insistent demands that this Economic Interests Group be transformed.

Finally, all decisions are taken bearing in mind the overall environment in the sector concerned, particularly as regards the balance of power between Europe and the United States. What are the foreseeable developments ? What is the desirable European and trans-Atlantic set-up ? How can Spain better integrate into a system of restructuring ? These are the sorts of questions being asked.

IV-3. How are the different factors applied in CASA's case ?

Those involved in the privatisation of CASA were unanimous : this company was considered to be very important for the Spanish government at all levels :

- in terms of employment ;
- in terms of overall technological issues associated with the aeronautics sector ;
- in terms of CASA's skills and investments, particularly in the military transport field ;
- in terms of what was at stake with regard to the restructuring of the aeronautics sector.

With all this at stake, it could be assumed that the Spanish State would try to retain significant decision-making power in a privatised CASA. Observers, including those within the company, were convinced that a solution would be found whereby an industrial partner would be involved, a reference shareholder but a minority one, the rest of the company's capital being shared among banks, institutional investors and individuals. The possibility of registering of a golden share was not excluded either.

As it happened, another solution was adopted, but this does not necessarily mean that the philosophy governing the rapprochement between CASA and DaimlerChrysler Aerospace was all that different.

Firstly, this decision was made by the highest Spanish authorities : the prime minister, the minister for industry and the president of the SEPI, thus involving the top level of the Spanish State.

Secondly, it seems that the determining factor behind this merger was the general context of aeronautics restructuring in Europe and the world.

The decision taken can be interpreted in two ways :

- The Spanish government opted for the most integrated capitalistic alliance possible. It therefore seemed that the choice of a simple industrial partner in CASA would not enable the Spanish to guarantee the durability of their aeronautics sector. They needed to become part of a larger entity, which could only happen with a merger.
- This merger with DaimlerChrysler Aerospace also reduced the number of players involved in this European restructuring, which simplified subsequent discussions, particularly in the civil aeronautics field with Airbus.

All in all, this merger slotted perfectly into the context of the declarations made by the six ministers for defence on 20 April 1998, and reiterated on 6 July 1998, calling for the construction of a major European aeronautics and defence company. Once the solution of a "big bang from the top" became impossible following the merger of GEC and BAe, the solution of two-by-two mergers should, effectively, lead to the same result in several steps. Rather than push back the deadline and integrate into a larger group later on, the Government chose to ally CASA with a larger company immediately.

As the restructuring of the aeronautics sector had been a determining factor, we now need to assess the role played by the other factors.

The choice of DaimlerChrysler Aerospace rather than BAe, Aerospatiale Matra or Finmeccanica seems to be the result of several considerations.

The desire to retain as much control as possible over CASA's fate worked in favour of an association with a company that was not too large. At the same time, too small an ally would not have significantly increased their weight for future negotiations. Taking this criterion into consideration meant that the large partners like BAe/GEC and Aerospatiale Matra and the smallest partner, Finmeccanica were not in the running.

In terms of industrial attractiveness and distribution of civil and military activity, Aerospatiale Matra seemed without a doubt the best choice. At this level BAe was hindered by its focus on the military sector and DaimlerChrysler Aerospace did not perhaps offer the same guarantees of technological competence as Aerospatiale Matra.

However, DaimlerChrysler Aerospace had an essential advantage over Aerospatiale Matra : the fact that they were an active partner in the Eurofighter programme which, as mentioned above, was one of the Spanish armed forces' largest financial investments in the future.

Finally, it would appear that the top Spanish authorities felt rather worried about allying with a partner where a major public shareholder remained, even if Aerospatiale Matra is now formally privatised and the industrial reference shareholder is indeed the Lagardère group.

IV-4. How would power be distributed in DaimlerChrysler Aerospace/CASA ?

It is still too early to assess all the consequences of the merger between DaimlerChrysler Aerospace and CASA with regard to the economic and strategic co-operation model set up between the two companies. In any case, this model could be a determining factor in the subsequent restructuring of the armaments industry in Europe, because it is the first capitalistic trans-European merger that has not been 50/50.

We have seen that the Spanish model of State-Industry relations revealed an obvious interest on the part of the State in this industry. It remains to be seen how the Spanish will look out for their interests in the future company. At this level, certain conclusions can already be drawn by analysing the capital distribution of the future company.

The agreement made public on 10 June 1999 plans for a merger between the two companies in which the shareholder will be a holding company via which the SEPI will hold 13% of the merged entity. In fact, this shareholding needs to evolve rapidly because it is planned that :

- The SEPI will put 40% of CASA on the market, bringing its share down to 60%.
- DaimlerChrysler Aerospace, of which the shareholder is DaimlerChrysler at 94%, be listed on the stock exchange, which would cause the shareholder distribution in DaimlerChrysler Aerospace to be rapidly modified. Mention was made of the possibility of placing around 60% of the capital of the subsidiary of DaimlerChrysler Aerospace on the market, which would bring DaimlerChrysler's share in an entity merged with CASA to slightly less than 30%.

If this overview is correct, DaimlerChrysler would become a kind of reference shareholder, but the SEPI would retain a sufficiently significant stake to be able to make a shareholder's pact with terms that would protect Spanish interests. Furthermore, when this merger was announced, the Spanish minister for industry, Mr. Piqué, declared that CASA's interests had been protected by the agreement that was reached³⁰.

It is more than likely that the general terms of such an agreement were what was decided upon before the announcement of 10 June and that made them possible.

In view of the declarations able to be made before this merger, it could be thought that the terms of this agreement could cover the following main elements :

Management of DASA/CASA will essentially be in German hands. However, it could be assumed that the Spanish would have ensured that a certain number of measures require the agreement of the Spanish public shareholders, if it is confirmed that the SEPI retains a share in the capital of the merged entity. Examples of the sort of decision that would require approval by the SEPI would be :

- closure of sites
- the entry of another reference shareholder in the capital
- the strategy and decisions to be taken within Airbus.

Finally, the agreement must certainly provide guarantees as to the choice of the site of Seville as final integration line of the ATF.

All in all, it is not certain that a golden share will be registered by the Spanish State if it is guaranteed the right to control the subsequent restructuring process via the granting of a sort of right of veto on the entry of other reference shareholders to the company.

Subsequent declarations by the CEO of CASA, Alberto Fernandez, are interesting, because they help us to better understand what the Spanish want.

As soon as the agreement was announced, Alberto Fernandez, CEO of CASA, invited BAe, Aerospatiale and Alenia to join the new company, thus confirming that the option chosen had been taken with a view to seeing the main European aeronautics companies join together at the highest level.

In the days that followed, Alberto Fernandez specified his point of view, focussing this prospect of subsequent association on Alenia, of the Finmeccanica group.

In a declaration to Flight international, he stated that Alenia could be the next ideal partner for CASA/DASA. It is certain that besides the industrial community on a certain number of subjects : the Eurofighter programme, the future military transport aircraft A-400 M, even Airbus, such a merger would enable both the German-Italian-Spanish industry to be almost identical in size to the British and French. However, it would also enable the Spanish to slightly further dilute the majority shareholding of DaimlerChrysler in the company, and thus be forearmed, with the help of the Italians, against any decisions that might go against their interests. The Italian option would therefore sustain and confirm what we could envisage as a possible distribution of power and decision-making process within the merged Daimler-Benz-Aerospace/CASA group.

In conclusion, it can therefore be said that even with a greatly reduced public shareholding, doubtless without golden share, this economic and capitalistic co-operation model aims to grant the minority shareholder (i.e. the State and the company that represents it) rights that are not in line with the industrial and financial weight it carries. As such, we would be faced with a model that would continue to provide intergovernmental representation (i.e. complying with State law), in a company that is, indeed, totally similar to the Anglo-Saxon models of

³⁰ DASA-CASA merger ends single industry dream ; Jane's defense weekly 23 June 1999.

corporate governance with a relatively diluted shareholding³¹. It remains to be seen if this form of antinomy can function over time. It is plausible that conflicts of interests could arise between the States on the one hand and the industrial reference shareholders and small shareholders represented by pension funds, on the other.

³¹ It should, however, be noted once again that the Spanish model is relatively similar to the German model in that it makes banks major shareholders.

CHAPTER 3 : France

I. THE FRENCH ECONOMIC AND INDUSTRIAL MODEL

One of the French model's characteristics is that the State plays the role of regulator, entrepreneur and shareholder. It is a long-standing role, rooted in the Colbertism of the seventeenth century. However, growing market globalisation and strong reservations expressed by foreign investors are increasingly calling it into question. A second prominent feature is the high proportion of intersecting participation between companies (both private and public). Of course, what we call the "French model" is not one single structure, but is rather a mosaic of organisations in which the Government, private investors, banks and sometimes other stakeholders play roles of varying importance.

The following will be presented :

- A recap of the particularities of public companies and the role of the Government ;
- An analysis of the powers of Boards of Directors (for public and private companies) as structures representing several groups of stakeholders ;
- An assessment of the place of banks in the system ;
- A typology of how these companies (public and private) are monitored.

I-1. The particularities of public companies in France

The main particularity (from a theoretical point of view) arises from the difficulty in identifying and dealing with the agency relationship that could exist in the case of a public enterprise (particularly between the voter-taxpayer (Principal) and the director (Agent)), due, among other things, to several political layers interacting between the two. This particularity carries repercussions on the monitoring procedures and mechanisms employed by the Government, as both shareholder and representative of the owner Nation.

External monitoring and sanction mechanisms :

The Government having a share in the capital gives rise to certain characteristics, in particular the inalienability of the shares that it holds (hence lessened liquidity and effectiveness of the financial market for title deeds). On the debenture market, the Government's guarantee could lead to less discipline being imposed on the public company which is liable to generate high levels of debt and relatively lax management. Furthermore, the participation of the Government in certain banking institutions has sometimes lead to rash or inefficient support being given to public enterprises (contrary to what the market might have done).

The Government's imprint can sometimes even affect the accounting data sent by public companies. CHARREAUX [1997] uses interviews with directors (or ex-directors) of these firms to highlight the fact that in such contexts, French accounting is fairly flexible (everything depends on what the majority shareholders wish to hear), and encourages the discretionary power of the Director (and that of some certifying organisations) as the driving belt.

With regard to integrating salaried employees into the mode of governance, it is appropriate to note that these employees benefit from more favourable financial treatment and are better represented than their counterparts in the private sphere. However, it can be noted that the directors of public companies sometimes attempt to portray the unions as unrepresentative to weaken the powers of employee representatives and adopt a more Anglo-Saxon form of governance.

Internal monitoring and sanction mechanisms :

The Government is the majority shareholder in the company, but its involvement can take several forms (monitoring being able to be carried out directly or indirectly) : under the supervision of a Government ministry, Government representatives on the Board of Directors, directives, circulars or audits by the Audit Court and Parliament. With regard to informal influences, networks of acquaintances can be mobilised to monitor a company discretely.

The Government is often accused of having a more lax attitude than private investors for two reasons : firstly, its share portfolio is very widely spread, hence it has little inclination to monitor everything, and secondly, the decision makers (of the company or the Government) are not personally responsible, and any losses are eventually borne by the tax-payer.

Regarding the relative inefficiency of public companies :

Economic publications generally consider public companies to be less efficient than private ones. The management of public companies is subject to certain constraints (the presence of the Government, more rigid or not so rigid funding possibilities, varying degrees of independence in management and strategy etc.). Shortcomings in the systems of governance can be clearly seen, such as audits essentially carried out "after the event", in accordance with the principles of accounting and financial "compliance" rather than in accordance with the economic and strategic pertinence of decisions taken. However, it should be recalled that public companies are still more efficient when market imperfections are present (barriers to entering a sector, natural monopolies etc.). Furthermore, as soon as a conflict of interests arises, the management of coalitions becomes more complex, even though in an unstable and complex environment, market mechanisms seem to become more efficient.

One of the explanations given for the reduced efficiency of companies is the unrest that a high turnover of directors can sow within a company. Nonetheless, like those in the private sphere, directors in the public sphere have plenty of room to manoeuvre. From which springs the question asked by ZECKHAUSER, HORN & MURPHY[1989] : can we attribute the poor economic performance of public companies to a shortcoming in the system of governance ? Or, on the contrary, are there too many constraints placed on the directors who run them, in certain cases leading them to make inappropriate choices ?

I-2. The powers of the Board of Directors

This point underlines the particularities of public companies' Boards of Directors in comparison with those of private companies in France. Numerous legal constraints pertaining to the appointment of board members, of the Chairman of the board as well as the length of their mandate, affect the life of public companies. These constraints are as follows :

- For public companies with more than half their capital in the hands of the Government, the Chairman of the Board of Directors is appointed by decree from among the board members and on proposal by the board.
- The length of a Chairman's mandate is usually three years. The Chairman is invested with a range of powers : all decisions relating to the major strategic, economic, financial and technological lines of action taken by the company may not be made without first consulting him and obtaining his prior approval.
- There are two typical configurations for the Board of Directors : either tripartite with equal representation of the Government, the workers and the other shareholders, or a third for the employee representatives and two thirds for the other components. For CHARREAUX[1997] "Public control, even if it takes a form other than direct majority control of the Government, must be accompanied by elected employee representatives and Government representatives appointed by decree". This helps us to understand the reaction of the British in the Aerospatiale case.
- The role of the members of the Board of Directors, both observers and monitors (whether in a public or a private company) is three-fold : check and approve the accounts, monitor general company policy and ensure the internal organisational structure operates efficiently. In public companies, the presence of employee representatives causes certain important decisions to be made outside (such as those with direct repercussions on employment) and the Board of Directors can become a formal source of information and place for recording decisions made.
- In the event of a crisis, the role of the Board member representing the Government is supposed to become more active. He must keep the other Board members informed, and, if necessary, bring the dispute before the Chairman ensuring the shareholders' rights are upheld. The mandates for members of the Board of Directors in public companies are five years long with a maximum limit of three successive mandates. The members representing the Government and qualified public figures are able to be dismissed. For salaried Board members, dismissal is possible in the event of serious fault, via the legal system and on the request of the majority of members of the Board of Directors.

The fundamental difference between the Boards of Directors of public and private companies is that those of public companies play a more consultative than active role, the true counterweight to the powers of the Chairman being the Government authorities. Furthermore, the Board of Directors of public companies have less legal power, but it would appear that the members representing the Government benefit from easier access to information than private firms do, due, among other things, to their relationship with the Treasury and major public financial organisations.

It should be specified that the Government can intervene in decisions whenever it deems it necessary, outlining the direction it would like to see taken (explaining why certain companies sometimes wander misguidedly, such as the Credit Lyonnais, which the Anglo-Saxons never cease to hold up as an example of the risks of State intervention in a large company).

I-3. The role of banks.

In France, the role of banks is quite different from the role we described in the German model. Historically and legally, the sectioning-off of banking activities and the Government's desire to develop markets have contributed to reducing the influence of banks as shareholders. Up until 1984 (Loi bancaire), the separation of deposit banks and business banks did not give businesses easy access to saving ; on the one hand this limited the relationship between banks and industry, and on the other encouraged development of financial markets. French companies, which favoured funding via an intermediary up until the beginning of the nineties, now turn more naturally towards the markets, and do not think twice about playing the banks off against one another.

I-4. An outline of monitoring methods.

The objective of this outline is to specify, without being exhaustive, the major types of shareholdings listed in France. These will be presented in increasing order of State intervention.

- Control Holding Company : Such companies do not exercise a specific activity and generally manage the stakes they hold in their subsidiaries. The advantages of this system are : direct monitoring of subsidiary management (in a caricatured way, the managers keep to managing the daily running of the subsidiary and making tactical decisions, while strategic choices are made by the owners) ; arbitration in the case of dispute between subsidiaries ; the possibility of righting any financial imbalance within the group ; and the impossibility of losing control of the group (no new shareholder without the agreement of all the other owners). The Government does not usually get involved in this sort of structure (at least, not directly).

- Open shareholdings. In this case, the market is the companies' main source of finance, in accordance with the rules of the game. The shareholding therefore varies (depending on the industrial and financial logic of the investors) and the group becomes more vulnerable. However, given the rapid development of financial engineering, there are enough categories of non-voting shares to increase the capital, without placing the structure of the directing team in danger (right of double vote, certificate of investment without voting rights, non-voting share with priority dividend etc.). Privatised, private or mixed-economy companies often turn to these "safety-net" financial products to develop their funds and help globalisation.

- Reference shareholdings. The reference is, of course, the German model. It would seem in the case of Aerospatiale that the German partners reproached the French Government for not playing the role of reference shareholder well enough, and only intervening in a discretionary manner. In fact, they would prefer the French Government to behave like an active shareholder and wise manager. In the specific case of Aerospatiale, Dasa would actually like the French Government to let the enterprise develop in the same way as a private company.

- Hard core shareholdings : This is the model in which private and privatised companies constitute the nebulae of shares which enable the shareholding and power structure to be locked (conventional acquisition of holdings : "circular holdings" between subsidiaries of the same group ; "crossed-holdings" between allied companies). This system limits access of outside investors to the group (hence criticism), and freezes the capital of the companies concerned. In France, the central element of this system is the grouping of

companies around the poles which are now Axa-UAP and the Société Générale, after the financial scene was rearranged and the Crédit Lyonnais weakened in its role as the third pole, of public origin.

In the context of privatisation, hard cores have often been set up : it involved constituting "private groups under high public surveillance" (with a public company shareholding in the financial hard cores). This method made it possible to "choose" the shareholders of companies, from the outset reserving a certain proportion of the capital for the industrial and financial allies who willingly accepted reciprocal acquisition of holdings.

The system of hard cores also makes it possible to strengthen existing ties between teams of directors (the majority of directors have been to the same schools and universities) and to entrust the directors with considerable room for manoeuvre as well as significant financial support. Nonetheless, this delicate and subtle balance remains sensitive to transfers of ownership from the public to the private sector, and vice versa, which can render the directors' positions very fragile.

In theory, this threat of eviction should be sufficient to keep the directors in line (particularly since they are supposed to value their reputations with a view to being head-hunted later on) and to put them to work for the good of the shareholders. Unfortunately, the ties and networks that they weave with the public and private sectors allow them to act as they see fit, without being too concerned for their future. The observation that can be made is that a managerial elite has existed for decades in France, hence the following comment : "French capitalism functions more and more like a dictatorial-type technocratic blend and family capitalism. Managerial capitalism is hardly to be seen in France" BARRER and MOUROT [1995].

At the current time, companies are re-centring their activities and are tending to remove non-strategic shareholdings from their share portfolios. We could therefore assume that the French system of hard cores is on a natural course towards extinction. In reality, the shares are merely changing hands within the group and tend to consolidate the financial poles (according to Francois Morin : "There is too much shared interest involved for the system of hard cores to be done away with").

It would seem that the French model is developing along the lines of the Anglo-Saxon model. This trend is obviously heightened by globalisation of markets and capital. However, bearing in mind the characteristics of the companies and activities which concern future European enterprise, study of the particularities of the three models we have just described is still relevant.

I-5. Analysis of the group Aerospatiale Matra with regard to Corporate Governance

It is difficult to give a precise analysis of the group Aerospatiale Matra with regard to the rules of corporate governance since the company was only created recently. Obviously we will need to wait for a few months before being able to give a detailed description of how this company works. However, knowing the culture of the two companies and the general development of relations between the French State and armaments companies provides a basis for some initial comments.

I-5-a. Analysis of Company Structures

Aerospatiale Matra management is shared between a board of directors and a supervisory board.

The board of directors consists of two people, Yves Michot who is the CEO, and who was the CEO of Aerospatiale and Philippe Camus, the Managing Director who comes from Matra and was the director of Matra Haute Technologies.

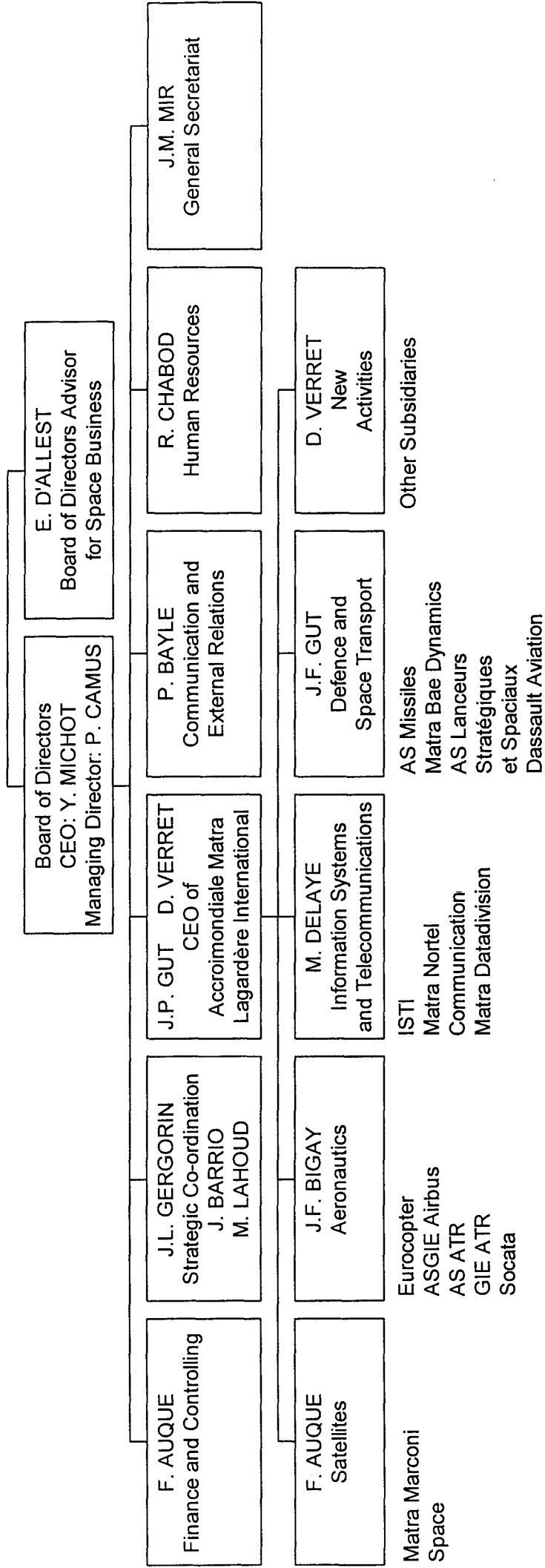
The supervisory board is made up of 16 members. Six are appointed by the French State, four by Lagardère, two are persons qualified in the company's sector of activity, one is an employee shareholder representative and three are elected by the employees. There is also a seventeenth administrator who does not have voting rights and represents the golden share retained by the State. As in the case of Thomson-CSF, the general delegate for armaments, Jean-Yves Helmer, has been appointed to this position by the State.

This company structure, with a board of directors and supervisory board is not common in France. It is a sign of the fact that the company Aerospatiale Matra is the result of a merger of companies rather than a take-over. This form of union is also unusual in the corporate world.

It highlights the State's goodwill underlying this merger, along with the need to consider the sensibilities of public company structure and private company structure in France, particularly regarding the employees of both companies. An initial analysis of whether the bringing together of Aerospatiale Matra constitutes nationalisation of Matra or privatisation of Aerospatiale gives the answer : neither.

Therefore the structure of Aerospatiale Matra can be compared to that of a 50/50 joint venture where the balance is found between the board of directors and the supervisory board on the one hand, and the two directors on the other.

This balance can also be found within management, because the executives of Matra and Aerospatiale are evenly distributed among the company's management positions (see organisational chart below).



However, the fact that Jean-Luc Lagardère will be the chair of the supervisory board puts this balance into perspective.

I-5-b. Distribution of Capital and the Shareholders' Pact

Initially, the distribution of capital in the company Aerospatiale Matra can be seen to correspond to nationalisation because it was decided on 22 July 1998, the date the merger of the two companies was announced, that the Lagardère group would hold 33% of the company's capital after the contribution of Matra-Hautes Technologies. This analysis should not be retained for two reasons.

- 1) The distribution of capital will change. When the merger was announced, it was decided to privatise the company Aerospatiale Matra by putting 17.5% of the capital on the market. This privatisation process was completed on 4 June 1999, the first day the company was listed on the stock exchange. In total, the State now only holds a 47.5% stake. It could even be considered that the State's moves to disengage itself will continue, an analysis which would back up the shareholders' pact.
- 2) Indeed, the shareholders' pact gives particular rights to the private reference shareholder, the Lagardère group, in particular as regards capital evolution. If the capital was required to evolve, Lagardère has the option of maintaining its stake at 33%. If the State gives up any of its capital, the Lagardère group has a right of pre-emption over the State's shares, an important factor should it merge with another company and the French State wish to withdraw. On the other hand, the French State has a right of pre-emption should Lagardère wish to disengage capital from Aerospatiale Matra.

All in all, the general feeling is that this is a company undergoing gradual "depublicisation". This disengagement is happening gradually, couched in euphemistic language in order to reassure the employees of Aerospatiale and to focus on the advantages of shareholder value and the creation of company value with regard to foreign companies and governments.

The entry of this company into the competitive sphere seems to be both inexorable and rapid. The role of the individuals in charge of managing the new company is of the utmost importance in this process. It can be confirmed that the combination of Matra management (accustomed to this exercise in managing an industrial sector company listed on the financial markets) and high civil servants who : are former members of ministerial cabinets, are part of both the management of Aerospatiale and of Matra and are converts of this evolution, will help the future company to develop all the more rapidly.

The only factors that could put a brake on this evolution lie firstly in the continued existence in the new company's management of people still from the inner circle that set up the French armaments manufacturing system between the sixties and the nineties, and who have passed through the General Delegation for Armaments. The second hindering factor lies in a board of directors that still remains partly traced on the public company model, a board of directors that is used to being "transparent" and, in line with the French model, not being the centre of governance.

II. THE FRENCH MODEL OF THE RELATIONSHIP BETWEEN STATE AND INDUSTRY

II-1. Background of the French model

II-1-a. The political factor : from the power theory to national sovereignty

Without going into details, it can be said that the historical context weighs heavily on the model of our relationship between the State and the armaments industry.

In France, even more than in the United Kingdom, armaments constitute one of our country's factors of power. From the time of Colbert arms manufacturing has been one of the Government's prerogatives, and this monopoly has never, until now, been truly called into question. At the beginning of the century, an aeronautics industry was set up and, when the military interests for aviation were realised, it was nationalised.

After the World War II, two events shaped the physiognomy of our armaments industry. The fourth republic arose from a popular patriotic reaction and upheld the values of the nation, representing the people as a whole. Social rights were written into legal codes in the foreword to the constitution, and a certain degree of mistrust was instilled with regard to private interests when an activity was of interest to the nation as a whole. The armaments industry is a public activity by nature and the engine manufacturer Snecma was nationalised in 1946.

However, French industrial fabric then had to re-build itself and our armies used American equipment.

The French armaments industry would certainly not have become as important as it has if two political events had not given a new lease of life to the theory of nationalised industry. Ten years apart, the Suez crisis in 1956 and the withdrawal of NATO's integrated military structure in 1966 justified the existence of an industry which enabled us to pursue a foreign policy that was independent of our American ally.

The renovation of the French armaments industry therefore stemmed from an initiative of public power which was to shape, to a large extent, the relationship with this industry. The industry itself was at the service of a political policy, it did not have an economic objective per se, which, for a long time explained the relative lack of interest in the structure of armament companies.

II-1-b. Industrial structure : the weight of strata rather than ideologies.

Studying the structures of French armaments companies tends to show that historical heritage explains, in essence, the structure of French companies. Beyond the major political changes that occurred in 1936, 1945, 1981 and 1986, one is forced to realise that in France today, industrial structures under Government authority (the DCN), public enterprises (Giat-industries and Aerospatiale), companies with a grouped shareholding (Thomson-CSF) and companies with a diluted shareholding (like the Lagadère group and Alcatel) can all exist side-by-side. Therefore, this examination reveals that different Governments have not tried as hard as one might have thought to establish a theory on the economic structure of the armaments industry, or at least that their influence has been more limited than we imagine.

Furthermore, when theories were developed, as in 1981, and in 1986, they took little account, in general, of the particularities of this industry. The wave of nationalisation in 1981, which led to the nationalisation of Thomson of Matra and in theory of Dassault, was part of a policy generally aiming to acquire production means which could contribute to increasing the direct influence of the Government's economic, social and international policy. Nationalisation in the armaments industry in 1981 constituted but a part of the wave of nationalisation, just as in 1986 privatisation in this industry only constituted a part of the wave of privatisation.

Overall, it should be remembered that, outside the nuclear sector, the older the type of armaments, such as powders and explosives or land and marine weapons, the more the structure of production is governed by the State. However, "recent" armaments (defence electronics, missiles) tend to be manufactured in industrial structures which have always been, or are once again, private. The aeronautics sector falls between the two. It was nationalised in the middle of this century, with the exception of Dassault which was established after World War II. Therefore, we possess an industrial structure marked by this phenomenon of strata more than by a fundamentally State-oriented or liberal ideology. The trend is veering nonetheless towards privatisation of armament companies, as in all industry and service sectors, but this is evolving slowly, no doubt due to the conservative structure of French society.

II-1-c. The organisational factor of the relationship between State and industry : the DGA

In France, the nature of the relationship between the State and industry almost certainly owes as much to company structure as to the relationship that was set up with the Bureau for Armaments (Délégation Générale pour l'Armement, DGA).

The French armament industry is both a French tradition and a recent product, dating back to the end of the fourth Republic and the beginning of the fifth Republic. It is a product which the DGA has played a major part in shaping.

Since it was created in 1961, at the time called the Délégation ministérielle pour l'armement, it has been endowed with very wide-ranging powers :

- It manufactures certain armaments itself

- It specifies and runs the programmes
- It purchases materials

Finally, and perhaps more important still but rarely studied, in terms of organisational sociology the DGA is made up of a relatively coherent core of individuals, armaments engineers, able to move around the companies either to manage and advise, or to monitor them in the case of public enterprises.

This provides a relatively coherent ensemble where the DGA is the instrument of a strong political will, the construction of an armaments industry, with a large amount of credit (for a long time there were no major financial constraints) and where the industry, regardless of its legal status, pursues objectives strictly in line with those of the Government that monitors it. This is what caused Jean-Paul Hébert to say in his book on "armament production", that a company like Dassault "despite being private from a legal stand point....can be characterised as having the culture of a national enterprise".

In fact, perhaps the question at that time was raised in terms of company culture. In the sense that the relations between the State and industry were friendly and characterised by common objectives (to construct the highest-technology armaments industry regardless of cost - in the sense that the DGA takes responsibility, in choosing its contracting parties, for organising the competition and the industrial fabric and for keeping foreign competition at arms length), the legal definition of the structures of those companies that manufactured its products was of little concern. It was the political objective attributed to the armaments industry and the relationship between the DGA and the companies, which shaped the French system, not the legal structure of the companies. As a result, up until 1981, structures as different from each other as Dassault Matra and Thomson on the one hand and the DCN and GIAT on the other, were able to rub shoulders without raising comment. This also explains how the leaders of armaments companies have long, and unquestioningly (political ideological considerations aside) considered that privatising the armaments industry would not constitute a fundamental change with regard to a public company structure³².

³² Jacques Buzenet expressed an opinion along these lines during a symposium organised by the IRIS on the future of the defence industry on 9 June 1993

II-2. A model turned upside down

For the past few years, the French armaments industry model has been experiencing a period of change, not to say crisis. In 1994, Jean-Paul Hébert described this change in his thesis on weapons manufacturing. The past four years have thrown further light on the main conclusions of this thesis :

- Firstly, what Jean-Paul Hébert calls the diversion of costs is perhaps not a phenomenon resulting from abuse of the relationship between the State and industry, but a phenomenon inherent to the very system of this relationship. The aim of armaments manufacturing in France has never been to manufacture better equipment for less, but to incorporate the highest-performing technology in the equipment whose operational specifications were liable to vary with time. Rather than a diversion of costs, it would be more appropriate to talk about a lack of cost control, a phenomenon which only proved awkward once we reached the limits of France's economic ability to finance the production system under such conditions. Then resulting cuts in the defence budget from 1992 onwards, and the crisis of the consumer credit mechanism, added to the difficulties.
- Whenever it was possible, certain companies increased their civil activity almost mechanically. Dassault, Aerospatiale and Snecma, did not really want to move away from the defence sector, there was simply a corresponding reflection in their results when they gradually replaced the military market by the civil market, because at the very time the former was cutting back, the latter was tending to expand. Simply by moving away from a protected market, these companies entered into a competitive sector, and felt the need to benefit from the same advantages as their competitors. Thus, in 1993, the president of Aerospatiale, Louis Gallois, pleaded the case for the privatisation of his company so he could fight on an equal footing against competitors such as Boeing, and MacDonnel Douglas.
- Those who saw their situation as being protected by this combined State-industry regulatory model and who only operated within the context of the armaments field have found their situation dramatically called into question due to the drastic reduction in Government orders and their inability to adapt to a new style of relationship which now takes the cost of armaments into account. This was the case for companies such as Giat Industries and the DCN.

The old model is no longer efficient and has been called into question. But one of the particularities of the current situation is that it is very difficult to qualify the relationship model which has been set in place.

II-3 A new, but poorly-defined model

The model described by Jean-Paul Hébert and which involved friendly relations between the State and its industry, with identical interests (to be distinguished from relationships in the United Kingdom where the current situation satisfies State and industry interests even though the two do not share common goals) no longer prevails. A new model has been set up, but one of its main particularities is that it is neither truly defined nor truly established with a view to consistency. The responsibility for this would appear to lie with a double political division.

II-3-a. the split between sovereign industry and expression of that sovereignty

The reform of the relationship between the State and the armaments industry truly began in 1995 when Jacques Chirac was elected President of the Republic. However, there is no real theory which defines the new relationship.

With regard to the principles, we reiterate that the French armaments industry is necessary for the expression of our sovereignty. The different views on the subject which arose from Jacques Chirac's speech on 22 February 1996, from public appearances made by the Minister for Defence, Charles Millon and from the military programming law for 1996-2002 are but an extrapolation of the 1994 white paper on defence. The worth of the French armaments industry extends beyond mere economic worth, but nothing distinguishes this line of thinking from that which can be seen in the United States and the United Kingdom. Furthermore, the importance placed on export development shows the necessity for this industry to stop depending on the French Government alone to guarantee such development. Above all, at no time has the relationship between the State and industry been described : the armaments industry is an industry necessary to the expression of sovereignty, but how the State will ensure that its interests are safeguarded is not explained.

II-3-b The split between what is political responsibility and what is administrative responsibility

To give a brief outline, it could be said that the policies implemented since 1995 are in two parts :

- The privatisation of Thomson CSF and Aerospatiale which was planned in the 1993 privatisation law but was not carried out.
- The modification of the relationship between industry and State which includes the reform of the DGA.

However, it can be noted that these two reforms were never actually incorporated into a global concept of the State-industry relationship. In fact, it seems as if privatisation of the armaments industry is a decision of a political nature, while reform of the DGA is purely an administrative matter. Thus, from 1995, the government ran the process of privatising the armaments industry, while giving the impression of leaving the DGA to carry out its process of reform alone, as if the stakes involved were nothing more than a simple matter of administrative efficiency.

In this context the debates on both subjects, rather than dealing with the issues in their complexity and particularly in their entirety, focused on a few specific aspects.

The armaments industry privatisation debate is only approached via the public company "efficiency vs. inefficiency" issue and not via a complex issue where three things must be known : whether the State should (or not) organise industrial restructuring in this phase of privatisation of the industry ; what is the most suitable capital and financial structure for a market which is becoming global ; and how the State will ensure that its interests in the armaments industry retain their value in the future.

However, we have seen that in the British model it was not so much the golden share that was the State's instrument for action in the armaments industry, but the manner in which procurement was organised. Furthermore, this system of procurement had to be able to continually adapt to the evolving industrial situation.

Thus it can be considered that although the privatisation of the armaments industry is necessary above all to seal foreign alliances and to free the State from its social responsibilities in an industrial sector, it is actually the reform of the DGA and procurement

which is liable to fundamentally transform the relationship between the State and industry in France.

However, this question only seems to be dealt with from the very simplistic stance of the cost of armaments. The reform of the DGA and its relations with the industrial sector is particularly intended to reduce the cost of the programmes, the objective of a 30% gain has been set in a context of reduced financial availability.

Yet the thinking followed by the British also makes itself felt ;

Competition ? Aside from the aeronautics sector where competition seems an impossibility, it is desired, including in the missile sector. But the restructuring/grouping movement is already underway, even at European level and can only limit its effects.

In practice, the desire to enter the competition seems to be real but difficult to implement with regard to the State sector or near-State sector being in difficulty (the DCN and Giat-industries)³³.

The need to extend the study phase for the programmes, the need to involve the industrial teams in carrying out the programmes ; all things that became relevant with Smart Procurement in the United Kingdom three years down the track, will also arise in this reform of the DGA.

Three years after it began to be applied, major doubts remain as to the result of this reform of the DGA and especially as to its industrial objectives.

The practice of grouped orders is being set up, but this measure at the very most is the result of a cleaning up of budget management.

Other issues also need to be dealt with in the context of the reform.

How are the programme teams operating ?

Does the DGA have the means to control the specification of the industrial cost of the programmes and the profit margin of the companies ?

Will the armaments contracts enable the ? companies to achieve the profit margins required to satisfy private shareholders ?

How is a balance achieved between the available budget, the sophistication of armaments required and keeping costs to a minimum ?

What is the financial impact of entering the competition and the limitations of this exercise during a phase where monopolies are being created ?

One of the lesser paradoxes of the armaments industry today is indeed that preserving the State's sovereignty requires it to be able to generate the profits from this industry and thus

satisfy the shareholders' interests. Objectively speaking, this goal is in contradiction with those of the client State which wants the lowest prices, but it is not necessarily cause for antagonism, as we have seen in the United Kingdom.

The French approach thus seems to take inspiration from that followed by the British since the early eighties. However, it should not be forgotten that a certain number of parameters have changed since then. Indeed, the British initiated their approach at a time when defence budgets were at their peak and the concentrationist initiative of certain armaments companies attempting to attain a monopoly situation had not truly begun. And still, certain British companies experienced difficulties in their period of adaptation.

Therefore it cannot be denied that the approach undertaken in France is being carried out at a time when budgetary circumstances are least favourable and when competitor companies are the most likely to have a predatory attitude.

II-3-c. Origins, terms and conditions of use and scope of French action spécifique

It will never be emphasised enough, the action spécifique (French translation of the golden share) is not a legal invention sui-generis, but is associated with the privatisation of French companies. France experienced its first privatisation movement in 1986, with the change of government, and followed the wave of privatisation resulting from the Left coming to power. At that time the objective was to return to the situation which had previously prevailed.

Among the companies listed for privatisation by the Law 86-793 of 2 July 1986 authorising the government to take various economic and social measures, was the company Matra. After being adopted, this draft law was submitted to the constitutional council which, in France, ensures that laws comply with the Constitution. The constitutional council explicitly expressed reservations regarding the privatisation of companies needed to safeguard national independence. Law 86-912 relating to the terms and conditions of privatisation decided by Law 86-793 of 2 July 1986 established, in Article 10, the need for an action spécifique when it was necessary to protect national rights.

According to this Article 10, if the State decides to transform an ordinary share into an action spécifique, the latter "enables the minister for the economy to authorise shares in excess of

³³ cf matter regarding ordering a trailer for the Leclerc tank and repairing the Jules Vernes.

10% of the capital held by one person or by several persons acting together". This authorisation can be demanded at 5% for companies covered by Article 223 of the Treaty of Rome, that is to say armaments companies.

However, it should be noted that this action spécifique has a life span of 5 years. It was under this system that Matra was privatised in January 1988. The action spécifique was requested by the State. The effects of this action spécifique therefore came to an end in January 1993.

After a change of power in 1993, the government led by Edouard Balladur decided upon a new wave of privatisation for that year. Privatisation Law 93-923 of 19 July 1993 plans for the privatisation of 21 groups, the terms and conditions for privatisation being those, with some modifications, of the 1986 privatisation law.

To be counted among these modifications is that of the terms and conditions for using the action spécifique.

Law 93-923 of 19 July allows :

- that the decree establishing the action spécifique sets the thresholds beyond which authorisation is required from the minister for the economy,
- for the nomination to the board of directors or monitoring body of one or two state representatives, appointed by decree and without voting rights,
- that this action spécifique allows the state to oppose "decisions to transfer shares or use them as a guarantee, when such decisions could harm the national interests".

Finally, there is no longer a limit to the time in which these actions spécifiques are effective.

The transformation of this action spécifique into an ordinary share even seems impossible for defence companies because in the last paragraph of Article 7 of this law states that :

"Unless national independence is in question, the action spécifique can, at any time, be permanently transformed into an ordinary share by decree".

To explain this "hardening" of the terms and conditions for using the share, the minister for finance explains :

"We were concerned about the risks regarding national sovereignty which the privatisation of certain companies involved in strategic activities or the defence sector could engender. The device I have just described accords the State very important prerogatives as regards privatised companies when national interests are in play".³⁴

³⁴ *Assemblée Nationale*, 28 June 1993

With these new terms and conditions for application, the French State has used this ability to set up an action spécifique on two occasions ; on the privatisation of Thomson-CSF and of Aerospatiale.

The two decrees setting up the action spécifique were enacted on 3 August 1996 and 16 February 1999 respectively.

On studying these decrees it can be seen that the spirit of the law has been applied differently in the two cases, particularly as regards share transfer.

In the case of Thomson-CSF, the share covers the entirety of the company, including subsidiaries and joint ventures with other European companies, thus preventing application of the clause covering the pre-emptive right to profits of the partner companies in these joint ventures.

The action spécifique also covers the foreign subsidiaries of Thomson, such as Thomson UK Holdings Ltd.

However, and still as regards share transfer, the use of the action spécifique is limited in Aerospatiale to the ballistic missile sector as well as to Aerospatiale's majority shareholdings in the companies CILAS, SODERN, Nucletudes and the Cosyde group.

On the other hand therefore, it-excludes the use of this action spécifique for share transfer for the civil aeronautics sector, for the Eurocopter joint venture and for tactical missiles.

Thus, the notion of action spécifique is wider than the notion of golden share in the United Kingdom because it applies both to the control of investments and the share transfer.

However, this control of share transfer is more recent than is generally thought because it only dates from 1993. After being applied extensively for Thomson-CSF, this ability to oppose share transfer was limited to activities associated with deterrence forces and the manufacture of lasers in the case of Aerospatiale, i.e. sectors where one can imagine that the notion of national independence, in its strictest sense, still means something.

The investment question never

Nonetheless, these tools have never been used and debate over the future of the action spécifique is particularly associated with negotiations over the AEDC.

The recent application of the action spécifique in the case of Aerospatiale tends to prove that applying it to share transfer would not pose any problem for the AEDC because sectors associated with deterrence would be given special treatment in any case.

From a French standpoint, the existence of an action spécifique could, however, be useful if a trans-national European company were to be established, diluting the shareholding of such a company almost mechanically. However, who would hold such an action spécifique and against whom it could be directed would remain to be seen.

II-3-d. Summary of the French model

In its principles and in its line of thinking, the French model is still a model of sovereignty. With regard to its objectives this model is more difficult to grasp, because, at no moment has a comprehensive theory establishing the relationship between the means implemented and the objectives sought been put forward.

Fundamentally, the means implemented bear a strong resemblance to the British model. But we have seen that this model is not without its pitfalls, particularly during the transition period, and can lead to a loss of control of the armaments industry.

It therefore appears necessary to always make optimum use of precise instruments for measuring the cause and effect relationship between the practice of procurement and the economic, financial and industrial situation of the armaments industry. The maxim according to which the client State would be sufficient to guarantee the State's sovereignty, is indeed far from reflecting the complexity of the problems. Indeed, it would appear today that no European State can guarantee, as sole client of its industry, the interests of this industry and therefore its durability. It also appears that the procurement method plays a major role both as regards the structure of this industry, and as regards the control the State can exercise over the equipment manufactured and the costs involved.

In the line of thinking there is certainly a model which aims to preserve these interests of sovereignty, in reality it is not certain that the economic situation of this industry will enable us to fulfil this objective.

III. ANALYSIS OF FRENCH COMPANIES' STRATEGY AND BALANCE SHEETS

III-1. Aerospatiale

III-1-a. Strategies pursued between 1992 and 1998

Until now, Aerospatiale's strategy has been one of specialisation. Knowing how to stay at the cutting edge of technology, the French group has been able to maintain a competitive advantage so far. This has certainly been felt as regards its competitive position, in that, according to the group's directors, Aerospatiale was the only group able to maintain, and even improve its position on a topsy-turvy market.

However, Aerospatiale did not neglect its partnerships in any way. In fact, since around 1994, Aerospatiale would have been more than happy to see a Franco-German bond form in this sector, combining technical and technological efficiency and marketing force, continuing well-honed activities as well as branching out into new areas. It was with this in mind that it had already drawn closer to DASA.

On an operational level

Unlike its German partner, Aerospatiale benefits from being at the forefront of technology in many areas, which has enabled it to be among the world leaders and number one in Europe. It should be noted that the French group's strategy is to specialise. All activities are finely honed, in order to maintain a technological advantage, and alliances made are principally aimed at reaching critical size (to be profitable on the world market). Nonetheless, it would seem that the public company is under-capitalised in comparison with its competitors, which does not prevent it in the slightest from being profitable.

The annual reports show that Aerospatiale was aware of the need to have partners, rather than go it alone. The terms and conditions for such partnerships, however, were not specified, but it would be logical to assume that Aerospatiale was thinking of becoming a private company so it could then strike alliances with other European companies. The following clues lend substance to such an assumption :

- It is clearly written in the 1995 report that Aerospatiale was studying the terms and conditions for transforming the company in the middle of the financial year ;
- It can be noted that of the people appointed by decree to the board of directors, several have called for the privatisation of the public company under their governance ; it is therefore plausible that the idea could have crept into Aerospatiale's board ;
- It cannot be forgotten that the European bodies have been trying for several years to limit the financial support given by the Member States to their public companies. It would be appropriate to study European jurisprudence relating to the aeronautics and space sector to be sure that it is not the exception to the rule ;
- Finally, Aerospatiale and DASA gave the impression of being a united front when they pleaded in favour of the rapprochement of the companies in this sector, therefore in theory, the decision-makers of the two groups held a relatively similar view of the future.

III-1-b. Comment on the Accounts

General characteristics of the balance sheets

The first thing that catches the eye when comparing the accounting structures of DASA and Aerospatiale, is that the total sum of fixed assets and stockholders' equity are significantly lower in Aerospatiale than DASA. [This would tend to suggest that the French group is smaller than the German one]. However, the two groups have essentially the same level of activity (see : current assets, where the stocks and accounts payable play an important role ; an important detail is that the discrepancy existing between accounts payable and deposits received on orders is fairly small, which is healthier for the group's accounts).

Aerospatiale's accounts reveal that it dips into its savings less frequently than DASA. As for its net results, these are constantly improving, proving that the Aerospatiale group is efficient and profitable.

However, this is not the main characteristic of Aerospatiale, in fact, it carries a considerable level of debt (currently being reduced), which is significantly greater than the stockholders' equity – a result of under-capitalisation. A private company could not sustain such a level of

debt for long (furthermore, it would certainly have to deal with creditor mistrust, who could demand immediate payment, thus exacerbating the company's financial difficulties).

It is appropriate to highlight, however, that the majority of this debt is medium/long-term debt to financial institutions, thus somehow guaranteeing "good relations" between the group and its banks (these relations being long term).

Other accounts

The consolidated results reveal Aerospatiale's effectiveness : its RACI have been improving significantly since 1993, and have been in the black since 1994.

Regarding sales, and therefore the group's specialisation, it can be noted that everything relies on the aeronautics sector in particular (planes and helicopters). For the past two years, the Space and Defence division has markedly improved performance. It should be highlighted that Aerospatiale participates in the majority of international aerospace projects.

The contribution to Aerospatiale of the State's 45.76% stake in Dassault Aviation had the logical consequence of increasing the group's stockholder equity, without immediately increasing the capital, the corresponding sum is registered in Aerospatiale's financial report as funds to be capitalised, this contribution will be covered by an increase in Aerospatiale's reserved capital at the beginning of 1999. In return, the French State will receive Aerospatiale shares.

The current assets, which reveal a company's level of activity, have been increasing since 1996. However, the integration of new activities, particularly those of Dassault Aviation, obviously generate a larger volume of stocks.

The group's net results are 27% down on those of 1997. This drop in Aerospatiale's profits is partly due to the increase in grants to cover current liabilities (+20%), when between 1996 and 1997 they decreased. These liabilities consist mainly of the risks associated with marketing the Airbuses. The principal issue concerns the guarantees given to investors who have bought certain aircraft and who are renting them out to airline companies.

The favourable impact of Dassault Aviation's VMPs (rapidly liquifiable assets) on the group's treasury can be noted. Indeed, the VMPs contributed by Dassault Aviation represent 70% of the VMPs in the consolidated financial report.

Global debt (financial debt + commercial debt) remains higher than 1997 (+ 13%). But whereas financial debt is falling - 9% lower than 1997 and 1996, commercial debt has risen by 16% since 1997.

The increase in stockholders' equity has improved the group's working capital. However, new funding needs (net funding requirement : + 42%) have arisen with the increase in stocks, client accounts and attached accounts.

Notes : Accounts : Definitions.

*** Working capital :**

The working capital is the excess of fixed capital assets (stockholders' equity + current liabilities + medium to long-term liabilities) over net fixed assets. It represents "the proportion of capital put forward to fund the operating cycle".

Indeed, to function normally, a company must finance not only its fixed assets, but also its current assets. As these current assets are not necessarily perfectly liquid, they generate funding requirements. In the majority of companies, short-term debts (working debts) are not sufficient to cover operating needs, hence generating a net funding requirement, which should be covered by the fixed capital assets if the company wishes to avoid cash flow problems.

*** Situations :**

- Working capital positive, net funding requirement positive, accounts positive : the working capital is thus greater than the net funding requirement and so the accounts are positive. This is a satisfactory and usual situation, providing however, that funds are used correctly, that is to say invested appropriately.
- Working capital positive, net funding requirement negative, accounts positive : the current operations of the company bring in resources over and above those generated by the working capital, and the accounts are positive. This is a very favourable situation in that it enables the company to invest its funds and improve its profitability thanks to the interest. It is sometimes possible for companies to finance their RACI with the interest they earn on investments.
- Working capital negative, net funding requirement negative, accounts positive : the company has a negative working capital, lower in absolute value than its net funding requirement, also negative. The accounts are positive. This paradoxical situation generally characterises companies of the hypermarket type : their operating system enables them to draw sufficiently stable resources from their current operations to enable them to finance a part of their fixed assets.

III-2. Matra

*** Problem raised by activity reports :**

This problem concerns the extent of incorporation of the accounts made available. Indeed, it concerns the accounts of the Lagardère group, which include the consolidated results of the Matra-Hachette group responsible for the Defence and Space sectors. The processes carried out for the three major European aeronautics groups cannot be implemented here.

The only elements developed by the annual reports are very succinct, the consolidated accounts of the Matra group and those of the two sectors were not provided. Therefore we do not have any information on the results, the debt situation or the breakdown of results. It is therefore impossible to specify company strategy in the two sectors and subsequently assess their impact on the accounts. The main elements concerning the two aforementioned sectors are as follows :

*** Matra 1992.**

*** Main events :**

- Progress made with group's turnover thanks to Space and Automobile branches, but the Space sector does not seem to have had a decisive impact on the upturn in operating results (an upturn attributable to the results in the Automobile and Telecommunications sectors).
- The year's major operations occurred in the Press and Communication sectors.

*** Space Branch :**

- Activity deemed satisfactory, will soon enable performance to be consolidated and a phase of stability to be reached. Efforts to be competitive to be made "making it possible to compete on the national market under the best possible conditions".
- 4 new Hispasat programme satellites -Matra Marconi Space is the project manager for several phases-, sent into orbit thanks to Ariane.
- Confirmation of MMS's strategic choices ; 15% increase in turnover and increase in order book, representing 18 months' turnover.

*** Defence Branch :**

- Export penetration into Far East.
- Success of international programmes, particularly Franco-German programmes.
- According to members of the Lagardère Group, a tight budget has not harmed Matra Défense's activity. Nonetheless, the turnover is down on 1991 (-6%), export sales representing 50% of total sales. Marked increase in incoming orders.
- Restructuring of the industrial perimeter : strengthening of R&D and commercial teams, to the detriment of production.
- Information systems well placed on the international stage (considered to be an area of excellence at Matra Défense). Birth of Matra Cap Systèmes.
- Work with Fairchild Space, on behalf of NASA and the American government.

*** Matra 1993.**

*** Space Branch :**

- Difficult context, increased competition, but MMS maintained high level of activity (order book ~ 15 months' turnover).
- Several missions relating to Satellite activity met with success. Apparently, the design and development of telecommunications and observation satellites is a speciality of Matra Marconi Space.
- In space transport, the production units began to be rationalised, in order to improve competitiveness. Hence a cost reduction policy (particularly staffing costs), accompanied by a reduction in productive workforce and the recruiting of young graduates, and the implementation of a total quality management policy.

*** Defence Branch :**

- Also a difficult context, but slight upturn in turnover compared with 1992.
- 4% increase in turnover from Missile activity compared with previous year (exports accounted for 55% of total turnover, which reached 4,550 million francs). Development continued on manufactured products in order to perfect them. In this activity, Matra Défense had great expectations of the French government's new military policy, hoping it would help them achieve a good position in the sector both in France and abroad.

- Still regarding Missile activity, Matra Défense seemed to suffer on account of the drop in petrol prices and budget difficulties, constraints which affected its sales potential in the middle east. But it counted on opportunities offered by the Asian markets. Plans to draw closer to BAe were already underway.
- Regarding the information and control systems, the restructuring of Matra Cap Systèmes with the merger of Matra MS2i and Cap Sesa Défense ; the new objectives are to capitalise on know-how and maintain innovative potential both in key technology as in strategic resources such as knowledge and training of engineers.
- Signing of a promising contract with the US Air Force.
- Policy of alliance via projects with other groups in the sector ; commercial development both in France and abroad.
- Matra Défense Espace has a 100% stake in Fairchild Space and Defense, hence the contracts signed with the American government and NASA. Despite American military budget cuts, Fairchild maintains its level of activity, particularly since they are working in parallel with Boeing (although even here there are variations in activity). Furthermore, for the production units located in the USA, there is a policy of alliance with other American companies in the sector.

*** Matra 1994.**

*** Space Branch :**

- The directors of the branch are much more optimistic than the year before, in that MMS is one of the European front runners in the space field, via its take-over of BAe Space Systems and the "Communications via Satellite and Micro-wave Components" division of Ferranti International.
- MMS seems to have been able to cope on the international scene, being awarded several projects in the Satellite field (civil and military), and it has a very diverse client range.
- Continuance of major Earth Observation programmes thanks to government intervention.

- Negotiations among European companies and governments over the specification of new military satellites, in which MMS would be likely to play an important role.
- Bearing in mind the competition, efforts made to improve competitiveness were continued.

*** Defence Branch :**

- The fact that, despite budget cuts, France maintains a military budget that is proportionally larger than those of other Western countries, not only benefited Aerospatiale, but also Matra Hautes Technologies.
- Hence the continuation of the majority of programmes underway, however, in exports there was a drop in orders from the Middle East (which did not deter Matra Défense from getting hold of some Brazilian market share).
- Matra Cap Systèmes seems to have consolidated its position on the international market both as architect and integrator of control, communications and imaging systems.
- Client satisfaction in the military sector ; diversification via the use of technology developed for the military sector in civil products. To increase the profitability of Matra Cap Systèmes, the directors envisage widening their product range (particularly in the civil sector) and improving company productivity.
- Negotiation with the company Orbital Sciences Corporation of Virginia, for the sale of Fairchild Space and Defense Corporation. Matra Défense Espace would retain only the "on-board control systems" of Fairchild, which would become Fairchild Controls.

*** Matra 1995.**

The sketchy information outlined in the activity report concerns products manufactured by Matra Marconi Space, Matra Défense and Matra Cap Systèmes. Regarding the decisions taken by these companies over the year and their situation at the end of the financial year, only the following information can be gleaned :

*** Space Branch :**

- in 1994, MMS became the leading integrated European company in the Space sector, and in 1995 it strengthened its position on the major civil and military space markets.

- Information identical to that provided in the 1994 report, with additional details regarding the number of launches in the current year.
- According to the report : "The short and medium term prospects for Matra Marconi Space are very satisfactory, despite the increasingly competitive environment surrounding the development of commercial telecommunications. In this regard, it should be noted that the constant efforts undertaken over the past few years to increase the company's competitiveness will be continued and expanded".

*** Defence Branch :**

- Drop in turnover due to "slowdown in certain short-cycle export orders, partly compensated for by more satisfactory national sales performance". Overall : loss of ground on the international scene. Deferment of certain orders for export, which will not take place until 1996.
- Maintenance of a sustained pace in "Design" activity.
- Widening of Matra Cap Systèmes' range, enabling it to consolidate its market position and re-launch an aggressive export policy.
- As regards the evolution of the Defence sector in France and in Europe, the Matra group companies seem to be waiting for government decisions to be taken.

*** Matra 1996.**

*** Space Branch :**

- Sharp increase in both turnover and orders, particularly in the civil telecommunications sector (which tends to reassure MMS directors). Continuation of institutional observation satellite programmes ; good performance from the rocket launcher and human space flight activities, despite the failure of Ariane 5's qualification flight.
- MMS is European leader in live television satellites. Its ability to provide complete communication systems enabled it to win several contracts, particularly in Asia and with the British Ministry of Defence.
- Upcoming participation of MMS in capital of Arianespace (which is about to increase its capital).
- Continuation of efforts to improve competitiveness (especially in civil telecommunications where competition is fierce).

- Same comment from directors for the past three years : "The position of Matra Marconi Space regarding its two main product lines – Earth Observation and Telecommunications – should enable it to make the most of space market development in the years to come, characterised by the rapid growth of the military space sector and space telecommunications".

*** Defence Branch :**

- Marked growth in turnover, in particular due to a few export contracts.
- Important year for the Missile sector, with the BAe alliance forming Matra BAe Dynamics. MBD becomes the leading European missile manufacturer, and the third largest in the world ; a wide range of products which will help it to maintain, or even improve its market share.
- General context still difficult. MBD also has a stake in Euromissile Dynamics Group consortium.
- For Matra Cap Systèmes (now Matra Systèmes et Information), the year was more difficult, given its dependence on defence budgets and the competitive environment. Nonetheless, it continues to make technological progress, in order to stay in the running.

*** Matra 1997.**

*** Space Branch :**

- Stagnation of turnover deemed to be a result of the current climate and several years growth.
- 6 May 1997 agreement signed between Lagardère and Daimler-Benz, on bringing together all activities of Matra Marconi Space and DASA including satellites, rocket launchers and orbital infrastructure (this would rank the new company second in the world in these areas).
- In civil telecommunications : signing in 1997 of a strategic partnership agreement with the American company Motorola, to supply the satellite platforms required for civil telecommunications.
- This augurs well for MMS, promising a high level of activity ; the supply contract following the agreement is not to be signed until 1998 and will only commence when project funding is completely finished.

- Continuation of programmes with the British Ministry of Defence and live television satellites.
- *"On the Earth Observation satellite institutional markets, work is progressing most satisfactorily under the management of Matra Marconi Space"*. Launch of multi-use products which have had a certain degree of success on the export market.
- Regarding the space rocket launcher sector : success of Ariane 5, providing good prospects for MMS ; delay in finishing the Ariane 4 project, implying that new orders will be placed with the French company.
- Continuation of efforts made over the past few years to improve competitiveness.
- For the years to come, the directors of MMS seem to think that the main profitable sectors will be the military space and space telecommunications sectors.

*** Defence Branch :**

- Very strong upturn in turnover following the return of several major export contracts.
"The 1997 financial year was marked by the completion of three strategic stages, and by the high number of orders taken, affecting almost all the fields in which the branch is leader".
- "Firstly, 1997 was the first financial year of Matra BAe Dynamics, which confirmed the wisdom of merging the activities of BAe and Lagardère from the strategic, industrial and commercial points of view. This alliance illustrates the shared desire of Matra and British Aerospace to take first place on the world tactical missile market".
- Lagardère takes back the defence activity of the Compagnie des Signaux brought together in its subsidiary, CS Défense. The activities concerned cover the naval, territorial and aeronautics sectors. Thanks to this : Lagardère's reputation as a naval weapons system manufacturer is strengthened, in that the range offered is now wider, and in that it is based on the combination of skills already possessed by Lagardère and acquired via the take-over of CSD. => New entity = Matra Défense Equipements & Systèmes.
- Matra BAe Dynamics takes a 30% stake in LFK, a subsidiary of DASA, specialising in missiles.
- MBD is now a European leader in air-to-ground missile activity. A new contract is signed with the British Ministry of Defence (this time regarding Storm Shadow missiles). Contracts obtained with Brunei and South Korea, on short-range ground-to-air missiles, despite fierce competition (particularly from Thomson). Negotiation with the United Arab

Emirates for the sale of air-to-air missiles. Order from the French army to equip their Mirage 2000-5 and Rafale Marine.

Other contracts : with Australia for missiles, with Kuwait and Great Britain for equipping national marine forces.

- Matra Systèmes et Information managed to achieve its objectives despite increased competition both in France and abroad. Redeployment to the civil sector by using dual technology and to export via improved opening of geographical zones.
- Final comment from Lagardère group regarding defence activity : "Whereas American companies have already restructured, the first significant consolidation manoeuvres in Europe were carried out by the Lagardère group with the creation of Matra BAe Dynamics and its stake in LFK. On the European stage, the Lagardère group is therefore in a leadership position and is a central player in the domain of missiles".

Activities of Matra Hautes Technologies 1998.

The report provided firstly presents the year's consolidated accounts for the Lagardère group. The second part presents a brief review of the accounts of the group's major branches, including Matra Hautes Technologies.

*** For Matra BAe Dynamics :**

- Continuation of programmes underway. Regarding sales, the turnover achieved in France can be attributed to orders placed during the previous financial year ; in Great Britain it would seem that the British government can be thanked for turnover (see the year's major orders). In addition, the directors of Matra BAe seem to count on the British government to enable these programmes to continue.
- For 1999 : Rapprochement envisaged with Aerospatiale Missiles.

*** For Matra Marconi Space :**

- Unfavourable economic context, but MMS still managed to expand its captive American market.
- Merger with space activities of DASA and Finmeccanica.
- Similarly to the other two companies : presentation of company performance and that of its programmes. MMS projects for 1999 : participate in more international projects ;

invest in satellite service companies ; "finalise agreements between Lagardère / GEC / DASA / Finmeccanica".

*** For Matra Systèmes et Information :**

- 1998 = First year spent within the Lagardère group ; company restructured.
- Desire to :
 - continue penetration into the export market,
 - expand its range in certain product sectors,
 - strengthen its position in certain sectors, concentrate on the civil sector.

In fact, the directors of the company hope to be able to present a "global range" (vast set of product ranges, with the aim of becoming indispensable to the client), "in collaboration with the other companies of the group".

Data Relating to the Space and Defence Activities of the Group

Matra - Hautes Technologies

<i>In million FF</i>	1997	1996	1995	1994	1993	1992	1991
<i>Turnover</i>							
Lagardère Group	65 903	56 401	52 579	53 018	53 981	55 102	53 112
Defence	7 683	6 101	4 010	4 562	5 510	5 465	5 896
Space	8 465	8 437	6 777	5 992	5 123	5 557	4 817
<i>Turnover %</i>							
Lagardère Group	100	100	100	100	100	100	100
Defence	11.7	10.8	7.6	9	10	10	11
Space	12.8	15	12.9	11	9.5	10	9
<i>Operating results</i>							
Defence	1 715	817	133	205	323	339	-
Space	424	392	381	328	315	275	-
<i>Net Results</i>							
Defence	1 005	569	157	364	384	274	254
Space	313	245	384	249	231	97	126
<i>Financial Investment</i>							
Defence	-	-	-	8	10	88	-
Space	-	-	-	130	-2	8	-
Tangible and intangible Investment							
Defence	-	-	-	108	152	201	-
Space	-	-	-	246	97	58	-

<i>In million FF</i>	Matra Hautes Technologies			
	1996	1997	1998	Variation
Turnover	19 542	20 704	20 975	1.3
Operating results	1 296	2 113	2 249	6.4
Financial results	92	165	(29)	
Current results	1 388	2 278	2 220	-2.5
Activity results before tax	1 169	2 218	2 636	
Operating Margin	6.6%	10.2%	10.7%	
Self funding gross margin	1 015	1 571	1 516	

IV. STUDY OF ECONOMIC AND INDUSTRIAL CO-OPERATION MODELS INVOLVING A FRENCH COMPANY

IV-1. The co-operation models only concern activity-specific subsidiaries

There has never been a merger, in the true sense, between European companies of different nationalities within the armaments industry.

To date, only two scenarios have been recorded :

- The out and out take over of a company or one sector of activity of a company. This was the case particularly in those countries which had a small armaments industry after the fall of the Berlin wall. At that time the companies of these countries gave up their defence activities. This was the case of Philips in the Netherlands and FN Hertsal in Belgium. However, it was rare for large French German or British companies to give up their defence activities with the notable exception of Siemens. And even here it should be specified that in this case the companies that picked up the German and British branches of Siemens (British Aerospace and Daimler-Benz Aerospace) were companies of the same nationality.

None of these mutations can be described as mergers because the company that is taken over is purely and simply dissolved into the company that bought it.

- The setting up of joint ventures when the two parent companies have common sectors of activity.

These companies are interesting to study because their very set-up implies that neither the parent companies nor the countries upon which they depend, accept, in principle, to relinquish the activity in question or the control over the bi- or multi-national company that is set up.

Three companies have been analysed thus far : Matra-Marconi space, Matra-BAe Dynamics and Eurocopter.

It should be noted that the new structure of Matra-Marconi space since its merger with Alenia and Daimler-Benz Aerospace has not been studied. Airbus has not been studied in detail either, even though it is referred to particularly as regards its decision-making processes.

Up until now, no major European armaments company has merged with another in a trans-national context. Indeed, as the very subject of this study, the matter could be summarised thus : in which context and under which conditions could a major trans-national merger take place between two European companies ?

Until now the major European armaments companies have preferred to make parts of their sector of activity into subsidiaries in order to set up joint ventures that are specific to a certain specialisation.

The companies see several advantages to setting up these activity-specific joint ventures :

- They can offer a world-size supplier to export clients. Generally speaking by grouping together the aim is to occupy a leading position on an international level or to be in a position to challenge the leadership of an American company. The three companies which have been studied specifically concern missiles, satellites and helicopters. The problem for Airbus is the same even though it is an economic interests group and it covers the domain of civil aeronautics.
- They offer economies of scale by eliminating redundancy in management and technical teams. Generally speaking, as many of the staff as possible is integrated, whether at management level, within the marketing teams or of the technical directors. This merger of teams is however limited for two reasons :

- There is no legal structure covering these European companies. We are obliged to create legal entities that have overall responsibility for them, entities which do not necessarily have their headquarters in the country where the actual company is located. In this way Matra/BAe Dynamics BV is a company covered by Dutch law.

- The export control mechanisms, problems relating to confidentiality of the technologies used and the absence of uniform European labour legislation make it necessary to create national entities that are subsidiaries of the activity-specific joint ventures.

This method of grouping means that there is no merger of capital as such. Indeed in this case the companies contribute their activity to the joint venture, this joint venture having a number of shareholders that is limited to the number of parent companies participating in it. Thus, as usually only two companies are involved, there are only two shareholders. Therefore the shareholding cannot be diluted and these companies are not listed on the stock exchange. At this level the setting up of a joint venture between four countries in the satellite field would be interesting to study in that it would almost mechanically lead to a dilution of the financial rights of each partner.

In the sense that these activity-specific joint ventures group together companies that are liable to merge in the future, for example Matra and BAe in the missile sector, Matra and Dasa in the satellite sector and Dasa and Aerospatiale also in the missile sector, they could be seen as a mere stepping stone. However, their operating systems should be studied closely because they constitute, whatever may be said, the current model that represents the relationship between State and industry that is acceptable for all governments. In addition, if these companies exist, then by definition it is because they fulfil the objectives of their shareholders, i.e. their parent companies.

IV-2. Co-operation models are still inspired by sovereignty concerns

Analysing the operating systems of activity-specific joint ventures tends to prove quite conclusively that sovereignty imperatives dictate a number of the rules which are not necessarily found in joint ventures in the civil sectors. Two main rules have been identified.

IV-2-a. The tendency to equally divide shareholding and management

Whether looking at Matra/BAe Dynamics, Matra Marconi space or Eurocopter, the shareholdings are relatively equally distributed.

It is 50/50 in Matra/BAe Dynamics and 51/49 in Matra Marconi space. The shareholding of Eurocopter is the least equal because in this company Aerospatiale holds 70% and Daimler-Benz Aerospace 30%. However, an intermediary structure has been created between Eurocopter and the parent companies. This intermediary structure consists of Aerospatiale which directly holds 25% of Eurocopter and of Eurocopter Holding of which Aerospatiale is only 60% shareholder while Daimler-Benz Aerospace holds the remaining 40%. This distribution makes it possible to artificially increase the power of Daimler-Benz Aerospace with regard to the real value of the financial rights of this shareholder.

Above all, it can be seen that the management of the different companies is extremely evenly balanced. In each company the distribution of positions is made equally between nationalities, whether it be within the control and orientation bodies, the Board of Directors or the monitoring committee, or within the directing bodies with the management teams or the management of Eurocopter. Even the British demand that responsibilities be evenly distributed in this way. However, at Matra/BAe Dynamics this principle has a time limit. Managerial equality has been established for six years only. Furthermore, at British Aerospace it is felt that this rule should not prevent the "best man for the job" being appointed.

At Eurocopter, despite the fact that the shareholding is not evenly shared between Daimler-Benz Aerospace and Aerospatiale, Daimler-Benz Aerospace has the same number of people on the monitoring committee and in management as Aerospatiale.

In the context of this even distribution, the companies can however make the most of their specific areas of expertise. Thus, British companies tend to demand the position of Finance Director within the management structure (as is the case of Matra BAe Dynamics) in order to watch over the financial interests of their shareholders.

When asked about the reasons behind the distribution of jobs, the companies³⁵ tend to claim that it is necessary to have a balanced representation for their client countries. At Matra BAe

³⁵ in the context of this study, the following people were interviewed :

Fabrice Brégier, Director of Matra/BAe Dynamics

Claire Hocquart, Strategy Director of Matra Marconi space

Bill Giles, Chairman of British Aerospace France

Patrice Hummel, Deputy Finance Director of Aerospatiale

Gert Runde, the representative of Daimler-Benz Aerospace was not able to be interviewed, the meeting having been postponed several times.

Dynamics, particular point is made of the fact that without pre-specifying the distribution of tasks, (making British managers the only interface with British companies and French managers the only interface with French companies) in the event this distribution fell into place almost naturally for reasons of efficiency. The British have a better knowledge of the demands of the British client and ditto for the French.

Finally, the Chairman of Matra BAe Dynamics considers that the representatives of BAe in his company take into account, almost naturally, the concerns of the British government, particularly in terms of employment. Thus the dichotomy whereby the companies only take their own interests into account, particularly the need to gain value, at the expense of Government interests, is not true in the United Kingdom. So the behaviour of the British is not as different from that of the French as one might think.

It also seems that the models of co-operation with the Germans are more difficult to implement as regards distributing responsibilities than those with the British. This is partly due to the structure adopted, which calls for a Board of Directors and a monitoring committee. This model indeed seems to institutionalise a phenomenon of counter-power, as the directors hold identical power.

The British, for their part, accept the French system where there is only one boss, but seem, in general terms, to regret the fact that decisions are made according to a principally hierarchical model, when they feel that the system in British companies is more collegial.

Which brings us to a field that could be described as "the sociology of decision making" in companies where practices differ between countries.

IV-2-b. Unanimous decision making

At first glance, it could be thought that this practice is associated with the often equal distribution of shareholding or with the fact that these joint ventures only have two blocks of shareholders. Indeed there are no small shareholders in these companies and it seems logical that the interests of everyone be taken into account.

In the event, the subjects that are held up for unanimous decision are limited. Furthermore, from one joint venture to another the same general topics are to be found. These include :

- approval of the business plan (Matra BAe Dynamics, Eurocopter, Matra Marconi space)

- investments above a certain amount (Matra Marconi space)
- bids above a certain amount (Matra Marconi space)
- major strategic outlines (Eurocopter)
- strategic agreements with third parties (Matra BAe Dynamics)
- closing of sites (Matra Marconi space, Eurocopter)

And it should be added that as regards the last matter, the French representative of Matra/BAe Dynamics would not dream of being able to close a site in the United Kingdom without the agreement of the British partners.

Analysis reveals therefore, that the partners in these joint ventures have a truly joint power of decision regarding the management of these companies when the decisions are strategic and fall within the company's three spheres of influence ; the financial, industrial and social spheres.

This need to share common objectives in these three domains leads the representatives of these companies to consider that :

It is indispensable for the partners of a joint venture to have the same interests in mind. It is particularly important that their investment policy be in line with the policy that another joint venture could have. Thus certain people believe that joint ventures between Aerospatiale and Daimler-Benz Aerospace in missiles and satellites could not have worked anyway because the interests of the two players were different, Daimler-Benz Aerospace favouring satellites and Aerospatiale missiles.

The policy regarding retaining industrial sites inhibits the integration of the company and the improvement of its productivity. They consider nonetheless that this is specific to the industrial sector because civil companies generally disregard the employment interests of the country. This particularity being accepted, they consider that it is up to the shareholders and the governments to envisage restructuring policies that reconcile as far as possible the need to comply with the law of the countries (in this case maintaining high-level jobs and skills in each country) and the need to obtain the best possible industrial rationalisation.

At this level this objective is envisaged with relative optimism in both the Franco-British joint ventures, the concrete result being esteemed disappointing in Eurocopter. In a certain way, the integration of Eurocopter thus appears to be a relative failure, industrial rationalisation not yet having been possible.

Finally, it should be noted that the decision-making systems in these companies is not as different as one might have thought from those in the economic interests group Airbus, with the difference that there are four partners in Airbus, none holds a majority of financial rights and there is even a small shareholder ; the Spanish company, CASA.

IV-3. The reasons behind the "intergovernmentality" of decision making in joint ventures

By "intergovernmentality" we mean the fact that the three joint ventures studied only make major decisions with the agreement of the shareholders of their parent company. However, this "intergovernmentality" of decision making can be attributed to several factors. Although two of these relate to the role of the State in the armaments industry, the third relates to the nature of these joint ventures.

IV-3-a. "intergovernmentality" associated with the nature of the parent companies

Indeed, it should be remembered that the joint ventures that exist today in the armaments industry merely consist of the joining by two companies of one of their spheres of activity. Several of these companies' characteristics can be attributed to this fact. For example :

- firstly, the essential objective of these companies is to create, in a given sector, a supplier on a world scale. The objective is therefore of a commercial rather than capitalist nature. Another expectation is that productivity will gradually and reasonably increase.
- a corollary of the first characteristic, is that the strategy of these companies is specified at parent-company level, and the parent company has to integrate into the context of this strategy as much as possible. The Board of Directors is therefore faced with strategy delegations from both parent companies, and is expected to produce an acceptable synthesis of the two strategies.
- finally, the fact that decisions taken within these companies are "median" decisions, resulting from compromises acceptable to both parent companies. However, the limitations of this exercise, in particular with regard to the operating principles of Anglo-Saxon corporate governance, must not be ignored.

Firstly, this operating system seems to be accepted providing the commercial advantages associated with combining forces outweigh the disadvantages associated with the operating system, which is not considered to be the most effective according to the rules of corporate governance.

Secondly, delegating strategy decisions to the joint ventures is not perceived as a problem for a company such as British Aerospace, providing the sector of activity of the joint venture only represents a small part of the parent company's activity, which is the case at the moment because missiles only represent 10% of BAe's turnover (non-consolidated balance sheet before merger with GEC). In a word, the management and the shareholders of the parent companies do not wish to become a holding company managing interests in joint ventures which would have the effect of distorting the coherence of the overall strategy. The eventual objective is indeed to achieve single leadership of the merged companies rather than leadership based on establishing a consensus within the administrative body, whether of a large merged company or of various joint ventures in which it has shares.

It can therefore be said that although "intergovernmentality" of decision making exists now, Anglo-Saxon directors would like to see it disappear in the future.

IV-3-b. "intergovernmentality" associated with the role of the State

The lack of a single client at European level

All the representatives of joint ventures have emphasised the fact that having several countries as clients, and not a single European client, has forced them to take the all different desires of these clients into account. However, how this client-supplier relationship influences decision making in the companies has not been clarified, beyond the fact that it was preferable to have citizens of the client country within the management structure. At this level the advantage lies in having an in-depth knowledge of the client's practices and, quite simply, the ability to work in their mother tongue.

In addition, these client countries, which in the case of the United Kingdom and France are used to purchasing from their national suppliers, have an enormous influence on the industrial

and technological policy of their suppliers in a field where programs and purchases are rare and are investments which are spread out over many years.

However, it could be thought that these States do not have or will no longer have an influence (as individual countries) over the strategy of private companies. As already noted, shrinking markets and diversification of the number of clients is leading larger companies to enter into a monopoly situation which guarantees their sustainability in the armaments sector. However, having several clients leads the company, when it has a commercial choice besides governments, to naturally favour the largest client. The risk is therefore to eventually see the smaller clients have the type of equipment that the largest client would have chosen imposed on them.

Having arrived at this stage, it is understandable that today the setting up of integrated European armaments companies with private capital is not a major risk if we consider that these armaments companies will be solid and competitive enough to supply the European States. However, the competition has begun to see who will determine the standard for European armaments which depends on how they are meant to be used, which in turn is determined by both foreign policy and security policy.

The preservation of State interests does not therefore seem to be about the companies, but about the ability of the governments to influence the determination of common foreign and security policy, or, if this proves impossible, to maintain defence budgets at a sufficiently high level in relation to other European clients so as to maintain control over the industrial and technological policy of the supplier.

"intergovernmentality" associated with employment

All the company representatives interviewed emphasised that maintaining high-technology jobs in the armaments sector (the same is the case for the civil aeronautics sector) constitutes a major influence of the State over the companies. However, this influence has a slightly negative effect because it slows down the progress of productivity of the armament joint ventures. In addition, the primordial element is whether or not to maintain design agencies and skills strictly at a national level, a question which is partly associated with solutions which will be found in the 6-member working group on the security of procurement as covered in the letter of intent of 6 July 1998.

All in all, it is difficult to measure the impact of the effects of "intergovernmentality" associated with maintaining employment levels. The answer to this question varies in accordance with three rules.

The first rule dictates that the more funding a country dedicates to its defence, the more it will be able to influence the employment policy of the company.

The second rule is that the discussion and negotiation phase of setting up the companies is where the States will have the most power to influence the employment policy of trans-national companies. In particular, a clause will no doubt ensure, as in activity-based joint ventures or as in Airbus, that in trans-national companies, the State can oppose the closure of sites via the representative on the Board of Directors who would represent the national subsidiaries. However, if it turned out that this principle was too much of a handicap to the operation of the companies, in particular their financial operation, it could cause withdrawal of investment, particularly if the shareholding is diluted.

Finally, the third parameter, it is certain that as this grouping together of the armaments industry continues, the less competition there will be, reducing the governments' ability to put pressure on the companies.

IV-3-c. The conditions for smooth operation of these co-operation models

These joint ventures are globally based on an intergovernmental operating system, even though the management, technical and even sales teams are integrated. However, it can be seen upon examination that in reality this equality in management and decision making relies on two conditions :

- 1) that the companies share common interests in the operation of the company. The notion of common interests is not in itself reliant on an equal distribution of the shareholding, but a shared expectation as regards return on investment. In a word, the parent companies must have the same interests to invest in the company.
- 2) the contributions of each company to the joint venture must be on a par. They include :
 - technological skills
 - size of national clientele
 - export contracts

However, although these contributions must be similar, they do not need to be strictly identical. A sort of "bonus" for the partner that contributes the least exists for two reasons :

- 1) In the armaments industry restructuring movement, the race to increase the overall size of the company, and to capture new markets, particularly in Europe, is of fundamental importance. Therefore it is the largest companies that in the end are looking for alliances. This explains why BAe paid a lot of money for GEC Marconi. And it also explains why an alliance between BAe and Dasa was difficult to achieve, but does explain why this alliance, despite all the difficulties the two companies experienced in coming to an agreement, would be fundamentally more strategic than the alliance between BAe and GEC. An alliance between BAe and Dasa would indeed have enabled them to increase the number of contracts and create the largest European group whose operating systems would have been difficult to dispute by the other partners who would have liked to join the alliance.
- 2) The principle of State sovereignty and the globally recognised need to create Europe, requires that the company of a new State entering into a trans-European alliance must be accorded a place that is proportionally greater than that which it might otherwise have been given, with regard to its contributions vis à vis technology and national and export contracts. For Germany, this is increased due to the fact that this country is the strongest European economic power. Naturally, political personnel such as German company directors tend to consider that this status of strongest European power gives them the right to demand what could be termed a sort of "corrective coefficient" with regard to the technological contributions, the size of the German market and the German armaments industry's export opportunities. They also subscribe to the dynamic perspective that followed the fall of the Berlin wall and which will unavoidably see this country become increasingly louder in its international expression.

In conclusion, it could be said that for the moment, the co-operation models are inspired by a perfect mix, where it is uncertain whether the principles of sovereignty will temper the economic principles, or whether the economic principles will temper the principles of sovereignty.

IV-4. Industrial co-operation models

IV-4-a. Institutional environment of industrial co-operation in the armaments sector

Armaments co-operation programs constitute the oldest form of co-operation between European industrial companies in the field of armaments. This co-operation met with great industrial and commercial success in the 1960s and 70s, for instance the Franco-German tactical transport aircraft, Transall, the Franco-German missile family of the Euromissile economic interests group, and the combat aircraft, Tornado, which brought together Germany, Italy and Great Britain within the consortium, Panavia.

However, this form of co-operation has always been subject to criticism due to two major shortcomings :

These co-operation programmes were initiated at State level and, in exchange for their participation, the governments required that their industries receive a workload in proportion to the State's financial contribution. It is now widely accepted that this law of "fair return" was detrimental to the European industrial fabric. Indeed, the States and their companies tended to request that the work be shared in such a way that rather than distribute the tasks in accordance with the recognised industrial skills of the participants, the work be distributed with a view to creating skills where they were lacking. This resulted in the development of useless over-capacity and competition, a phenomenon that only became clear with the cuts in European defence budgets and massive downsizing that occurred in the early 1990s. In addition, this policy also increased the risks of technological problems on the programmes, causing both delays and excess costs. One of the oft-cited examples is the electrical flight control software for Eurofighter, assigned to the Germans. Regarding the same Eurofighter, even the British, staunch supporters of this plane, smile when they talk about the manufacture of the left wing in Great Britain and the right wing in Spain. Of course these incidents are not limited to this particular programme.

Despite all these set backs, armaments-related co-operation has always been considered a lesser evil in Europe. The excess costs associated with inefficient management of these

programmes are compensated for by the widening of series and increased export capacity of these programmes thanks to a European label and no unnecessary competition.

The States, which initiate this co-operation, have tried to remedy its shortcomings. The bulk of the discussions were held within European institutional bodies responsible for co-operation in the armaments sector. Work was carried out within the WEAU for several years without any decisive conclusions being reached. The European armaments agency provided for in the WEU declaration appended to the Maastricht treaty never materialised. However, upon the initiative of France and Germany, who wished to set up a structure to encompass their co-operation programmes, a joint armaments co-operation organisation, the Organisation conjointe de coopération en matière d'armement (OCCAR) was created in 1996.

After much coming and going, the United Kingdom and Italy, the two other countries in Europe with a major armaments industry and that participate in many co-operation programmes, joined the OCCAR. Initially it was hoped that the other European countries would adhere to the OCCAR via a sort of agglutination phenomenon, creating a European Armaments Agency. The diverging interests between those countries that had an armaments industry and those that did not prevented this from happening, and it therefore became necessary to establish a specific treaty to give the OCCAR a legal status, which was done on 9 September 1998.

Indeed, to rectify the economic and industrial inefficiency of armaments co-operation, the OCCAR's main principle was to become the place where co-operation programmes would be managed, implying that this organisation could sign contracts with companies on behalf of the countries participating in co-operation programmes. This integration of programmes was accompanied by another rule aimed at remedying the errors of former co-operation activities, consisting in applying the principle of fair return on a multi-year and multi-programme basis.

An initial analysis reveals, nonetheless, that almost eight years after the signing of the Treaty of Maastricht, the European Armaments Agency still does not exist, and that two years passed between the announcement that the OCCAR had been created and its actual consolidation via a treaty, and that one year down the line, this treaty has still not been submitted for ratification approval to the French parliament. The OCCAR definitely exists, it manages certain co-

operation programmes, but it still has no specific instrument at its disposal to be able to remedy the shortcomings of programme-based co-operation.

In conclusion, and despite all the initiatives which have been taken since the beginning of the 1990s, it can be concluded that progress in this field has been minimal or even non-existent since the beginning of the decade.

IV-4-b. Frequent breakdown of co-operation in the armaments field

In counting the total number of co-operation programmes that have been brought to life during the 1990s, it is clear that their number is not diminishing. On the contrary, given a drop in the total number of programmes initiated by France, it can be seen that almost all major programmes are the result of co-operative ventures. Armaments co-operation could therefore be assumed to be going well if we left it at that, and did not make a qualitative analysis of the status of these programmes.

HÉLIOS II :

Definition : optical observation satellite.

Co-operation : Franco-German co-operative venture set up at the summit of Baden-Baden in December 1995, confirmed at the Summits of Nuremberg in December 1996 and Poitiers in June 1997. Spain has expressed a wish to participate.

Programme status in 1999 : France is financing the programme alone. The industrial structure has been designed to retain German industry's stake if they provide funding. The failure to fund Hélios II was one of the reasons the satellite branches of DASA and Aerospatiale did not combine in 1996.

SYRACUSE III OR TRIMILSATCOM :

Definition : military communications satellite

Co-operation : France/Germany/Great Britain

Programme status : two consortiums led by two project managers, Alcatel Espace and Matra Marconi Space were in competition with each other. The UK decided to withdraw in 1998 from a programme that was not meeting its operational requirements. Matra Marconi Space decided to make an offer to the British government on the basis of a PPP (private public partnership) and is campaigning for the other governments to do the same.

TIGER HELICOPTER :

Definition : protection support combat helicopter (France) and anti-tank combat helicopter (Germany and France)

Co-operation : France/Germany. The agreement protocol for launching this programme was signed on 29 May 1984. Its development contract dates from 13 November 1987. The industrialisation contracts were signed on 20 June 1997. The first joint order for 160 aircraft was not placed until two years later, again at the Bourget exhibition in June 1999.

Programme status :

There are two major reasons why this programme has been so difficult to get off the ground :

- 1) budget difficulties in both countries
- 2) Difficulties in reaching agreement over the operational specifications of the helicopter.

The tasks assigned to the French and German versions are not the same, and the anti-tank and anti-aircraft weapons also differ (Hot and Trigat, Mistral and Stinger).

Although it is an advantage to have a joint Franco-German company (Eurocopter) as the project manager, there is a strict division of tasks between the two countries which was established in a Memorandum of Understanding before the creation of Eurocopter.

NH 90 HELICOPTER :

Definition : tactical transport helicopter

Co-operation : France/Germany/Italy/Netherlands. France : 41.6%, Italy : 28.2%, Germany : 23.7%, Netherlands : 6.5%. The memorandum for the design and development dates from 25/6/1991. The development contract dates from 1 September 1992.

Programme status : The programme has experienced many ups and downs associated with State funding problems. In 1990, Italy announced that it could not finance all its development activities. It was the company Eurocopter that picked up the tab, but orders from the French army will not cover the funding and workload requirements. This part of the MOU must therefore be revised. The Dutch company which was project managing for the Netherlands, Fokker, was taken over by DASA, and then went into liquidation. Finally, France has the least urgent need for this helicopter and is delaying orders for the NH90 while trying to reduce costs.

HORIZON FRIGATE :

Definition : Anti-aircraft Frigate

Co-operation : France/United Kingdom/Italy. The MOU of 1993 created a joint project office (JPO). The JPO runs the technical, contractual and financial aspects of the programme, and reports to a tripartite management committee. DCN international, GEC (which became BAe/GEC) and Finmeccanica/Fincantieri are the three Project Managers.

Programme status : It became clear very rapidly that these three countries had very different requirements concerning this frigate. To rationalise the running of the programme, the British wanted to make BAe/GEC sole project manager. France refused and the British withdrew from the programme on 27 April 1999. At the moment, France and Italy are studying the possibility of continuing the programme alone.

FAMILY OF FUTURE GROUND-TO-AIR SYSTEMS :

Definition : air, territorial and naval ground-to-air defence missile systems

Co-operation : France/Italy 50/50. The programme is managed by the economic interests group, Eurosam made up of equal parts of Thomson/CSF, Aerospatiale and Alenia/Difesa.

Programme status : this programme is progressing satisfactorily.

PRINCIPAL ANTI-AIR MISSILE SYSTEM (PAAMS) :

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Definition : system of anti-air missiles intended to equip the Horizon frigate and member of the future ground-to-air systems family.

Co-operation : the PAAMS MOU was signed on 21 March 1993. The company managing the project, Europaams, is made up of Eurosam (France/Italy) and UKAMS. In reality, the take-over of UKAMS by Matra BAeDynamics and the Aerospatiale Matra merger meant that all European missile manufacturers were integrated into Europaams. Europaams is 66 % owned by Eurosam the remaining 33% is held by UKAMS which is 100% owned by Matra BAe Dynamics, itself a 50% subsidiary of Aerospatiale Matra. Thus, it can be said that everybody's interests come together in this structure. This programme was not harmed by the British withdrawal from the Horizon frigate.

THIRD GENERATION, LONG-RANGE GUIDED ANTI-TANK MISSILE :

Definition : a system of long-range anti-tank weapons intended to equip combat helicopters.

Co-operation : France 36%, Germany 36%, United Kingdom 28%. The Economic Interests Group, Euromissile Dynamics group (EMDG) is project manager.

Programme status : In 1995 the United Kingdom decided to purchase Apache helicopters and withdrew from the programme. The Germans, who wish to make use of the anti-tank version as soon as possible, will have a version equipped with Hot missiles initially. The five-year gap between the French and German anti-tank versions of the Tigre is hampering the programme.

THIRD GENERATION, MEDIUM-RANGE GUIDED ANTI-TANK MISSILE :

Definition : Medium-range anti-tank system.

Co-operation : France, Germany, United Kingdom 30% each, Netherlands, Belgium 5% each. Project manager is EMDG which consists of Matra BAeDynamics, Aerospatiale (missile branch being merged into MBD), and LFK (Germany).

Programme status : After much procrastination, the British Government wanted the United Kingdom to continue its involvement in Trigat-MP. This decision was made by the

politicians. As the UK was the programme's largest client, its withdrawal would have been extremely harmful.

IMPROVED ROLAND :

Definition : ground-to-air missiles

Co-operation : the first Roland air defence systems developed via Franco-German co-operation appeared in 1972. This co-operative venture is run by the economic interests group, Euromissile (Aerospatiale/LFK).

Programme status : Germany withdrew from the improved Roland programme in 1993

TORPEDO MU-90 :

Definition : Submarine torpedo.

Co-operation : France 50%, Italy 50% (24% Thomson-Marconi sonar and 26% DCN), 50% Alenia Difesa.

Programme status : industrialisation underway.

COBRA ARTILLERY RADAR :

Definition : artillery radar

Co-operation : 40% Germany, 40% France, 20% United Kingdom. A company governed by German law, Euro-Art was set up to manage the programme covering Racal (UK), Lockheed-Martin (USA), DASA (RFA), Thomson-CSF (FR).

Programme status : the programme has just been integrated into the OCCAR.

BREVEL OBSERVATION DRONE :

Definition : battlefield observation drone.

Co-operation : Franco-German within Eurodrone, economic interests group made up of Matra-BAe Dynamics and STN Atlas.

Programme status : In both France and Germany the programme is no longer a priority and has ground to a halt.

In conclusion, of these thirteen programmes, four have had one of their main partners withdraw, causing one to shut down, two to continue on a national basis and the last, the Horizon frigate, to be reviewed.

A fifth programme, the Brevel one, is operating at such a slow pace it seems almost non-existent.

The two anti-tank programs are still not in the clear. The two helicopter programmes have been delayed considerably and the participants' attitudes have altered since the outset.

The last four programmes are progressing satisfactorily for the moment.

Thus the assessment is hardly favourable, giving rise to the question of why there have been too many breakdowns and major ups and downs in the course of these programmes.

IV-4-c. Analysis of the breakdown in armaments co-operation.

These breakdowns seem to be caused by several factors :

A) The adverse effect of too much state influence in armament co-operative ventures.

Since the early 1960s, all armaments co-operation has been based on the principle that each State should be assigned a workload proportional to the percentage it contributes to the programme funding. This means that from the outset, each State must specify not only the amount of money it wishes to dedicate to the research and development of the programme, but also the quantity of equipment it plans on ordering. Obviously the greater this proportion is, the higher the workload. The industrial structure that will shape the programme throughout its life time will depend considerably on this initial distribution.

However, the most important phenomenon that affected defence budgets in the 1990s will have been their reduction, furthermore a reduction that often occurred outside the budget framework initially established. France, Germany, Italy and Spain in particular suffered from these military budget cuts in the middle of the financial year, which acutely affected the co-operation programmes.

As regards France and Germany, it can be said that their co-operation programmes were strongly affected by these budgetary factors. They are responsible for the indefinite shut-down of the Helios II programme. They are also one of the reasons behind the many knocks that so severely affected the NH90 and Tigre helicopter programmes.

In addition, the structure of these programmes is arranged such that financing problems at the top mean a complete restructuring of the industrial distribution cannot be avoided, often demanding long negotiations.

Finally, a general mistrust developed among the partners, who accused each other of increasing their planned orders when signing the MOU, so as to acquire an advantageous proportion of the work.

The fact that these programmes were called into question throughout the 1990s is certainly due to budgetary difficulties. However, the very design of these co-operative ventures laid them open to this potential risk.

B) The lack of agreement between European military leaders on operational specifications for equipment.

It is evident that very often disagreement over operational design was at the bottom of the difficulties encountered in armaments co-operation. It is not simple to analyse these difficulties, because their causes are multiple and it is hard to give one more importance over another. In enumerating the causes of these breakdowns, and without trying to quantify the responsibility of each, the following can be found :

- 1) Disparate concepts of operational functions at a European level,
- 2) Lack of co-ordinated equipment renewal deadlines,
- 3) Lack of desire to develop common "basic" specifications for equipment,
- 4) Procurement procedures disparate, reinforcing divergence on operational specifications rather than eliminating it.

At this level, obviously it is unfortunate that the political decisions were not followed up on the initiative of these programmes. A few of these programmes escheated because the government was not able to provide the necessary impetus to revive them. Often, differences regarding operational specifications could have been overcome if the government had been more firm in asking the military leaders to reach an agreement.

The enormous differences in procurement methods in each country (in France in particular, the General Armaments Directorate is used to specifying and qualifying its weapons systems down to the smallest detail) in themselves are not conducive to finding common ground, let alone when there are such divergent points of view.

C) Extremely Unwieldy Co-operation Structures.

Armaments co-operation also suffers from extremely unwieldy operating structures. In the extreme cases, everything is doubled-up in bilateral co-operative ventures, from the body that directs the programme and buys the equipment to the industrial project manager.

The example of the Horizon frigate also shows that there is no point in setting up an integrated programme management structure if it merely consists of people with different points of view but no means to settle disputes.

The lack of a single industrial project manager is also a major disadvantage because the rivalries liable to develop throughout the life time of the project are institutionalised.

The creation of economic interests groups made up of the different companies involved in a programme is insufficient to mitigate this problem. Without any decision making power, the economic interests groups are not companies in themselves, and their directors are obliged to refer to the parent companies if disputes arise. This wastes time, admitting that these disputes can be resolved.

The lack of true integration, both at state and industry level, generally tends to exacerbate the difficulties because disputes become conflicts of power between states or economic competition between companies. In negotiations, the side that seems to have given in to the other will be considered to be a loser even if the programme is saved.

These difficulties associated with the unwieldy and poorly-adapted armaments co-operation structures are an extremely important factor in determining the landscape of armaments co-operation.

In particular, we can predict that the OCCAR will not be able to fulfil its supposed role if it functions from the outset as an inter-state organisation and not an integrated European organisation.

In particular, it would appear necessary, before beginning to launch any programme via the OCCAR, to ensure that the military leaders have developed joint operational specifications for the programmes to be implemented, or at least that the OCCAR is only managing the parts of these programmes where agreement has been reached.

It would also appear to be necessary that the OCCAR member countries harmonise their procurement and programme operating procedures beforehand, or risk encountering the same problems, that the joint operating rules of this organisation will not be able to resolve.

IV-4-d. Remedying breakdowns in armaments co-operation.

Over recent times, it has been observed that a certain amount of almost identical equipment has or is about to come into service in several European armies without this equipment having been the subject of a formal armaments co-operative venture.

The major example is the "Storm-Shadow/Scalp" stand-off missile of Matra BAe Dynamics.

Initially, this missile was developed for the French Air Force, which wanted a missile that could be launched from a safe distance equipped with anti-runway sub-munitions. From the Apache missile developed by Matra-Défense, the French company undertook design studies on behalf of the DGA to make it into a veritable cruise missile, the "Scalp".

It was at this time that Matra-Défense was to combine its missile sector with BAe to give birth to Matra BAe Dynamics. The new company immediately won the British tender for a stand-off missile by offering a new version of the Scalp, the "Storm-Shadow".

As the order was so large, costs were reduced and Matra BAe Dynamics was able to make an offer to the DGA to reduce the cost of the Scalp by following the Storm-shadow specifications. It is the same sort of missile that, in 1999, has just been adopted by the Italian Airforce, theoretically giving rise to a co-operative venture, the capital distribution of which is not yet formalised, with Alenia Difesa.

It can therefore be seen that in these cases it has been the companies that have initiated a form of co-operation in the armaments sector. The equipment delivered to the three armed forces will not be completely identical, but three countries will have shared joint development costs, paying only for their own specific developments themselves. As for the industrial distribution problem, it is solved within the company itself, thus avoiding all power struggles and competition disputes between companies, even if, as seen above, a certain form of "inter-statism" reigns within these companies regarding industrial property and employment issues. It is likely that this is the form of co-operation that could exist in the air-to-air missile field if the Meteor is chosen by the British in the BVRAAM tender.

It can therefore be said that in these examples the companies have overcome state-related obstacles to armaments co-operation by getting the different countries to choose identical or at least largely identical equipment both in terms of design and choice of technology. Therefore, there is no longer any need for an inter-state structure to manage the programme, nor for an ad hoc industrial structure, as the cross-border companies already possess the necessary framework for conflict resolution.

Of course, the sine qua non condition for such a form of armaments co-operation to exist is the existence of a pan-European company.

Although cross-border companies make it possible to overcome difficulties associated with the structure of armaments co-operative ventures, the development of programmes in a public/private founding (PPF) or in a private founding initiative (PFI) could help to overcome difficulties associated with the lack of agreement over operational specifications.

If this were the case, the industrial companies would take the initiative of developing a system or providing a service which would not be bought by the states, but merely rented by them.

Initially, the PFI was mainly confined to the service domain. At the beginning, certain states wanted to outsource functions not essential to their sovereignty, and which they considered would be better fulfilled by private initiative than public administration. The United Kingdom in particular encouraged this phenomenon, asking the private sector to provide helicopter pilot training for the ministry of defence.

Initially limited to environmental and logistics functions associated with the armed forces, the PFI mechanism is perhaps suitable to be extended to military systems themselves, on the

condition that these systems meet a wide enough common need or that they have a civil purpose.

At the current time, Matra Marconi Space is proposing the PFI mechanism for developing the military telecommunications satellite, Trimilsatcom ; the armaments co-operative venture that was intended for its construction broke down.

The principle of the PFI would be the construction of a civil and military satellite, which the states would pay to use, with differing priority of access. Basic specifications would be established, but each state would be able to ask for particular services or specifications that they would pay to have developed.

It is still too soon to say how the PFIs may develop. For the moment, they are limited to service contracts and no examples yet exist of real armaments programmes initiated by a company which several states would pay to use. It is a future opportunity that should not be neglected, but it is by no means certain that all the states would make use of it in the same way, particularly since it is part of a philosophy aiming at reducing the perimeter of state intervention.

CHAPTER 4 : Italy

I. THE DEFENCE INDUSTRY IN ITALY

Since the end of the cold war, European defence industries have been brought face to face with some major difficulties, forcing them to take drastic restructuring measures. In Italy, the situation for armaments companies has been aggravated by certain particularities of the country³⁶ : a political system in the midst of transformation, causing, among other things, intense focus on internal politics ; general lack of interest among politicians for armaments issues ; the lack of a "real" industrial defence policy ; extremely unwieldy and complex acquisition procedures ; a lack of co-ordination between the defence industry and the armed forces ; a restricted and unbalanced defence budget ; and very restrictive export regulations.

It is true that the Italian industry has succeeded, despite its structural handicaps, in developing (and in maintaining) some cutting-edge technology. In the aeronautics sector in particular, this success is due, above all, to a long tradition of participation in international programs : via the production under licence of Anglo-Saxon systems (F86K, F/TF-104), the Italian industry gradually acquired sufficient technological capacity to lead (small) programmes on an international scale (G-91), and then bi-lateral programmes (Italian-Brazilian collaboration in the AMX programme), and finally participation in the two European combat aircraft, the Tornado and Eurofighter.³⁷ But the country's industrial foundation has never been independent and, in several fields, Italian companies are found lacking in comparison with their international competitors. These weaknesses are due on the one hand to the low level of funding dedicated to R&D by the State and the companies, and on the other, to the long-standing fragmentation of the sector.

Over the past few years, Italian industry has, however, entered a major restructuring, consolidation and rationalisation phase. Between 1989 and 1994 this led to the suppression of 20,000 jobs. In 1995, the defence industry employed 100,000 people, two thirds of which

³⁶ For the continuation see Maurizio Cremasco, "The Italian Defence Industry : Issues and Prospects", ESAN-Projekt "Arms Production and Cooperation", Paper No. 11, SWP Ebenhausen, 1997. Reinhilde Weidacher, "Italy's Role within the European Defence Market", FOA, Find-Programme, Stockholm, 1998.

³⁷ More than half of Italy's military programmes are run in co-operation. The national director of armaments currently manages more than 70 international co-operation projects. In the eleven largest programmes, France is the main partner of the Italians (73% of collaboration programmes), ahead of Germany (55%) and the United

directly. 25,000 people were employed by the State's arsenals (which only produced 5% of armaments requirements). The armaments sector overall thus represented 0.7% of industrial employment as against 5.8% in 1983.

Italian industry is traditionally dominated by public groups. There are barely half a dozen large private companies. The rest of industry consists of multiple SMEs, networked around the territorial armaments and defence electronics sectors.

The private sector essentially centres around the giant, Fiat. From its birth, at the beginning of the twentieth century, Fiat has invested in the armaments sector. However, their military sector now represents less than 3.8% of the total turnover. The group's defence activities are represented by Fiat Avio and Iveco Military Vehicles Division (IMVD). Since it acquired Alfa Romeo Avio in 1996, Fiat Avio is the only Italian manufacturer of aircraft engines which participates, among other things, in the design and manufacture of the EF 2000 engine. Happy with the role of sub-contractor, the Agnelli family does not consider it necessary for Fiat to enter into any groups with European or American partners. However, IMVD has made a commitment with Finmeccanica, to development projects for tactical and logistical vehicles.

Another player in the private sphere is Aermacchi, 75% owned by the Foresion family, via the holding company Aeronautica Macchi Holding Group. Since SIAI-Marchetti was bought from Alenia in 1997, Aermacchi holds a monopoly in Italy in the manufacturing of light training and attack aircraft. The company is also an important sub-contractor and supplier for many European aeronautics companies. Other private players are Elettronica, a defence electronics company, 53% owned by the Fratalocchi family, and Beretta, well-renowned producer of small weapons and Intermarine, a company of the Ferruzzi group which constructs small surface ships.

The State holding company, IRI (Istituto per la Ricostruzione Industriale) is the main entrepreneur of the armaments sector in Italy. IRI was created in 1933 to deal with the consequences of the 1929 crisis. Its creation was not directly associated with any interventionist desires of fascist ideology, but rather with a reorganisation of the banking system, intended to do away with the German model of mixed banking, to enable the banks to

Kingdom (27%). British dominance can be noted in the aeronautics sector, off-set by a tradition of collaboration

withdraw from their industrial commitments. In 1937, the IRI changed status, becoming a standing institute. In the absence of private investors, it could not give up its shares in the public companies. Renewed in the 1950s and 60s in the context of the *programmazione* (such as the ENI), the IRI became a virtual framework, leaving the public companies under the holding company considerable autonomy in developing their own strategies. In 1991, the IRI was shareholder in a thousand companies, and directly controlled 380 of these in very different fields (steelworks, banks, communication, naval construction, aeronautics and defence). The defence activities of the IRI were divided into two sub-holding companies, Fincantieri and Finmeccanica.³⁸

Fincantieri Cantieri Navali Italiani S.p.A is the largest Italian manufacturer of commercial and military ships. The current company was firstly founded in 1959 as a holding company for the naval construction sector within the IRI group. Then, in 1984, it was converted into an operational company under its current name, directing two distinct divisions, one dedicated to the design and manufacture of commercial ships and the other to the manufacture of war ships, destined for the Italian marine forces and export. A third division, specialising in the design and manufacture of diesel engines was recently transformed into a separate company of the group. Fincantieri belongs to the State but operates as a commercial enterprise : although it is a public company, the company is not subject to the conventional personnel management rules of the public sector. It uses methods similar to those of commercial enterprise law to reduce or increase its workforce. Having suppressed a quarter of its positions in seven years, Fincantieri now employs around 9,500 people. The company controls several naval construction sites across the whole of Italy. Fincantieri's war ship construction division has its headquarters at Genoa, and controls the naval construction sites of Muggiano and Riva Trigoso, located to the north of the Mediterranean coast.

The IRI's aeronautics and defence activities are grouped under Finmeccanica. This public holding company was created in 1948 and today is the second largest Italian company behind Fiat. Finmeccanica became the "national champion" of the Italian defence industry between 1989 and 1995 during this sector's first major restructuring phase. In 1989, the IRI decided to transfer the electronics activities of Stet to Finmeccanica. One year later, two Finmeccanica

with the French in the missiles sector and with the Germans in the field of territorial armaments.

³⁸ See "L'avenir de l'industrie publique italienne face aux enjeux du grand marché européen", directed by Jean François Daguzan, Crest, Paris, 1995.

companies, Selenia and Aeritalia, respectively national leaders in the defence electronics and aeronautics sectors, merged, giving birth to Alenia. In addition, Finmeccanica acquired a major stake in several companies liable to be dismantled (25% in Ferranti Italia, Fiar and Aermacchi, 31% in Rinaldo Piaggio, 47% in Elettronica). In 1995, Finmeccanica had taken over all the defence activities of the EFIM (Ente Partecipazioni e Finanziamenti Industria Manifatturiera) which until then had held the main armaments companies (Augusta, Oto Melara, etc.). Added to this was Whitehead, bought by Fiat at the same time. Thus, two thirds of the Italian defence industry were concentrated under Finmeccanica's roof.

Holding the main groups, the Italian State was the instigator of most of this restructuring. At least at the beginning, action taken by the different governments was motivated rather by social and political constraints, not by strategic and industrial considerations. The main role of public (defence) companies was to create and safeguard jobs via state-held capital when private capital defaulted. This was also the case of Finmeccanica. Lacking a real industrial policy on armaments, the holding company's structure evolved gradually, without any specific objectives. The result was the duplication of commercial and administrative structures, as well as the birth of a vast set of widely different activities. Finmeccanica's management objectives were also more socio-economic than strategic. The direct consequences were high investment not only in industry, but in R&D, financed by subsidies or injections of capital, which put the company in considerable debt.

II. FINMECCANICA – A GROUP IN THE MIDST OF TRANSFORMATION

II-1. The planned end of the IRI

To understand the current situation of Finmeccanica, it is necessary to go back to the upheavals that the entire Italian public sector in general, and the IRI in particular, have been through since the beginning of the 1990s. Until now, the public sector had dominated the Italian economy, and its financial influence over the State was considerable. In 1991, five of the seven largest companies in the country were public groups and the percentage of employment in this sector was the highest in Europe. At the same time, public companies absorbed more than 40% of bank credit. Finally, the lack of budgetary control by the

companies and the State gradually drove a wedge between industrial decision making and economic rationality.³⁹

The economic and monetary crisis of 1992 crushed this system. The decisive event was the collapse of the holding company, EFIM, whose level of debt rose to the phenomenal sum of 8,500 billion Lira. The Italian State was forced to dismantle the conglomerate, taking over its debt and placing the companies of the EFIM under the wing of other holding companies. As mentioned above, the armaments companies were all grouped together under the roof of Finmeccanica, belonging to the IRI group.

Worse still, straight after the liquidation of the EFIM, the Italian government was also obliged to give in to pressure applied by the European Commission to dissolve the IRI. Indeed, the Commissioner of Competition, Mr. Van Miert, had imposed, as a condition to granting subsidies in 1993, that the IRI drastically reduce its debt and that the enterprises of the holding company break their ties with the Italian State. After several years of procrastination, political resistance and arm wrestling between the European Commission and the Italian State, the decision was made to dismantle the IRI before 30 June 2000.

This process is now well underway. Until 1997, the IRI sold shares for a total of 65 trillion lira, and withdrew from 490 companies. From 1995 to 1997, the holding company brought its debt down from 55.54 trillion lira to 2.67 trillion. In summer 1999, it will sell its shares in the airports of Rome (ADR), Alitalia and the highway company, Autostrade. It will then be the turn of Cofiri, the bank of the IRI group, to be privatised. In November 1998, the Chairman of the IRI, Mr Gros-Pietro, reconfirmed his determination to meet the June 2000 objective.⁴⁰

Governments have been spurred into privatising public enterprises by the dual pressure of the monetary and financial crisis on the one hand, and EU regulations regarding deregulation and competitiveness on the other. "The State had to exchange its entrepreneurial status for that of regulator, the objective being, besides to the economy on its feet and raise cash, to encourage individual shareholders and liberalise the financial market by creating new institutional investors".⁴¹

³⁹ "L'avenir de l'industrie publique italienne...", p. 52.

⁴⁰ See Ulrike Sauer, "Abschied von einem Wirtschafts-Monstrum", Süddeutsche Zeitung, 10.11.1998.

⁴¹ "L'avenir de l'industrie publique italienne...", p. 52.

II-2. The new, privatised Finmeccanica – financial or industrial holding company ?

The consequences of these events were of fundamental importance for Finmeccanica. Barely turned national armaments champion, the group found itself obliged to privatise, a process which included two major restructuring efforts. During the 1990s, two distinct stages could be noted, guided by two opposing approaches. Firstly, the vice-Chairman, Fabiano Fabiani wanted to integrate all similar activities into one group, in order to create technological and commercial synergy, rationalise the administration and to accelerate the decision-making process. His objective was to maintain Finmeccanica as a large, privatised and diversified entity. Therefore in 1992 Finmeccanica incorporated Alenia, Ansaldo and Elsiel, changing from a financial into an industrial holding company. In December 1996, the 100% owned defence and aeronautics subsidiaries (Agusta, Alenia Spazio, Oto Melara, etc.) were also integrated. In this way, these legally independent companies became divisions of Finmeccanica.

This policy of integration was reversed in May 1997 with the resignation of Fabiano Fabiani. From his successor, Alberto Lina's point of view, Finmeccanica could not be privatised as it stood. Firstly, the unusual organisational structure of the group had made its accounts distinctly ambiguous, because the divisions consisted of companies whose activities were not clearly separated. Secondly, the previous policy of growth by acquisition and absorption had led to so much debt and diversity of activities that consolidation and refocusing on the basic activities became inevitable.

Furthermore, the divisions dealing with the basic activities did not have the critical mass to be able to stand alone in their sectors of activity. For them, integration into international groups was the only solution.

The conclusion of this analysis was the (re)transformation of the group into a financial holding, and the gradual transformation of the divisions into subsidiaries. It was the only way to give up the less important activities and establish joint companies with international

partners in the basic activities. The new management therefore divided the Group's activities into three categories :

- *Core interests*, represented by the aeronautics and defence divisions. These activities were not to be sold, but integrated into international joint venture ;
- Activities in the automation field. Considered to be *non-core businesses*, these were to be sold ;
- The energy and transportation fields, hanging halfway between the above two categories. The objective for them was to improve profitability in order to find an industrial partner that would be prepared either to team up with the companies concerned in the context of a joint venture, or to buy them.

Thus the restructuring plan presented by Mr Lina when he was appointed in April 1997 was as follows :

- To reorganise the group into 9 independent divisions : *aeronautics, space, helicopters, defence, transport, energy, process automation, service automation, industrial automation* ;
- To strengthen market position by forming joint ventures ;
- To straighten out the capital structure of Finmeccanica by selling non-strategic businesses at a price that would bring in 3,000 billion Lira ;
- To reduce net debt (accounts payable and receivable) to zero in 1999 ;
- To increase capital by 2,000 billion Lira. This increase consisted of 1) capital regrouping (93 new shares for 100 old ones), 2) issuing 5 new shares for 4 old ones, 3) issuing share subscription bonds ;
- To reach equilibrium in 1999, with drastic reduction of general management and fixed costs, control of cash flow and working capital in each division ;
- To implement rigorous management methods. The management of the holding company, characterised thus far as "a total mess"⁴², was reformed in line with liberal management principles ;
- To develop a plan and governmental directives for privatising Finmeccanica.

Today, progress on this restructuring plan is already well advanced.

⁴² Ibid, p. 63.

- In 1998, Finmeccanica gave up more than 20 non-core businesses for around 300 billion Lira ;
- For 1,300 billion Lira and with a write-off of 1,000 billion, Finmeccanica sold its stake in Elsasg Bailey to ABB. This sale contributed considerably to reducing debts from 7,673 billion Lira at the end of 1997 to 3,324 billion by the end of 1998 ;
- The activities of Ansaldo Trasporti and Breda Construzioni Ferroviarie were integrated, Ansaldo Energia was restructured ;
- The structure of the group was further simplified, condensing it into six divisions : *aerospace, helicopters, defence, energy, transport, industrial automation.*

Key figures of Finmeccanica SpA

	1994	1995	1996	1997
Turnover	12117	12844	13883	15282
Exports	54%	56%	65%	65%
Employees	59041	56661	60012	61240
R&D	1263	1173	1297	1426
Self financing	782	747	746	n,c
Debt	4411	4878	5113	7245
Net Profits	52	40	-540	-2350

Key figures by division

	Turnover		Net Profits		R&D		Employees	
	1998	1997	1998	1997	1998	1997	1998	1997
Aeronautics	2160	2299	270	166	174	178	9078	9997
Space	1029	998	101	61	213	172	2795	2664
Helicopters	1179	1015	137	54	268	240	5177	5225
Defence	2327	2351	104	119	580	621	9719	9913
Energy	1949	3015	-202	-228	28	23	7238	7922
Transports	2206	1983	64	25	57	59	6946	7093
Industrial Automation	644	661	-69	5	19	12	3525	3577
Service Automation	711	648	43	25	34	32	2573	2264
Total	12205	12970	448	227	1373	1337	47051	48655

II-3. The strategy of alliances

In the defence and aerospace fields, Finmeccanica's policy is guided by the desire to integrate the different divisions of the group into international entities. In 1998, this policy was crowned with several successes :

- In April 1998, Finmeccanica and the British group GKN signed an agreement regarding the merger of their helicopter divisions, Agusta and Westland. These two divisions already collaborate within EH Industries and have complementary product ranges. The new entity would be fourth in the world, based on their 1997 turnover.
- In July 1998, GEC Marconi and Alenia Difesa signed a final agreement to create a 50/50 joint subsidiary in the field of territorial and naval radar, air traffic control, C3I systems, missiles, simulators and training systems. The agreement also allows for the establishment of mutual stakes in the field of weapons systems and armoured vehicles as well as avionics, with : - a 25 to 40% stake by Marconi in the avionics division of Alenia Difesa ; - a 25 to 40% stake by Alenia Difesa/Otobreda in a new Marconi entity, combining the territorial activities of Marconi Marine/VSEL and Marconi Control Systems. This alliance should lead to an equal-share joint company in the defence electronics field, called Alenia Marconi Systems (AMS), an avionics company under the control of Marconi Avionics, of which Alenia Difesa Avionics would become a subsidiary ; as well as a territorial systems company under the control of Alenia Difesa/Otobreda of which Marconi's territorial arms entity would become a subsidiary.
- In October 1998, Agusta and the American company, Bell announced the creation of a joint venture (Bell Agusta Aerospace Corporation, BAAC) to develop the civil BA609 tilt rotor and that of the AB139 medium helicopter.
- In December 1998, Finmeccanica, Matra, GEC Marconi and Dasa signed an agreement to integrate their space interests. Following this agreement, Alenia Aerospazio, Matra Marconi Space and Dasa Dornier Satellitensysteme are going to form one single European entity, Astrium.

Airbus remains one of the great unknowns in Finmeccanica's alliance strategy. For the moment, Alenia is only a sub-contractor for Airbus and makes a section of the fuselage for

A321-100 and A 321-200. In light of the indisputable success of the European consortium, Finmeccanica's directors would desperately like to see Alenia become more involved in Airbus. This should happen when the switch is made from "Economic Interests Group" status to that of SCE. However, there are still plenty of obstacles to be overcome, in particular the fact that Alenia is one of Boeing's major sub-contractors, working particularly on the Boeing 717.

The arrangements announced in 1998 have also had a few hurdles to overcome : while the Agusta/Westland and Astrium agreements were concluded with nothing more than the "usual" delays, the agreement between Alenia Difesa and Marconi was seriously called into question by the integration of the latter into BAe. The planned mutual stakes in avionics and territorial weapons now seems to have been abandoned completely ; AMS has indeed existed since the beginning of the year, but its future is still far from guaranteed.

The difficulties encountered in the agreement with Marconi demonstrate that Finmeccanica is not prepared to accept unequal partnerships. For its "strong" activities, only a 50/50 formula can be considered (which was called into question by the unexpected "growth" of the British partner). In sectors where such a balance cannot be reached with only two partners, Finmeccanica is trying to integrate its divisions into multilateral joint ventures (enabling the minority partner to benefit from variable majorities).

II-4. Shareholding Structure

In 1994/95, Finmeccanica made an initial increase of capital to the tune of 1,688 billion Lira. The objective was to reduce debt and finance the acquisition of companies of the EFIM. Thus, the EFIM's creditor banks, all public at the time, became shareholders in Finmeccanica, taking a stake in the company in return for the credit they had given to the EFIM. It was a 30% stake approximately, held by, among others, the banks San Paolo (6.54%), Comit (3.66%) and B.N.L. (3.37%). Around 13% was held by private investors and the IRI retained a 63% stake.

Today the capital is being increased once again by the issuing of subscription bonds. The IRI still has a 61.6% stake (including COFIRI's share) ; at the end of the financial year, this stake should drop to 52% (excluding COFIRI). According to Finmeccanica management, the IRI's share will drop by half again by the end of the year. Banks which took a stake in

Finmeccanica immediately after the EFIM was dissolved, have been privatised and practically all of them have sold their shares. Today only 4.2% of the capital is held by Italian institutional investors, 9.1% by foreign institutional investors and the rest by small shareholders. Therefore there are no more major Italian investors (apart from the IRI, of course), the largest non-public shareholder is the American Fidelity fund with 3.7%.

Once the privatisation process is complete, the State will retain a 25 to 30% stake in Finmeccanica, to be held by the treasury once the IRI disappears. Therefore it will not actually be completely privatised, even if the IRI's plans envisage that institutional investors, particularly foreign ones, will hold the largest stake. This private shareholding would be scattered, with a share threshold of around 5%.

In this context it is important to know that Finmeccanica is looking exclusively for financial investors, not industrial investors to take a share in its capital. This excludes, for instance, all exchange of shares with another national champion. Finmeccanica thus wishes to remain a national group with a public reference shareholder. In this concept mergers play an important role, but they remain limited to activities.

II-5. The consequences for the group's governance

Of course, all these transformations are radically changing the governance of Finmeccanica. As an SpA company, Finmeccanica has a Board of Directors at its head, responsible for all the group's activities. This board is made up of 12 members, appointed for three-year terms. The leader is not the Chairperson, but the Vice-Chairperson, who is also the Chief Executive Officer. The board is supported by eight chairpersons responsible for the group's central services.

For the moment, the majority of the directors are appointed by the IRI. In the future, this will have to change in that other shareholders will acquire stakes and the IRI will be dissolved. Nonetheless, following privatisation the government will have at least one representative on the board, delegated either by treasury or the ministry of defence.

Not having shareholder rights, the employees are not represented in Finmeccanica's governing bodies. Even the works councils only exist at division and subsidiary levels and there is not systematic and institutionalised co-ordination between the councils of the different divisions. If the group's management wishes to deal with employee issues affecting the company as a whole, it therefore turns directly to the union leaders.

The ties between Finmeccanica and each division are personalised by the *istitore*, that is to say the director delegated by Finmeccanica. Responsible for the division, there is only a small team available to work with this delegate, because the "real" authority lay directly with Finmeccanica management right up until 1997.

The transfer of power from Mr. Fabiani to Mr. Lina has not altered management structure ; however, the way management operates has changed considerably. Within the board of directors, the directors have received increased shareholding rights, transforming the board into a collective body. The *istitore* has received more responsibility for strategic decisions concerning his sector, but, on the other hand, financial control of his activities has been tightened. Under Mr. Fabiani, the divisions did not operate as profit centres and only presented their results once every six months. Today, the accounts for the different divisions are kept strictly separate and each month the *istitore* must present his figures to the board of directors. Other important central services such as *Strategy, External Relations, Support* and *Marketing* are also set up by Finmeccanica.

Finmeccanica is responsible for negotiations concerning the integration of divisions into joint ventures. A prerequisite for such integration is for the divisions to become subsidiaries. The naval systems, radar and missile system divisions were transformed into one company, Alenia Systems SpA, which was then integrated into AMS. Agusta and Alenia Spazio are in the process of becoming SpA companies ; only the aeronautics, avionics and territorial armaments sectors are still divisions.

Once integrated into joint ventures, relations between the former divisions and Finmeccanica will, of course, change. Although the regulations governing these relations are yet to be defined it is already clear that Finmeccanica does not intend to become a simple financial holding company. It does not want to delegate all its decision-making power to the subsidiary

directors, nor does it wish to merely monitor the financial results. On the contrary, its objective is to retain strategic influence within the new international entities.

To play this role, Finmeccanica aspires, on the one hand, to having sufficient say in the management bodies of the joint ventures. Naturally this will depend on the stake it has in the structure and does explain why it is making such an effort to seek balanced solutions. On the other hand, Finmeccanica wishes to increase its own analysis capacities to ensure its ability to effectively control the policies of joint subsidiaries.

Such a policy requires a certain number of highly qualified directors, which Finmeccanica would seem to be having trouble finding. This problem can be explained by looking at the group's history. Finmeccanica's involvement in the majority of the defence sectors has been too short for it to have trained enough experienced executives. Those who work in the different divisions, for their part identify more with "their" company than with the group. They are even less inclined to work for Finmeccanica now that it is making draconian job cuts (in one year alone, the number of employees has fallen from 750 to less than 200).

III. THE ROLE OF THE STATE

In Italy, the State has traditionally been the main player in the defence industry. Until now, it has acted above all as an entrepreneur. With the dismantling of the IRI and the privatisation of Finmeccanica, its weight will, of course, diminish. The question is whether, and in what way, the State will manage to retain its influence over what is known as a strategic industry.

III-1. The State as Client

Despite a nominal increase of around 3,500 Lira since 1989, strictly military spending (*funzione difesa*) has in actual fact dropped by more than 16% in Italy over the past ten years. This discrepancy is due to the significant devaluation undergone by the Lira at the beginning of the 1990s.

Italian military spending in billion Lira (current)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Maintenance	4357	3814	3118	3197	2766	2429	2481	2975	3492	4155	3688
Investments	4852	4425	3839	4269	3684	3344	3385	4117	4771	5099	4256
Total	5387	4807	4221	3577	4150	3765	3863	4585	5034	5439	4630
Investments*											
R&D	495	610	721	1072	918	915	904	1142	1279	944	588
Funzione Difesa**	17977	17929	18304	17768	18136	18480	18389	21901	21767	21734	21405
Total Budget	22905	23154	24466	24517	25560	26167	25677	31235	31060	30988	30834

Source : Ministry of Defence, according to information from Michele Nones, 1999

* including the infrastructure

** without "temporary" pensions ; the increase in 1996 is due to reforms in the retirement system and social cover of the *Carabinieri*.

Funzione Difesa in billion Lira (constant from 1989)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<i>Funzione Difesa</i>	17977	18214	17203	17449	15520	15221	14377	16472	16097	15795	15985

Source : Michele Nones, 1999

Starting out at a fairly low level, the reductions were therefore significant and were aggravated by a (long-standing) poor distribution of funds intended for personnel training and investment.

Functional proportion of Italian military spending as a percentage

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Investments	30.0	27.9	23.1	24.4	22.9	20.4	21.0	20.9	23.1	25.0	21.6
Training	28.1	29.2	28.6	27.7	28.2	29.8	30.1	24.5	23.5	27.7	30.1
Personnel	41.9	42.9	48.3	47.9	48.9	49.8	48.9	54.6	53.4	47.3	48.3

Source : Ministry of Defence, according to information from Michele Nones, 1999

The current level of investment (less than 5,000 billion Lira) is still deemed by industrial companies to be insufficient. They feel that international competitiveness requires annual spending of around 8,000 billion Lira.

Budget cuts and the low level of investment have been aggravated by the lack of a "real" long-term procurement policy, as well as by the lack of integration within procurement bodies. The latest White Paper dates from 1985. It was updated by "additional notes for provisions in Defence matters" (*Note aggiuntive allo stato di previsione per la difesa*) which do not, however, include any long-term planning. The armed forces independently outlined their own investment programme, leading to doubling up on jobs and cost increases. Another characteristic trait of the Italian system is that there is no actual government agency or armaments directorate for military equipment procurement. It is the technical-administrative branch of the Ministry of Defence, directed by the Secretary General/National Armaments Director (SG/NAD) who is responsible for awarding contracts and managing programmes.

For a while now, we have, however, been able to observe attempts to rationalise procurement procedures. The recent "law on executive reform" (*Legge sui Vertici, d.d.l. n.1157, Riforma dei Vertici Militari*) is considered to be an important step towards applying the "new defence model" aimed at adapting the military sector to the new strategic situation. The law proposes governmental re-organisation, including a new role for the SG/NAD. The latter will now answer to the minister for administrative responsibilities and to the head of the armed forces for technical and operational responsibilities. The task of the SG/NAD will be to integrate the activities of the bodies concerned by co-ordinating the work of the managing directors and drawing up proposals for industrial planning. In addition, the position of SG/NAD and that of one of the two vice-SGs will be able to be held by civilians.⁴³

III-2. The State as Sponsor

As a sponsor, the Italian State also plays a modest role. For Finmeccanica for example, the government permanently suspended subsidies (*fondi di dotazione*) in 1991. Today, three types of financial aid exist :

⁴³ See Reinhilde Weidacher, "Italy's Role within the European Defence Market", p. 21 ; "New Horizons For Italian Defence Procurement", in : *Military Technology*, 3/1997, p. 93-99.

- In the context of Law 237-93, the ministry of technology contributes around 100 billion Lira per year to help defence companies rationalise and restructure. This sum is intended for the industry as a whole, Finmeccanica receives around 60% of it.
- In the context of Law 808-85 (aeronautics law), the government supports R&D in aeronautics companies relating to specific programmes, using reimbursable funds (once the product exceeds the break-even point). The ministry of industry thus contributed 1,150 billion Lira in 1994-1996 and 2553 billion Lira in 1997-2000 ; Finmeccanica received *grosso modo* half of this (725 and 1285 billion Lira respectively) ; the other half went to Fiat Avio, Aermacchi and Elettronica.
- Law 46-88 is also specifically directed at aeronautics companies. The ministry of research supports the (basic) R&T by contributing up to 50% of the cost of a research project. This is non-reimbursable assistance, but the total sum is very modest (10-15 billion Lira per year).

Given the budgetary constraints, it is unlikely that public spending for the defence industry will increase significantly in the coming years. As client and sponsor, the State will not have a very important role to play. Therefore, it will be as a regulator and shareholder that it will retain its influence over the industry.

III-3. The State as Regulator

In Italy, the State does not hold a Golden Share in the defence companies. Referring to Article 25 of the national law on protecting competition, the government can, however, prevent foreign companies from taking over Italian companies, on the condition that the same legislation exists in their country of origin.

Two laws passed in 1994 have even greater impact on the current restructuring efforts : Law 474-94 enables the government to maintain a certain degree of control over companies in the midst of privatisation (either via a specific share or some other mechanism). Law 332-94 for its part, gives the State the possibility of inserting clauses into these companies' statutes granting the treasury ministry special powers. These prerogatives can allow for, among other things, vetoing rights regarding the entry of an "important" shareholder, the signing of shareholder pacts, the dissolving of the company as well as the right to appoint at least one board member.

Thus, the government has effective means for controlling privatisation efforts and maintaining overseeing rights in the industry once the process has been completed. In the case of Finmeccanica, the State will probably use these prerogatives to retain a right of veto regarding status change, appointment of the CEO and the acquisition of more than 5% of the capital. However, other issues remain as yet unresolved : how to prevent, for example, an industrial investor from taking a stake in Finmeccanica after the majority of the shares have been put on the market ?

III-4. The State as Shareholder

As we have seen, the privatisation of Finmeccanica does not mean that the public power will be completely withdrawn from the group's capital. Via the treasury ministry, the State will, on the contrary, remain the reference shareholder of the holding company. With a planned 25 to 30% stake, its strategic influence will be even more significant in that the other shareholders will only be financial investors each with no more than a 5% stake.

Planning to have this type of shareholder structure clearly shows that the government wishes to retain influence over Finmeccanica. However, it does not mean that it will constantly interfere in the management of the group : the State's aim seems to be more strategic, i.e. to safeguard technological capacity and retain a certain political role in setting up an industrial basis for European defence. From the financial and economic point of view however, the government has already been an "invisible" shareholder these past few years, and this discretion will no doubt continue. The Italian state today has neither the means nor the ambition to return to the role of entrepreneur that it held before. This proves its desire to see the external financing of Finmeccanica come from the capital markets and attract foreign institutional investors, which, with a majority stake, albeit scattered, will limit the role of the public shareholder. In addition, the aeronautics and defence activities of Finmeccanica will, at the end of the transformation, all be integrated into international joint ventures. The influence that the Italian State could wield over the operational units will therefore only be indirect – via the holding company – and will be counterbalanced by the other international partners within the joint companies.

CHAPTER 5 : *United Kingdom*

I. CORPORATE GOVERNANCE IN THE UK DEFENCE SECTOR

Because the UK defence industry is virtually all in private hands, most corporate governance issues in the defence sector are the same as those applying to businesses in the economy as a whole.

Corporate governance received little attention in the UK until the late 1980s when interest was promoted by 'creative accounting, spectacular business failures, the apparent ease of unscrupulous directors in expropriating other directors' funds, the limited role of auditors, the claimed weak link between executive remuneration and company performance, and the roles played by the market for corporate control and institutional investors in generating apparently excessive short-term perspectives to the detriment of general economic performance'.⁴⁴ The most influential document in corporate governance became the Code of Best Practice on Corporate Governance issued in 1992 by the Cadbury Committee set up by the Stock Exchange, the accountancy profession and the Financial Reporting Council, although that code dealt only with the financial aspects of governance.⁴⁵ In general in the UK, although there is obviously a body of company law, corporate governance is largely a matter of self-regulation rather than legal obligation.⁴⁶

Corporate governance debates in the UK are based on the British tradition of the theory of the firm, which makes profit maximisation the only objective of a business and which makes shareholders' welfare 'the paramount consideration'.⁴⁷ However, corporate governance agenda is broadly defined and contemporary topics of concern include the long-term strategic targets of an organisation, the interests of employees, the needs of the environment and the local community, relations with customers and suppliers, as well as compliance with relevant law. A central element in contemporary corporate governance thinking is that a company has responsibilities to all its stakeholders, including its suppliers, customers, employees and local

⁴⁴ K.Keasey & M.Wright, 'Introduction...' in K.Keasey & M.Wright (eds), *Corporate Governance : Responsibilities, Risk and Remuneration* London, Wiley, 1997, p.1

⁴⁵ The Committee was chaired by Sir Adrian Cadbury and the report is reproduced as an appendix in S.Sheikh & W.Rees, *Corporate Governance and Corporate Control*, London, Cavendish, 1995, pp395-400.

⁴⁶ An issue discussed by P.Stiles, 'Corporate Governance and Ethics' in P.W.F.Davies, *Current Issues in Business Ethics*, London, Routledge, 1997, pp.47-8.

community. Thus Sheikh & Rees observe that : ‘the role of corporate governance is to ensure that directors are subject to their duties, obligations and responsibilities to act in the best interests of their company, to give direction and to remain accountable to their shareholders and other beneficiaries for their actions’.⁴⁸ Such observations obviously do not explain how conflicts among stakeholder interests are to be managed. The focus of corporate governance is the board of directors that have formal responsibility for the governance of their company, but who can exercise their functions through a wide range of possible involvement in the day-to-day running of the firm.⁴⁹ Doubts about the effectiveness of boards, even with a significant element of non-executive members present, has led to suggestions that owners i.e. shareholders should be active in overseeing companies.

Two elements worth highlighting in a defence context are the role of owners and their relationships with directors and managers, and the ethical dimension of governance.

The role of owners

A major issue in corporate governance concerns the relationships and responsibilities of a firm’s owners and managers. In Britain, the weight of institutional shareholders is very heavy with financial institutions (especially pension and insurance funds) holding more than 60% of UK equity. Equity holdings by individuals had fallen to less than 18% by 1993⁵⁰. Institutional shareholders, however, have traditionally been reluctant to become overtly involved in the running of the companies in which they have holdings. The economics-based explanation of this is that shareholders devoting resources to overseeing the companies in which they have a share provide a free service to other shareholders that do not devote such resources. There is thus a temptation to ‘free ride’ facing owners, to leave the management oversight role to other shareholders and to judge performance solely on the basis of short-term financial performance. By keeping their holdings to 5% or less of a firm’s stock, they can indicate their displeasure at how a company is going by simply selling their shares. The Cadbury Report, however, wanted the institutions to adopt a supervisory role over the company management on behalf of small shareholders.

⁴⁷ S.Shaikh & S.K.Chatterjee, in Shaikh & Rees, op.cit., p.8.

⁴⁸ Shaikh & Rees, op.cit., p.v.

⁴⁹ See P.Stiles ‘Corporate Governance and Ethics’ in P.W.F.Davies (ed), *Current Issue in Business Ethics*, London, Routledge, 1997, p.40.

⁵⁰ Keasey & Wright, op.cit., p.24.

This has not happened in any formal way and institutions are often reluctant, for instance, to use their voting rights at annual general meetings. However, there are signs that the institutions, with most closely co-located within 'the square mile' of the City of London, have many informal contacts with each other. They share information and also exercise influence through their equal informal contacts with their clients. The overall influence is thus hidden and not insignificant.⁵¹ Certainly major defence companies, like civilian firms, stay in close contact with their major shareholders and other sources of capital including banks.

The ethical dimension

Corporate governance in its modern manifestations stresses a company's responsibilities to all stakeholders in its activities and to the environment. It thus has an ethical dimension.

However, in order to capture the synergies in BAe's extensive capabilities across its previously rather insulated sections, in 1994 the top level management of BAe introduced a values programme, entitled Benchmarking BAe, as a central change management element in the company. Five values were articulated, promoted and their establishment monitored.

The five values were :

Customers

We will delight our customers, both internal and external, by understanding and exceeding their expectations.

People

All BAe people will be encouraged to realise their full potential as valued members of the BAe team.

Partnership

We will strive constantly to be our customers' preferred supplier ; our suppliers' preferred customer ; a respected partner in our alliances ; and a source of pride to our government and local communities.

Innovation and technology

We will encourage a hunger for new ideas, new technology and ways of working, to secure sustained competitive advantage for our company.

⁵¹ See H.Short & K.Keasey, ' Institutional Shareholders and Corporate Governance' in Keasey & Wright, op,cit., pp.23-60 for a discussion on this area.

Performance

We will set targets to be the best, continually measuring, challenging and improving the way we do things both as individuals and as members of our teams.⁵²

The emphasis on customer service is something that has been adopted by British defence industry as a grouping, through the Code of Conduct of the Defence Industries Council.

Clearly these approaches involve all customers having a similar moral status : they are all entitled to be delighted. However, this raises the ethical question of whether all BAe customers should be treated equally since some of the governments involved have attitudes and policies towards the rights of citizens that are very different from those found in the UK. Moreover, some of their procurement practices, involving extensive commission payments, present difficult ethical questions for a company seeking to be 'a source of pride' for its government and local community.

The response of BAe, and that of other UK defence companies, tends to be to entrust the ethical responsibility for their activities to the British government, particularly in the export area. BAe has led the argument that the company does and should leave ethical and other policy considerations to the government, and that the company fully respects the government's choices. It is the government that is elected by the people to regulate the activities of firms such as BAe and it would not be appropriate for the company to have different policies on arms exports, in particular, to that advocated by the British Government. This line has not won over the Campaign Against the Arms Trade, that has persistently opposed BAe exports. By buying BAe shares, its representatives have acquired the right to attend annual general meetings. At such meetings they have exercised their right to ask questions and have on occasions sought seriously to disrupt proceedings.

The Benchmark BAe exercise is an effort to establish corporate values in order to improve corporate financial and technological performance, not to establish a moral foundation for its own sake. Nevertheless, Benchmark BAe has clear corporate governance implications. Its reconciliation with reportedly common practices in the arms export area may not be straightforward.

⁵² Sir Richard Evans and Colin Price, *Vertical Take-off: the inside story of British Aerospace's comeback from crisis to world class*, London, Brealey, 1999, p.58.

II. THE BRITISH GOVERNMENT'S RELATIONSHIP WITH DEFENCE INDUSTRY IN THE UK

The British Government's relationship with defence businesses in the UK has three dimensions, each of which is discussed in this paper to provide a comprehensive overview.

The government seeks to regulate defence industry ;

It acts as a customer for defence industry ; and

It acts as a sponsor for defence industry.

The three dimensions are distinctive and each has its own significance. When the pressures they generate clash, complex situations are generated in which eventual government behaviour can be difficult to predict. However, the government aspires to produce coherent policy that generates a successful British defence industry. The UK definition of success for defence industry mainly means the businesses being cost-effective suppliers to the UK Ministry of Defence (MoD) and winning contracts in global defence markets. There was little concern in the 1980s and 1990s with defence industry as a technological dynamo providing a driving force for civil manufacturing.

II-1. The government as regulator of defence industry

II-1-a. Rejection of control by ownership

Of central importance is that the government is not willing to control industry by owning it. The Labour governments after 1963 increased the incidence of state ownership of defence businesses but, soon after Mrs Thatcher came to power in 1979, the government began an almost comprehensive sell-off of government owned defence industrial assets as part of a wider programme of privatisation.. Where possible companies were sold through shares issued on the stock market, as happened with British Aerospace (BAe) and Rolls Royce. British Shipbuilders was broken up and some yards sold in management buy-outs (e.g. Swan

Hunter). Royal Ordnance, the former state arsenal, could not have been sold to the public but was auctioned off to existing companies with BAe offering the highest price.

The British Government has sought a degree of control over some privatised firms by limiting foreign share ownership in them. This limitation has been contested by the two companies concerned, BAe and Rolls Royce, since reducing the number of potential investors in a firm has the effect of holding down the share price. The ceiling on foreign ownership has been steadily raised and now stands at 49%. In addition, the British Government keeps a 'golden share' in these firms that in principle allows a government veto on corporate action. In practice, however, the golden share power is not publicly known ever to have been exercised.

After privatisation, defence businesses enjoyed differing fortunes. In shipbuilding, GEC gradually gained dominance, buying Yarrow and VSEL businesses while Swan Hunter and Cammell Laird (which had been previously bought by VSEL) failed to win enough work to survive as warship builders. BAe slowly integrated RO into its main defence business with some RO plants, including Enfield and (shortly) Bishopton being closed in the process.

Of Britain's naval dockyards, the government closed Chatham when it was still under government ownership. The two surviving dockyards at Devonport and Rosyth were initially let out, after a competition, to commercial management and were for a while what is known in the USA as Gocos (government-owned, company-operated). However, in the 1990s the government went further and sold the sites to their operating companies. The main remaining Gocos are the Atomic Weapons Establishments at Aldermaston and Burghfield that are run principally by Hunting Engineering.

The British belief is that organisations operating within the private sector with a profit motive, especially when they are subject to competition, normally perform better than state owned businesses. Private companies have both incentives to perform and are normally better at raising capital. Thus state ownership, while providing control in a limited sense, cannot easily stimulate the effective behaviour desired of defence business.

The Labour Government in power since 1997 has continued and even reinforced the policies of the previous regime. In addition to the privatisation of manufacturing, private sector firms are being increasingly considered to undertake service tasks previously fulfilled by the armed

forces themselves. The Conservatives' initiative called 'Competing for Quality', in which private companies were asked to bid against the existing government service provider to discover the cheapest source for such matters as catering in messes and facilities maintenance, has been continued. The Government is looking at industry taking over from the armed services in many aspects of third line maintenance. Public Private Partnerships, in which a company contracts to provide specified levels of service over designated time periods, are being explored for tasks very close to combat operations. These include the supply of capability for the transporting of tanks, for air-to-air re-fuelling for the RAF, and for Roll-on, Roll-off (RoRo) sea transport. There is no agreed limit within which the privatisation of defence will be contained.

Still with regard to ownership, recent Conservative and British governments appear to have been relatively relaxed about foreign companies buying British defence businesses. Thomson-CSF has become a major investor by buying all or a major part of the Redifusion and Link Miles simulator businesses, Pilkington Optronics, and Thorn's defence electronics businesses. After Lucas merged with the US firm, Varsity, chiefly because of common interests in the civil automotive sector, there was no British objection in 1999 when TRW of the US bought Lucas Varsity. Lockheed Martin and Raytheon have defence manufacturing plants in the UK. After failing to win the Astor contract for an airborne ground surveillance system, Racal may well sell its defence businesses and Thomson-CSF and Raytheon could well be prominent bidders.

II-1-b. Positive control mechanisms

While rejecting ownership of defence businesses as a means of shaping their behaviour, the UK government uses other means of restricting what defence businesses can do.

In particular it controls their exports by requiring them to obtain Ministry of Defence permission for the release of classified information. Thus firms cannot market their equipment by releasing its performance characteristics without a government release. Before a sale can be completed, i.e. before a delivery can be made, a company must have an export license obtained from the Department of Trade & Industry.

The UK government sees arms exports as vital to sustaining UK defence industrial businesses (see below) and thus the UK arms export regime is relatively liberal. However, the

Government does now allow sales to states that are subject to UN or EU embargoes. In addition, the Labour Government on coming to power in 1997 asserted that it would pursue an ethical foreign policy that would be reflected in its arms export policy. This initially resulted in a slowdown in the speed taken to proceed export licence applications as officials passed upwards cases of concern. However, the UK maintained the existing target for exports (orders worth L5 billion a year) and by the middle of 1999 little was being heard about increased arms export restraint. The UK is a party to the EU Code of Conduct on arms exports. It is taking part in the working party on arms export policy in the framework of the Letter of Intent of July 1998, signed by six European states, on measures to facilitate the restructuring of defence businesses in Europe.

The other important area of defence industrial control is the UK national system for the classification of information and its release only to those with the appropriate UK security clearances. Thus, even transnational firms such as Matra-BAe Dynamics have to create mechanisms so that information specified for UK eyes-only is not seen by non-British personnel.

There is no formal position on exceptions to security clearance arrangements. However the UK has taken part in many collaborative projects where much information has been pooled. Also, the appointment of an Australian, Malcolm Mackintosh, as Chief of Defence Procurement earlier in the 1990s suggests that citizens of some Commonwealth states may be able to obtain de facto UK clearances. The UK is also taking part in the working group on security of information set up under the July 1998 Letter of Intent noted above.

II-2. The government as a customer of defence industry

As a customer, the British government has felt since the early 1980s that the best way to secure 'value for money' from the defence equipment budget is to award contracts wherever possible against competitive tenders. Even when the Labour government came to power and introduced its Smart Procurement Initiative (SPI), it kept competition as the basis of its procurement policy.

The British Government has felt that, as a result of being subjected to competitive pressures, British defence industry has become more efficient and competitive in global markets. It is this claimed consequence of competition policy that makes the phrase 'tough love' a useful summary of UK official policy towards its defence industry. The UK government as a whole wants its defence industry to survive and prosper, but believes that the best way to achieve this is to locate that industry in a constantly challenging, event threatening environment.

The stress on competition has evolved significantly since the early 1980s in three important respects.

First, British companies pressed to minimise their costs were increasingly ready to incorporate developed foreign sub-systems in their bids, rather than offering British-only bids where additional technology would have needed to be developed. An example from the end of the 1980s illustrates this clearly.

In the second place, in the light of industrial consolidation in the UK and of the failure of important firms such as Swan Hunter and Ferranti, the scope for UK-only competition steadily diminished. The proposed merger of BAe and GEC Marconi will reduce that scope still further as it had been common for both to bid for contracts. As a consequence, the UK government has shown an increasing willingness to consider foreign bidders for UK contracts, most notably from the US and continental Europe. The UK sought without success to persuade a US-led consortium to bid for its aircraft carrier requirement, although Thomson-CSF has emerged as ready to lead a competing consortium against the BAe-GEC bid. It is a reasonable forecast that, for many contracts, the British government will prefer to see a foreign bid, most obviously from the US, to match against what BAe-GEC offer. In 1999 this is happening, for instance, with the BAe-led Meteor competing against Raytheon's improved AMRAAM for the Eurofighter's future Beyond Visual Range Air-to-Air Missile requirement.

In areas where UK capabilities have not been developed, the government has run competitions where all bids have been led by foreign firms. The UK Astor and attack helicopter requirements, for instance, involved three US-led consortia in the first instance and a US versus a Franco-German product in the second case.

The third area of modification regarding competition concerns the government interest in 'partner' relationships between customers and suppliers.

In the Levene era after 1983 the Government rejected 'cosy' relationships between the government and defence companies, perceiving that such relationships reduced the companies' incentives for efficiency and innovation. Competition was stressed as the way forward and, with the government implicitly accepting minimum cost as the normal definition of value for money, industry was seen largely as the adversary of government. The more that industry took in profit, the less government had to spend on other equipment.

By the mid-1990s this view contrasted with many supplier-customer relationships in the civil sector. In many parts of manufacturing, customers viewed their suppliers as their 'partners' because the attractiveness of the customers' own products depended so much on suppliers' good performance. Customers had found that, if they wanted high quality, often just-in-time supply, they had to work closely with their suppliers. By the second half of the 1990s the UK MoD was exploring the extent to which it should be re-evaluating its relationships with suppliers and a dialogue began with the Confederation of British Industry. The result was a 1998 agreed document on 'partnering' and a sense under the SPI that the MoD would normally seek to cooperate closely with suppliers for their mutual benefit after the competitive phase was over. This meant after a prime contractor had been selected for a project. In addition, the MoD was exploring cooperation with industry in the very early stages of a project so as to gain industry's insights into feasibility, solutions to capability needs and trade-offs among time, cost and performance within a requirement. However, it was doing this in a tentative manner, less vigorously than British industry had apparently hoped given its input into the Strategic Defence Review before July 1998.

The British Government undoubtedly weighs the particular benefits in terms of employment, foreign exchange savings, and technological advance from using British industry for defence contracts. After the 1991 Gulf War and even the Falklands conflict, there is also awareness that a national firm may be more responsive in times of crisis or war than a foreign supplier. The British government thus has often exercised national preference in competitions, most clearly when it opted for the Challenger 2 tank and over-ruled the RAF with regard to transport helicopters. The RAF wanted an all-Chinook fleet whereas the government insisted that a mixed fleet also including EH.101s should be ordered. However, it will not normally

pay a large premium in terms of price, time or performance for a British product and of course industry cannot know if it will pay any premium at all in a specific case.

In the negotiations over the OCCAR Treaty, Britain rejected a positive statement in favour of European preference, but accepted the implicit preference in the treaty that bids from all WEAG states would be considered on an equal basis in OCCAR states. However, the treaty also states that bids from other states can also be considered provided those other states grant reciprocal access to their defence markets. These terms can be seen as recognition that the UK wants to be free to consider US bids, but that the US needs to reduce its own protectionism.

When Britain opts for a major foreign product, such as the AWACs purchase from Boeing, the Government has a policy of encouraging the supplier to place orders in the US, either on that project or others, to offset the jobs and technology costs of buying a foreign product. The Government has expressed its policy in the following terms.

MoD requests Industrial Participation (IP) proposals from all offshore contractors bidding for requirements valued at £10 million or above. Any UK contractors expecting their bids to contain £10 million or above worth of foreign content are also invited to submit IP proposals.

Work to be included in IP proposals must satisfy the following criteria :

Be defence work undertaken in the UK and placed with recognised defence contractors ;

Be new work placed as a consequence of the contract for the MoD programme ;

Have as high a technology content as possible (at least commensurate with the work placed offshore) ;

Be placed by competition. MoD does not pay a premium for IP ⁵³.

The government refusal to pay a premium for offset work was underlined by negotiations with the MoD, BAe and Denel of South Africa after the UK awarded a propellant contract to the South African firm. The latter was interesting in exploring placing part of the work for the contract with RO but the British government refused to pay any price increase resulting from offset arrangements⁵⁴. In general, the UK does not appear to enforce its policy with great

⁵³ MoD *Contracts Bulletin* 3 June 1998

⁵⁴ House of Commons Defence Committee (HCDC), Fifth Report, "Security of Supply and the Future of the Royal Ordnance Factory Bishopton, London, The Stationery Office, 26 May 1999, p.vi.

rigour and appears to be reluctant to penalise a foreign company which fails to live up to offset 'commitments'. The latter are anyway not legally binding.

Linked to a readiness to contemplate foreign bids is a reluctance to define in public, and probably in private, the areas where it is deemed vital that a British territory-based capacity for development and production be sustained. Dating from an internal study in the 1980s, the Government accepts that it should maintain a UK capacity in those technologies/capabilities that cannot be bought from foreign suppliers. The list of such technologies/capabilities is short and classified. In practice, the British government appears committed to a capacity to build nuclear weapons and nuclear submarines, although it has abandoned the capacity to build ballistic missiles. In 1999 it seems likely that the Government will allow BAe to close the Bishopton ammunition propellant plant and to become reliant on foreign suppliers, from a BAe subsidiary in the Netherlands and South Africa in the first place. In general, given the limited possibilities for effective UK-only competitive tendering in many areas, the government is reluctant to reveal precisely where it would like to keep a UK capability for fear of weakening MoD bargaining power over relevant contracts. As the House of Commons Defence Committee put it, "we appreciate that there is a case for not openly declaring particular capabilities as strategically important when there is insufficient competition to bear down on prices"⁵⁵.

The Government's broad statement on strategic capabilities demonstrates awareness of a wide range of factors but leaves the government with much freedom of choice in any particular circumstance. In 1998 the Government told the House of Commons Defence and Trade & Industry Committees that it had addressed

the extent to which key industrial capabilities should be sought to be retained. The criteria against which the desirability of retaining defence industrial capability can be assessed are defence-based, rather than encompassing wider industrial or economic objectives. They are intended to ensure that the UK retains a capacity to :

- meet operational requirements, unique national commitments, and maintain indigenous technologies ;
- support existing and future systems, security industry support for military operations, and to regenerate critical equipment ;

- contribute, from within a restructured European industry, to collaboration ;
- avoid the creation of a monopoly or over-dependency by a company or country ;
- promote defence exports.

How these strategic considerations will affect particular assessments will depend on the prevailing circumstances and costs, and not on any preconceived assessment of any individual capability as “important” or “strategic”. The latter approach would seriously undermine the MoD’s ability to run effective competitions and achieve value-for-money.⁵⁶

Partly as a result of the Bishopton debates, in 1999 the MoD is exploring whether it can reach a partnering arrangement with BAe/RO. The aim is to see if longer term understandings can be put in place that enable the UK to obtain sustained value for money in munitions procurement while at the same time giving the company the confidence to make long-term investments and perhaps enter into joint relationships with other firms.

The overall outcome of the government’s twin policies of privatisation and competition is a British defence industrial sector that depends on winning contracts at home and abroad for its survival and which can raise capital only insofar as it looks viable to banks, pension funds and other investors. Companies in such circumstances are always wishing to see their share prices rise and need to present to shareholders a satisfactory return on capital. A return of around eight per cent is the established target. Company boards feel obligated to maximise shareholder value, which means cutting costs whenever possible. Companies also must have a longer terms strategy for survival and profit maximisation. Such a strategy can also include a decision to abandon the defence sector in order to concentrate on other civil areas. Thorn EMI and most prominently GEC have recently adopted this course. GEC appears to have been motivated by awareness that the US would not allow it both to build its North American investments successfully and to develop closer relations with Thomson-CSF of France ⁵⁷. Given that defence was appreciated by GEC as a shrinking global market, and that GEC would probably pay for further integration with Thomson-CSF, it decided to maximise shareholder value by putting its defence businesses up for auction. BAe prevailed against competition from Thomson and Lockheed Martin.

⁵⁵ HCDC, 1999, *op.cit.*, p.xx.

⁵⁶ House of Commons Defence and Trade & Industry Committees, Eighth Report, “Aspects of Defence Procurement and Industrial Policy”, HC675, London, The Stationery Office, 1998, p.40.

⁵⁷ See Deputy Secretary of Defense John Hamre’s speech of 20 November 1998 in which he revealed that the US considered France to be a Category C security risk country. The UK was classified as Grade A.

Although Britain's defence industrial base is a significant part, perhaps 10% of UK manufacturing, most of the firms involved have defence as a significant but secondary element in their activities. To illustrate, military engines are less important for Rolls Royce than commercial gas turbines. For GKN, Smiths and Lucas Varity the automobile industry is more significant than defence. Defence including tank manufacture is less important for Vickers than general engineering and medical products. Of the major players, only BAe has really opted to emphasise defence as a core business. This structure means that many firms have the option of selling their defence businesses and using the revenue to fund other expansion. This is essentially the choice made by the GEC board.

II-3. The UK Government as sponsor of defence industry

The government sponsors defence industry in the UK in two main areas – paying for research and development costs in advance of production and delivery, and in multi-dimensional support for export efforts.

As far as R&D is concerned, the Government contracts to pay agreed R&D costs of a project incurred by companies in advance of production and delivery. In the commercial sector this does not normally occur and so the practice can be considered as industrial sponsorship. The government seeks, but does not always succeed, to link such payments to defined progress on a project.

However, some qualifications need to be made in this area.

First, in the competitive phase companies are drawn to spend more than the government has provided in order to improve their chances of winning the final contract. The government is reluctant to use open-ended cost-plus contracts, even for high risk development work. Second, the government does not pay directly for the costs incurred by a company incurred in bidding for a contract. A company losing a contract is not reimbursed for its bidding costs. The result of these factors can be that, in a protracted competition, a company can conclude that it can no longer afford the total cost of bidding. This essentially happened to Racal before a prime contractor for the Bowman contract was selected. Racal arranged with its rival that their bids

would be merged. The MoD found itself facing, not two competing bidders, but a single consortium called Archer.

Second, the government is looking to reduce its own capital contributions to defence capability and is exploring how companies themselves might be induced to find the funding. This appears more feasible in those areas of limited technological risk in which development costs can be modest and predictable. In mid-1999 the UK government is looking to procure capability in armoured vehicle transportation, satellite communications, roll-on/roll-off ferries and air-to-air refuelling through Public Private Partnerships. In such arrangements, companies own the equipment and provide specified levels of service in exchange for rates of pay dependent largely on usage. The government contracts for a normal, minimal usage rate and the company agrees to make available enhanced services in terms of crisis and war. The advantages of such arrangements include the government not needing to burden the public sector borrowing requirement with a large capital outlay, and the freedom of the service provider to use the equipment in civil markets when it is not needed by UK forces.

The government can also be seen as a sponsor of UK industry in that it normally allows a business to make free use of IPR funded by any government R&D money received by that firm. The UK government does, however, seek to insist that the Government also has access to that IPR to use as the government wishes.

This leads to the government's role as a sponsor of defence exports by British industry. The most obvious manifestation of this sponsorship is the government's funding of the Defence Export Services Organisation (DESO) to the sum of about L25 million a year.

DESO gathers export market intelligence in close collaboration with UK diplomatic missions and helps British firms to sell their products around the world. DESO's efforts signal to a potential buyer that a sale would have the endorsement of the British Government. DESO also works with firms to secure financing for sales, often involving the government's Export Credit and Guarantee service, which underwrites loans. DESO will also work to arrange high-level British political support for a sale, perhaps involving a ministerial visit or a visit to the UK by a potential purchaser. DESO will also work with the UK services to arrange demonstrations of UK equipment. Of significance, DESO treats firms with manufacturing in the UK, such as Thomson's subsidiaries, as 'British' companies.

Thus the British Government both subjects UK defence industry to intense competition at the same time as giving it real help with exports. Again the 'tough love' label appears clearly apposite.

Conclusion

The British government's model of 'tough love' with regard to its defence industries can be clearly articulated. However, that model appears to be in a process of change as the UK MoD explores partnering possibilities under Smart Procurement, as remnants of British preference are abandoned in favour of an OCCAR framework or even a NATO-wide understanding, as the British character of defence businesses in the UK is further eroded, and as appreciation grows of the military as well as economic value of defence industries.

CHAPTER 6 : Sweden

Introduction and Summary

For much of the Cold War, Sweden was well served by its security policy, which included a strong defence industrial dimension. By the 1990s, however, that security policy was coming under great pressure from economic and technological factors. The ending of the confrontation between the USSR and the West, and then the collapse of the Soviet Union, provided a useful pretext for the revision of a struggling approach to security. The revision process is well underway but it is not easy to perceive how exactly how it will conclude, since the country has adopted a course of incremental change rather than move to a radical but sustainable new position.

This paper looks at the tradition of Sweden's Cold War security policy as an important element influencing the country's defence industrial sector. Then a sketch of Sweden's defence industry at the end of the Cold War precedes a survey of the changing security policy and its impact on industry regarding the narrowing of national areas of capability, participation in collaborative projects, and industrial restructuring. Corporate governance is then discussed in terms of the management/oversight role of the owners of Swedish defence industry. Finally, Sweden's future defence spending levels, technological priorities and defence export capabilities are highlighted as important factors that will shape the future of the country's defence businesses.

I. SWEDEN'S COLD WAR SECURITY POLICY AND HISTORICAL OF SWEDISH DEFENCE INDUSTRY

During the Cold War, Sweden recognised the dangers to its territorial integrity and independence from a Soviet Union that, in the event of war with the West, would have sought to overrun and/or destroyed the whole of Western Europe within a period of days. The Swedish response sought to be both non-provocative but vigorous.

Its non-provocative character was based first on Sweden's refusal to join NATO, an organisation clearly directed against the USSR, and also the European Economic Community. Sweden also rejected nuclear weapons as part of any national deterrent effort. Sweden presented itself as neutral or non-aligned in the East-West struggle.

Yet Sweden's national defence effort was also vigorous, involving universal conscription (a 'nation in arms'), modern military equipment and significant defence spending. As a means of underlining its non-aligned stance and its determination to defend itself, Sweden developed and produced most of its defence equipment including surface combat vessels, diesel submarines, tanks and other armoured vehicles and combat aircraft⁵⁸. It was reluctant to buy major systems from the West (and did not import Soviet equipment). It declined involvement in the collaborative development and production programmes that proliferated in Europe from the late 1960s onwards. It also was reluctant to export its defence equipment, especially to areas of tension, as part of a foreign policy that discouraged the use of force by any party.

This policy had viability for several reasons :

- a) Sweden had only a limited border with the USSR and it was difficult to imagine that Moscow would attack Sweden except as part of a wider assault on NATO states including Norway and Denmark. Given NATO's responsibilities in areas adjacent to Sweden, and Sweden's cultural association with the West and its values, it would also have been a major gamble for the USSR to have assumed that it could have attacked Sweden in isolation without a NATO reaction. In short, Sweden enjoyed the benefits of NATO's existence without having to pay any subscriptions to the organisation.
- b) Sweden was a wealthy, sophisticated, industrialised state that was capable of near self-sufficiency in modern arms. As one Swedish authority has written : 'from a Swedish perspective, non-alignment and neutrality can only be a viable solution if the nation is reasonably self-sufficient in arms production'.⁵⁹
- c) It was compatible with the Swedish rejection of war as an instrument of policy that dated back to the beginning of the eighteenth century. Sweden has not fought a war since

⁵⁸ The author understands that Sweden's enthusiasm for self-sufficiency in combat aircraft production dates from the late 1930s when the country had ordered Hurricanes from Britain. When the Second World War broke out, the UK government diverted all Hurricane production to the RAF, leaving Sweden in the lurch. That stimulated the establishment of the Swedish combat aircraft industry.

Napoleon's time and by 1945 the Swedish body politic had turned away from using armed forces for any purpose other than self-defence.

Even during the Cold War, however, the policy was exposed to some stress.

- a) Although Sweden professed itself neutral, and although it predominantly had a socialist government that maintained a general social security system, its values associated it much more closely with the West than the USSR. It felt no sense of threat from NATO states but did from Moscow.
- b) Its policy of national defence industrial self-sufficiency was increasingly difficult to sustain given the rising fixed costs of equipment. Sweden's highly restrictive arms export policy meant that Sweden could rarely recoup fixed development costs through sales to third parties.
- c) Sweden certainly perceived itself as prospering through participation in the European economy. It wanted access to as many aspects of the European Community market as possible and its benefits from the European Free Trade Association appeared less and less adequate in the 1980s.

Sweden's defence industry

In 1986, the 15 leading defence producers founded the Association of Swedish Defence Industries (FIF) to promote matters of mutual interest. Today, the FIF members employ a total of 24,000 people of whom around 15,000 are directly involved in the development and production of defence materiel. The total sales of the member companies in 1997 amounted to SKr31 billion, of which SKr 15.5 billion represented defence equipment. Of defence equipment sales, Sweden accounted for approximately SKr 13 billion and the export markets ... for approximately SKr 3.7 billion.⁶⁰

Like many NATO states during much of the Cold War, Sweden had a largely state-owned company (Celsius) producing the guns and ammunition fundamental for national defence. For the most part, however, the Swedish government looked to privately-owned businesses in the country to supply its defence needs.

⁵⁹ Madeleine Sandstrom, *Sweden's Changing Defence Industry*, Ebenhausen, Stiftung fuer Wissenschaft und Politik, AP-3021, 1997, p.16.

⁶⁰ 'Northern Lights', *Jane's Defense Weekly* 23 December 1998.

The Swedish defence market, however, was too small to sustain competing firms in the same market sector. The government therefore accepted the emergence of national champions in different sectors and looked to build close relationships with them in order to obtain value for money from defence spending.

At the close of the 1990s, the main Swedish companies, and their main areas of defence concern, were :

- 1) *Celsius*, in which the state owns 60% of the voting rights and 25% of the capital.
The owner of
 - *Bofors* : manufacturer of anti-armour weapons, ammunition and artillery ; torpedoes and mines
 - *CelsiusTech* : manufacturer of electronic devices including warning systems, fire control systems and night sights, air defence equipment and mine hunting and clearing equipment ;
 - *Kochums* : builder of conventional submarines, coastal vessels, corvettes, minehunters and bridging equipment
 - *Celsius FFV Aerotech* : aircraft test systems, support and upgrades
- 2) *Saab* : combat aircraft, electronic warfare equipment, anti ship missiles and The owner of
 - *Volvo Aero Corporation* : jet engines
 - Ericsson Microwave Systems ; defence electronics including radars and communications equipment.
 - Ericsson Saab Avionics : airborne computers and related systems, and armoured vehicle electronics. Ericsson is the full or part-owner of electronics businesses in Denmark and Norway.
 - Haggblunds : military armoured and all-terrain vehicles. Haggblund has a vehicles company, Haggblund Moelv in Norway.

Among these firms, Ericsson and Celsius have significant non-defence interests. Ericsson is a major player on the global telecommunications front. Saab abandoned the civil aircraft sector in 1998, deciding not to pursue the next generation of its regional aircraft.

II. THE TRANSFORMATION OF SWEDISH SECURITY POLICY

From the late 1980s Sweden's traditional security policy of non-alignment coupled with self-sufficiency in armaments production, began to be abandoned. The policy became economically less feasible and politically less appropriate. Membership of the European Union and signing the Maastricht Treaty of 1991 were significant steps away from a pure non-aligned position.

In related defence equipment areas, some landmark events signalling change were :

- *The dilution of the national capability in major defence systems.*

Sweden followed the Viggen fighter with another Swedish national product, the Gripen. The Gripen's development was completed and 204 aircraft are being made for Sweden. but Sweden accepted considerable foreign help with its development. Its engine was American, as were the Viggen's, and BAe and GEC were among those contributing help to the airframe design and the fly-by-wire system. Saab kept design and systems integration capabilities but Sweden accepted that a significant part of the aircraft would be foreign. In 1999 Saab accepted a strategic link with BAe to help with the marketing of the Gripen, that had capabilities between BAe's own Hawk and Eurofighter aircraft. BAe took a 35% share in Saab as a tangible financial link bonding the two companies.

According to the Swedish FOA official Madeleine Sandstrom, 'official figures indicate that JAS Gripen includes foreign subsystems up to 40%. According to unofficial figures, few systems developed and manufactured in Sweden have less than 50% foreign content'.⁶¹

Sweden abandoned national tank development aspirations in 1994 when it agreed to buy 120 Leopard 2s from Germany. The tank is being built by Hagglunds under licence in Sweden so production facilities would be sustained.

Embracing collaborative projects with NATO members

Sweden moved into collaborative defence developments on a significant scale, not just with Nordic neighbours but also with other aligned European states. Sweden's first formal

endorsement of collaboration was in 1983 when it signed an agreement with Norway on cooperation covering all stages of the procurement cycle. This agreement resulted in the joint development and production of the ARTHUR artillery-locating radar. In 1994 the four Nordic defence ministers agreed to form a Nordic market for defence technology. By 1999 :

- Sweden was participating as an observer in the Western European Armaments Group, had a Partnership for Peace programme with NATO that included relations with the NATO Industrial Advisory Group, and was a full member of the European Union.
- Sweden had signed MoUs on arms collaboration first with Nordic states (1994) and then with France, Germany and the UK. The 1996-7 defence bill mandated procurement authorities to seek collaborative solutions for new systems.
- Kochums was working with DCN of France on technologies conventional submarines under an agreement signed in August 1998. There is also a project of merger between factor and HDW of Germany. If merger goes-on the company would be the first constructor of submarine in the world
- Kochums was developing the collaborative Viking submarine with Norway and Denmark.
- Bofors was working with Giat on the 155 BONUS smart artillery ammunition.
- Ericsson was working with Thomson on a new airborne surveillance radar.
- Hagglunds was working with Patria of Finland on the AMOS 120mm armoured mortar.
- Saab Dynamics was working with LFK/DASA on the KEPD 150 version of the Taurus air-to-surface missile. Celsius has a 33% share in this project ;
- Saab Dynamics was the largest sub-contractor on the collaborative IRIS-T short-range air-to-air missile led by BGT/Diehl.
- Sweden was looking at a collaborative procurement of a common transport helicopter with Denmark, Finland and Norway.

⁶¹ M.Sandstrom, Sweden's Changing Defence Industry, Ebenhausen, Stiftung fuer Wissenschaft und Politik, AP-3021, 1997, p.10.

III. INDUSTRIAL RESTRUCTURING AND CORPORATE GOVERNANCE IN THE SWEDISH DEFENCE INDUSTRY

III-1. Industrial restructuring

The government and companies accepted that the national character of Sweden's defence businesses needed to be compromised.

In 1995 Celsius bought a 15% share in Raufoss of Norway, which remains 50.3% owned by the Norwegian government. In 1998 Celsius began forming an ammunition joint venture called Nammo with Patria of Finland and Raufoss of Norway ; Nammo is based in Norway with Raufoss holding a 45% share. Celsius interest in buying up Kongsberg of Norway has not, however, led, to a purchase.

At the same time, Celsius and Patria agreed to form Nexplo, a powder and explosives jv in which Celsius would have a 60% share.

In 1997 Alvis of the UK was allowed to buy Haaglunds, the armoured vehicle manufacturer whose All-Terrain Vehicles are being bought by the UK and Germany.

In April 1999 Hagglands set up a joint company with Patria of Finland to represent both companies in armoured vehicle procurements in the Nordic region. Alvis will explore collaboration with Patria regarding the rest of the world.

In 1999 Celsius formed a joint venture with Grintek of South Africa to cover electronic warfare. Celsius has a 49% per cent share in the company.

As noted, a BAe 35% investment in Saab Aerospace was accepted.

Sweden joined five European members of NATO in signing the Letter of Intent in July 1998 on measures to facilitate the restructuring of Europe's defence industry, thus signalling that it was ready to contemplate its businesses integrated into wider European structures.

Reorienting defence policy

Although the end of the Cold War resulted in smaller Swedish forces, it is slowly being accepted that Sweden should build a greater capability for force deployment, as the proposed plan for the 2000-2004 period reflects⁶². This implies greater spending on surveillance and command and control systems, among others.

⁶² 'Over the past decade the Swedish army has been cut from 24 manoeuvre brigades to 13. Under Gen. Victorin's force-structure proposal, the heart of the field army would fall to 16 rapid-reaction battalions,

III-2. Corporate governance

The control of Swedish defence companies is complex. The government owns 61.7% of the voting rights of Celsius through its Class A shares. However, it owns only a quarter of the total shares and it has agreed to restrict its votes to one quarter so long as Swedish shareholders have a controlling interest in the company. In March 1999 non-Swedes held 29% of total shares. In practice, Celsius' top management increasingly feel commercial pressures and the impact of defence industrial restructuring in the US and Europe. Hence profit has achieved a more central role. In 1997 Celsius appointed Lars Josefsson from the privately-owned Ericsson and he announced an intention to focus the company's expertise more narrowly and to rise defence margins from around two per cent to eight per cent⁶³. However, the defence business area continued to struggle in the first half of 1999 with the government postponing orders and the company admitting to spare capacity in many areas⁶⁴.

BAe has bought 35% of the voting rights in Saab. However 20% of the equity and 36% of the voting rights are owned by the local Investor investment group. Saab report that 38% of its shares are owned in the UK, 17% in the US and 2 per cent in the rest of the world.⁶⁵ Investor, chaired by Peter Wallenberg, is the main investment arm of the Wallenberg family business empire and controls pension and mutual funds. In addition to the Investor holding in Saab, the Wallenberg Foundation owns 8.8% of the total shares and 5.7 per cent of the votes.

Marcus Wallenberg, the Deputy Chief Executive of Investor AB is vice-chairman of Saab AB (and Ericsson), among many other posts. Reportedly, Saab's capacity to propose wide-ranging offsets to South Africa as part of the Gripen offer was assisted by what other Investor companies could offer.⁶⁶ Investor sold Hagglunds as part of a reduction in engineering focus and an effort to concentrate on medical equipment.

which could be grouped into four brigades for operations if required', in 'Army cuts go too far' *Jane's Defense Weekly* 16 June 1999.

⁶³ 'Celsius looks to catch the defence consolidation wave', *Financial Times* 27 August 1999.

⁶⁴ Interim Report available through Celsius homepage 'http://www.celsius.se'.

⁶⁵ Saab homepage 'http://www.saab.se'; also 'Gripen sales to SwAF help Saab revenues to soar', *Jane's Defence Weekly* 26 August 1998

⁶⁶ 'Saab offers South Africa \$4b offset deal' *Jane's Defence Weekly* 21 January 1999.

Ericsson, 53% of whose 50,000 employees are outside Sweden, is a wide-ranging electronics and telecommunications group within the Wallenberg sphere of influence. Investor AB owns 22.2% of shares and the Wallenberg family a further 16.5%. However, 30% of Saab shares are owned in the US and altogether Swedish owners account for just half the shares.

This pattern of shareholding means that the major Swedish owners of the country's major defence business own large proportions of the companies that could not easily be sold on the open market. There is a contrast with the UK where the major shareholding institutions holding mutual, insurance and pension funds do not like to hold more than 5% of the shares in a company. The Swedish major owners, in particular the government, Investor, the Wallenberg Foundation and Skandia, own large percentages of shareholdings and are thus committed to the effective management and success of their investments. Unlike British institutions, the major Swedish institutions cannot afford to walk away from their investments by selling their shares on the open market. Not surprisingly, the major investors often hold places on the boards of defence companies, as the positions of Marcus Wallenberg illustrated.

Regarding the ethical dimension, Swedish firms have been tightly constrained in their export activities by the government. However, Sweden is a major trading nation with long experience, so when trading opportunities do arise, Swedish companies are tempted to do what is necessary to win. As the claims of bribery associated with the 1986 sale of artillery to India signal, Swedish firms do not appear immune to temptations to pay commission in order to win sales.

IV. FACTORS SHAPING THE FUTURE

IV-1. Swedish defence spending

The future of Sweden's defence industry will depend significantly on the level of defence spending that the government adopts. In the 1990s the government did not allow defence spending to grow with inflation and the consequence was that desired projects suffered. A five-year plan to cover spending in the 2000-2004 period was still evolving in 1999.

In 1999 the latest casualty was, at least for the time being, Swedish participation in the development of the Matra-BAe -led Meteor medium-range air-to air-missile. The Swedish armed forces announced in the summer that there was no money available for this project's development, although it could be bought later as a developed item. It had been envisaged that Sweden would take about 12-15% of the programme with Saab Dynamics developing the fuze and Ericsson working on data links. It remains possible that Sweden's political leadership will find the needed funding.⁶⁷ It's the same problem with the missile stand-off Taurus which is a co-operation with LFK-DASA. There are also threats over the national Bofors BAMSE surface-to-air missile. The burden of the Gripen on the procurement budget is great, with Gripen contracts accounting for 60% of Swedish government defence contracts with industry by 1999.⁶⁸ When spending is announced for the 2000 period onwards, it is possible but not certain that funding for all these projects will be found.

However, the Swedish procurement agency, the FMV, is under pressure to optimise the value obtained from the defence budget and to facilitate the restructuring of Swedish forces towards greater force projection capabilities. It does not feel an overriding duty to protect non-competitive Swedish defence firms and the government may opt for more imported systems. In 1998 British consultants hired by the Swedish government urged FMV to save money by considering more foreign equipment.⁶⁹

IV.2 Sweden's technological priorities

There is recognition that Sweden can not afford a comprehensive defence industry, but still wishes to keep a capability in five areas 'of vital and strategic interest for Sweden in case of crisis or even war conditions'.⁷⁰ These are : electronic warfare ; stealth technology ; aeronautical technology, underwater technology, and C3I technology. This list appears to have evolved somewhat since 1995⁷¹ and it is likely that, for war fighting reasons, Sweden will also want to keep fairly comprehensive maintenance capabilities.

⁶⁷ 'Sweden's armed forces close purse strings on Meteor'

⁶⁸ 'Swedish budget not expected to meet priorities', *Jane's Defence Weekly* 10 March 1999

⁶⁹ 'Sweden mulls cuts in defence spending', *Financial Times* 7 November 1998.

⁷⁰ Lars Vigert of FMV, in 'Northern Lights', *Jane's Defense Weekly*, 23 December 1998.

⁷¹ Sondstrum op.cit., p.23.

IV-3. Defence exports

Sweden's defence businesses need to serve more than the Swedish market to survive. In the past Sweden has pursued a restrictive arms export policy, but is today looking to achieve common ground with other European states that have long held more relaxed positions. Sweden as a member of the EU is a signatory of the EU Code of Conduct on arms exports and, as noted has signed the 1998 LoI which includes recognition of the need for European states with integrated defence businesses to have a common arms export policy.

Sweden has high hopes for the Gripen which, with BAe assisting with marketing, has been selected by South Africa. South Africa will take 28 aircraft. The Gripen is competing fiercely against American and other European combat aircraft for selection by the Polish air force and Saab has (reportedly) offered to loan the aircraft for five years if it is selected.⁷²

However, Sweden's readiness to supply to areas of tension and conflict, and thus to change its previous policy, could well be tested by an Indian request for a licence to manufacture more of the artillery pieces that it bought from Bofors in 1986.⁷³

Conclusion

Sweden has embarked upon a process of incremental security change without being clear about the parameters of change. On the security policy front, it has moved away from neutrality, accepted the desirability of a European common foreign and security policy, and is re-orienting its armed forces away from a purely defensive role. However, it is not clear that Sweden will be a full player in the emerging European security and defence identity and has concerns, for instance, about the proposed absorption of the WEU into the EU. Unbounded change is apparent also in the related defence industrial sphere. The Government, as are some companies, is torn between the priority to be given to Swedish sub-system capabilities, that could make a company attractive in international projects and that could be valuable in a wartime situation where there was a need for 'surge production'. The alternative course is to sustain systems design and integration skills to preserve the image of national armaments

⁷² 'Sweden offers loan of Gripen squadron....' *Flight International* 22-7 July 1999.

⁷³ 'Swedish ire over howitzer move' *Financial Times* 27 July 1999.

capability, even though extensive use has to be made of overseas sub-system providers. The Swedish government endorses ideas that European defence industry should be restructured on trans-national lines and that the days of Swedish self-sufficiency are over. It welcomes the foreign defence investments, especially in the Nordic area, of Ericsson among others, and it has allowed Hagglands' sale to a British company. Yet Saab remains under Swedish control and the state has kept its controlling interest in Celsius. This seems largely to ensure that the company remains in Swedish hands. In simple terms, Saab seems likely to flourish if the Gripen sells and the BAe link in general brings work. Ericsson's fate will hinge more on its civilian than its defence success. Much of the Celsius Group will struggle to achieve scale and further reductions can be expected there.

The fundamental point is that, with Sweden having abandoned self-sufficiency in defence production, no clear limits on the degree of foreign dependence have been set. As Madeleine Sandstrom wrote, 'In a time of reduced military threat, the political will to financially support a defence industry characterised by strong dependence on imported systems is diminishing'.⁷⁴

⁷⁴ M.Sandstrom, *The Changing Swedish Defence Industry*, Ebenhausen, Stiftung fuer Wissenschaft und Politik, AP-3021, 1997, p.9.

Conclusion

I. THE TRIUMPH OF ANGLO-SAXON CORPORATE GOVERNANCE UNDER THE EFFECT OF GLOBALISATION.

There is no point in describing or wishing for a world that doesn't exist to serve as the basis for this study's recommendations. The objective of this conclusion is to describe the existing situation and to envisage how industrial co-operation models between European arms companies could be organised.

The first clear tendency demonstrated by this study is that the Anglo-Saxon model of corporate governance is becoming established as the arms industry norm in the same way as it is firmly established internationally in industry generally. Thus, there is a "globalisation" effect that applies to the industry – or at least to its economics. Increasingly, the principal objective of the arms companies is to create value for their share-holders. It is by this yardstick of created value that the competitiveness and the global value of these companies are assessed.

This phenomenon is all the more important since it has been very rapid. It only really started in this sector in the 1990s and it has been a general trend. The evolution in France is proportionally at least as fast as the United Kingdom (UK). None of the European States concerned have had time to adapt to the resulting transformation of the relationship with their suppliers. The States have been late in reacting to the change in the private sector, and for the most part it is this gap that explains the sluggish restructuring of the arms industry.

Two examples will suffice to describe the importance of this change.

In 1992 in the UK, the privatised company BAE was on the brink of the abyss. The strategy of diversification into the private sector had failed and the company was making heavy losses. These losses were even more striking since they were the result of a five year strategy that no-one in the organisation had questioned.

Seven years later, BAE has refocused on the military sector. In numerous defence fields in the UK, BAE enjoys a monopoly. It is possible to imagine that this monopoly will soon become Europe-wide as in the missile market through Matra/BAE Dynamics. The profitability is more than 10%. The directors are remunerated essentially through stock options. Even whilst acknowledging that industrial preoccupations are part of the BAE strategy, the quarterly

accounts are closely scrutinised. At the time of the merger with GEC, the focus of the communications in the UK was the creation of value, and whenever BAE concludes a merger, they systematically request the Finance Director's post.

In France before the legislative elections of 1997, the socialists, at the time in opposition, envisaged the merger of their two large public arms organisations: Aerospatiale and Thomson-CSF. In response to the interrogation of the unions, Lionel Jospin, the first secretary of the socialist party, replied that Thomson-CSF would never be privatised.

Two years later, and despite the fact that the State had not yet totally withdrawn all interests in these companies, Thomson-CSF and Aerospatiale were privatised, notably through alliances with private companies in the defence sector : Matra and Alcatel. After the merger with DASA, the share of the State in EADS was no more than 15%. The share-holders, said to be the point of reference, have a large share in defining the strategy of the consolidated group. In order to remain competitive, and particularly having been floated on the stock market, these companies were obliged to modify their economic practices in line with the competition. In France, it seems obvious that if the State is to remain a share-holder, it will only assume a residual role to its strategic interests, and not interfere in the company's industrial strategy.

Of course it can be argued that these models are not strictly identical, particularly in the share-holding structure. In the UK the dilution of share-holding is the most striking. In Germany, share-holding is moderately diluted with banks holding the predominant share. In France the practice of a hard core share-holding means that there is a relatively small number of share-holders. In general it is necessary to distinguish between the arms companies that are companies in their own right, and affiliates where the share-holding is grouped.

These differences in share-holding of consolidated companies influence the right to vote and the decision-making processes. However, this does not have any real influence on the factors that motivate company strategy. And in addition, the culture of value creation as a motivating factor for French company strategy is only a recent phenomenon since these companies have only been privatised recently.

So as to create the strongest link between directors and share-holders, the model where the destiny of the directors is linked to the results of their companies is now becoming established across Europe.

One can certainly criticise this model. However, it is necessary to acknowledge that in this case this criticism would go beyond the scope of this study since it addresses the entire international capitalist model that globalisation is introducing. The essential of this study is to see how this evolution has influenced the restructuring of the European arms industry.

II) THE WEAKENING OF TRADITIONAL STATE POWER OVER THE ARMS INDUSTRY

The second conclusion that can be taken from this study is the world-wide weakening of State power over the defence industry, whilst there is a risk of imbalance of the State-Company relationship in favour of the company.

a) The weakening of State power: the progressive and inevitable retreat of public share-holders

One can speak of weakening of State power in the sense that a withdrawal from public share-holding by the State can be witnessed in countries where it wasn't already the case: France, Spain, Italy. It is clear that the fact of the State being a share-holder, often with the majority and sometimes unique holding, permits it to define the company strategy and thus to serve its own interests.

Nevertheless, it is necessary to qualify this analysis for many reasons, since there are "nuances" whose consequences are often at the origin of privatisation.

In Italy it seems clear that there was a kind of fictional "State as Defence Entrepreneur". The scale of the public sector, the existence of a large number of intermediaries between the State and the companies (for example, there are two levels of decision makers between the affiliates of Finmeccanica and the State) have meant that the State had little to do with the definition of company strategy. It only intervened in the event of a major decision with diplomatic consequences and repercussions on the arms supply policy of Italy. For example, Alenia Difesa after the merger of BAE and GEC, which was dealt with directly by the Ministry of Defence and the Ministry of Industry.

In France, the opposite is true, where a kind of fictional "Omnipotent State" existed with regards to the definition of public arms company strategy, so that the boards of directors had

little information at their disposal and no desire to act on these strategies. In pushing this reasoning to the extreme, we can assert that the State only intervenes in the choice of the Finance Director, and this is what gave rise to the myth of State omnipotence in public companies. The intervention of the State to re-capitalise the companies or to limit the range or effects of a planned redundancy scheme had the same effect.

The power of the Spanish State in its arms industry is somewhere between the French and the Italian examples.

In the second place, it is necessary to recognise that State share-holding had the effect of preventing the creation of standard company culture: improving productivity and competition. This situation only became a problem when the reduction of budget appropriation made a rise in costs of military materials intolerable compared to foreign competitors. Finally, the idea became entrenched in all countries that it was necessary to separate the tasks of the company and the State, since the State could play an antinomic role within the company.

It is the State's role to be both client and regulator of arms production; it also should define the conditions necessary to assure the security of its own supplies so as to defend its sovereign interests.

The company's role should be to strike a balance between its profitability and the maintenance of satisfactory social harmony. With respect to this last point, it is generally considered that it is the State's job to define the general legislative context of labour law, but that it could only be an employer in a competitive sector of industry if it does not act in a manner that contradicts the company interests.

The main risk of weakening State power is due to the fact that today no-one can guarantee security of supplies since the maintenance of activity in a company is dependent on its level of profitability. There is thus pressure exerted on the State as client to guarantee either global company profitability or the profitability of the activities for which supply security is deemed absolutely necessary. The paradox of the situation in a client/supplier relationship is that the State can have an interest in creating monopolies and in maintaining attractive profit margins for its supplier. It is by this rather indirect way that it can continue to influence company strategy.

b) The risk of introducing an imbalanced State/Company partnership

The State could be placed in a position of weakness in relation to industry under the combined pressure of three factors that each taken individually would not perhaps be damaging.

In retreating behind their role of State as client, the national arms departments have refocused on the function of simple purchaser. If it is certainly possible to contractually specify the quality of materials in requiring certain performances, it becomes difficult as a purchaser to assess the cost of this knowing that the offer is limited – maybe even unique -- and that the choice of supplier is not independent of political considerations.

This difficulty, in the name of preserving competition in the arms industry so as to maintain a European industrial and technological base for defence, is rendered even more arduous if the supplier acquires a monopoly that could become Europe-wide.

To these two factors comes a third linked to current particularities of co-operation in arms matters. The difficulty of the major European States to agree on a unique operational need, the difficulty of national arms departments to adopt rules regarding compatible contract approval procedures, the difficulty of the States to finance together and in a concomitant manner certain programmes, favour the development of compromise solutions even within the European companies. The intention here is not to criticise this practice, since it can remedy the deficiencies of public authorities in arms co-operation matters, but simply to acknowledge that this state of affairs continues to destabilise the relationship between the State and the industry in the industry's favour.

Faced with these three risks of imbalance affecting the State/industry client/supplier, the British are attempting to bring a solution via the Smart procurement initiative. The general idea is to associate the client and the supplier so as to collectively define the balance between the cost and the performance of the material. It is still too early to draw any conclusions from this initiative that presupposes three conditions for success :

- the assurance that the mechanism will maintain the possibility for the company to achieve profits in line with the share-holders' wishes,
- the client's capacity to have access within the company to all the elements that contribute to calculating the profit margin, to be able to contest this if needs be, and to be able to negotiate value for money without compromising the necessity for the company to return a profit

- the general adoption of such a work method at a European level (e.g. the difference of cost negotiation between States provoked delays in the signing of the order of NH 90).

The paradox of this situation is that to compensate for the weakening of the State's relationship with the supplier as a client, the British will no doubt be obliged to implement instruments of State control in private enterprise where they are fearful to see liberalism as we traditionally understand it. The success of such a procedure will be depend on the joint perception by the two actors of the common interests and so keep an open communication between them. It is equally necessary to be suspicious of pernicious effects of too much bureaucratic control that would have the effect of delaying the programmes despite the fact that Smart Procurement, by including a constituent destined to limit the number of State decisions and giving extended powers to the programme managers, aims precisely to limit the weight of bureaucracy.

III) INDUSTRIAL AND STRATEGIC MODELS OF CO-OPERATION ARE MADE ON ENCOMIC RULES

The restructuring of the European Arms industry is, today, no longer a myth. We can already draw some conclusions from company consolidations that have already taken place.

To begin with, it is the companies that are leading the restructuring of the arms industry and according to their own criteria.

The first criteria is that all structural alliances, that follow from the purchase of another company, a merger of companies or by the constitution of a sector joint venture, create value in the company. This creation of value consists of improving the profit margin of the company. For this, three principal factors affect the results of this objective:

- permit structural cost savings in the new company due to the merger,
- increase the technological capacities to endeavour to attain a dominant position in one or many sectors,
- reduce the number of competitors in the market.

Through analysis of these three factors, the priorities of the companies in these mergers can be deduced.

Firstly, a structural alliance via a merger will always be preferable to a simple joint venture and for the following two reasons:

- 1) Joint venture offers less capacity for structural cost saving than a company merger. The split of the share-holding is done on a 50/50 basis and the decisions taken must be unanimous.
- 2) The share-holders of the mother companies balk at seeing multiple joint ventures with other companies. The affiliates' results are less transparent, also the power of control is unclear since it is delegated to the directors of the mother company who become members of board of directors of the joint venture. Also, multiple joint ventures -- apart from the fact that they tend to transform the mother companies into simple holding companies -- may find their affiliates pursuing contradictory strategies.

Secondly, national consolidations are easier and, in a way, create more value than European consolidations :

- 1) Easier, since the split of power within the new company is simpler to define than in a transnational merger. Naturally, no dispute linked to State interests would occur in negotiations between companies of the same country. So it is not true to say that BAE preferred GEC rather than DASA or that Aerospatiale preferred MATRA to DASA or to another European partner. Simply, at a given moment when the opportunity presented itself, it seemed much simpler and faster to merge companies of the same country.
- 2) Until there is free circulation of military technologies in Europe, the creation of value resulting in a merger of transnational companies will be inferior to that resulting from the merger of companies of the same country. To this, can be added that structural cost-savings are also easier and faster to attain in the case of national mergers.

Thirdly joint ventures are easier to negotiate than transnational company mergers

Joint ventures are in general concluded with a 50/50 split of the share-holding and decision making which suits both the State power and the power of the mother company directors. The set-up of New BAE dynamics manages to maintain a certain equality of rights even though, henceforth, there are three partners : Alenia, BAE and EADS. Assuming integration of

general management, sales teams and technical teams when technology transfer is possible, the joint venture is an easy solution to put into place, even if the rationalisation that it offers is inferior to other solutions. It is significant to see that the alliance between DASA and Aerospatiale-MATRA was made on the basis of an equal split of power and share-holding. Measured in terms of turnover, Aerospatiale-MATRA was superior to DASA. Repositioned in the global context of the power of the two countries and their role in the European construction, the French company and the German company were considered to be on equal footing. In all cases, this 50/50 split, just like the strict sharing of posts, proves that much more than a capitalist merger, this is an intergovernmental model that has been implemented with the merit of not misrepresenting the economic reality too greatly.

From there we can draw a certain number of conclusions about the current situation and evolution of the restructuring of the arms industry.

First sub conclusion : the constitution of EADC, such as wished by the heads of European government on the 9th December 1997, was impossible to fulfil.

It is not the objective in itself that was impossible to achieve but the merger mechanism envisaged.

In asking the large European aeronautic and defence companies to merge in one single operation, difficulties tended to be maximised. It was necessary to resolve at the same time in the new company :

- the question of evaluating the contributions as well as the question of the split of share-holding and power,
- the question of security of supplies for the States.

These questions, already extremely difficult to treat in negotiations between companies of two different countries, became impossible with three companies and all the more so with six companies. The fact that the States signed the letter of intention of 6th July 1998, accepting to work on the constitution of EADC in their area of expertise, did not fundamentally change the problem.

In any case, even the fact that the large European aeronautic and defence companies had accepted to work on this and had, by the end of spring 1998, nearly completed the exploration

of the ways and means of such a merger, tends to prove that their objectives could be compatible with the States.

Second Sub conclusion : globalisation leads to consolidations in line with the political declaration of 9th December 1997.

One of the lessons of the study is that the most favourable situation for an arms organisation is to have the monopoly in the biggest possible market. From now on it is perfectly clear that it is as much the stock market as the Pentagon that has pushed the restructuring of the American arms industry and that it was the American government that fixed the limits in prohibiting the merger between Lockheed-Martin and Northrop Grumman.

In Europe, the arms companies could have the same interests, and it is certain that the plan to construct a defence identity for Europe that will establish it as a force in the international arms industry, could be a favourable result of the consolidations of the arms industry. The construction of a common defence identity that respects the different nations, tends to guarantee the survival of the directors of the different companies called upon to restructure. In the case of transatlantic merger, a viable economic alternative to European consolidations, all mergers would necessarily take the form of an absorption of a company by another, and thus in the current situation, of one European company by an American company, so with less guarantee of survival for the European directors.

Doubtless it is this reason that the objectives of the European arms companies and their directors are compatible with those of a good number of European States. Even so, the motivations behind these objectives can't be considered strictly identical in the sense that the company directors, like the share-holders, have above all the duty to maximise company profits before obeying political considerations with regards to the relative strength of the States. These motivational differences equally explain the adopted set-ups can be different to those advocated by the States, as we saw with the failure of EADC.

Third sub conclusion : in principle, the logic of capitalist consolidations prevents the companies of small countries from being able to obtain a directive role.

One of the principal difficulties of restructuring the European arms industry is due to the necessity to reconcile the objectives of the States with the economic rules that govern the company mergers. Yet the States, in a domain that directly affects their sovereignty, tend to

favour the rule according to which the different States are equal, while the economic rules that govern the companies tend on the contrary to favour the rule of the democratic majority, that is, he with the most economic “weight” makes the decisions. It is once again this that explains that the transnational mergers are difficult while mergers are easy between national companies and that joint ventures maintain a fictional equality of rights.

Moreover, this difficulty means that in theory the only capitalist mergers that could be easy would be those between two companies of identical weight from two countries of identical weight. That is to a great extent what we have seen with the rapprochement of Aerospatiale-MATRA and DASA. Even when these conditions are more or less met, and perhaps even because of it, negotiations can prove to be difficult. The French have always considered that they are the main technology providers, this being so, they couldn't share the power with the Germans. Inversely, the Germans whose defence industry in general calls upon the global force of the country in its terms of reference, proving that the rules that govern it are not just economic, consider that the global economic weight of their country justifies sharing power. In another domain the British always consider that the value of their companies is superior to the value of French companies whose profits are very much smaller.

Between “small countries” and “big countries” the problem takes another dimension in the sense that the relative force is much more obvious. For example, no-one would contest the superior weight of Daimler-Chrysler Aerospace with respect to CASA or to New BAE with respect to Finmeccanica.

Faced with this situation the reaction of the directors of the small European companies is to rely on two factors that can help reduce the natural disadvantage due to these relative forces :

First factor : their companies are the natural suppliers of their State. Politically as much as commercially the large companies of the three principal European armament countries (France, UK and Germany) woo the companies of the small countries because they need them in order to acquire the critical size that they are looking for in the European market, and to conquer this market that escapes them.

Second factor : the companies of small countries are relied upon by their State as client, albeit in a variable fashion, and this reinforces their negotiation position at a European level.

In this global panorama, the strategy of the small European armament countries varies according to their own particularities and the weight of their country in European politics.

First possible reaction : maintenance of power of joint decision making (*co-decision*) due to legal-economic artifice

In Italy, Finmeccanica has consolidated within the company all aeronautic, space and naval industry, some land industry and a large majority of its defence electronics. The possibility of this company concluding a big alliance at the European level cannot be excluded. However, the general conduct of their discussions regarding the restructuring of the industry tends to prove that the Italians always want the power of co-decision in the alliances that it concludes. This limits thus the possibilities of a vast capitalistic consolidation with Finmeccanica.

On the other hand, the number of trade joint ventures concluded by the affiliates of Finmeccanica is increasing despite the preoccupation of the Italians to obtain the guarantee of power of co-decision. This is the case in the bilateral joint venture in the helicopter industry with Agusta and Westland, and in defence electronics with GEC and Alenia Marconi systems. When the consolidation involves more than two companies, the legal-economic set-ups of the joint venture are more detailed but they always aim to guarantee the power of co-decision to the Italians. Let's cite two particular cases :

- Astrium in the satellite industry with MATRA, BAE/GEC and DASA,
- the new missile company resulting from the merger of BAE and GEC. In effect, the missile division from Alenia-Marconi system will be given to MATRA/BAE Dynamics. In this new company the Italians will be share-holders equal with the British, these two together being share-holders equal to EADS. The outcome is thus a system of co-decision in stages where the Italians share the power on the first rung with the British before sharing it communally with the British opposite the French. This system of stages permits, at least in theory, to respect the sovereignty of the share-holding of a country even if this represents a minor share of the total activity (in short, the Italians hold 25% of the company, whilst BAE and EADS hold 37.5% each).

Second possible reaction : simply, the sale of certain industrial sectors

The maintenance of the power of co-decision is only negotiable if the activity considered is technologically advanced and has sustained State financing. Small countries tend to carry out an inventory of their skills in matters of armament and of their financial capacities for the coming years, and thus choose between domains that they will continue to finance - notably in

the form of R&D funds - and some sectors that they abandon. This seems to be the process implicitly conducted by the Spanish government and the Swedish government.

This analysis brings to light that in the absence of financing, the States are ready to abandon their production capacities as long as the buyer guarantees the maintenance of the production sites and an acceptable plan of action. Such was the case of Spain in the land arms industry with Santa Barbara and no doubt in the future Sweden will follow suit with Celsius. In the two cases, it must be noted that the State is a share-holder of these companies.

Third possible reaction : partial capitalistic alliances leading to simple commercial agreements

This happened in the alliance between BAE and Saab. Originally, it was possible to imagine that the co-operation between the two companies would go further than a simple acquisition of a 35% stake in Saab by BAE. In fact it is not certain that is the case.

The stake-holding of BAE in Saab left the control of the company with the Wallenburg group. Any capitalistic merger that would go further would naturally give power to BAE. The Swedish considered that they really were skilled in this domain and wished thus to keep the control of their company as the president of Saab, Bengt Halse, told the French press on 20th May 1999. He indicated at this time that the mergers in progress in France and in the UK had created two large pillars of European aeronautics that were too powerful for Saab to find its place⁷⁵.

Today the situation, though imperfect, is satisfactory between the two allies since, far from being mutual competition in the export market, they each reinforce each other's proposition in the case that the other is better placed for the job. Thus the Gripen seems a less onerous alternative than the Eurofighter and more exportable in certain markets.

Fourth possible reaction : capitalistic alliance but in what conditions?

The capitalistic alliance between DASA and CASA is interesting in more than one way since it was the first example of an alliance of this type between European companies before the creation of EADS. However, it is difficult to analyse precisely this alliance since neither the

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legal-economic set-up nor the industrial agreements were completed before the constitution of EADS.

At first glance it is obvious that the Spanish accepted an unbalanced capitalistic alliance that was more in favour of Germany. But this was not a surprise. The acceptance of a model that moves away from the defence sovereignty of the States can be explained in several fashions.

- In the first place, Spain has the smallest armament industry amongst the six, and it was difficult to be able to claim the power of co-decision for CASA, even with alliances by joint venture. As for a simple acquisition of a stake in CASA, it offered few advantages neither for CASA , nor for the new stakeholder.
- In the second place, it is certain that within CASA, the Spanish are interested mainly in military transport and they tried to protect their expertise and their industrial sites in this domain through industrial agreements. This made for a successful conclusion of the accord dependent on potential industrial agreements, as much for the civil Airbus as for military transport planes. Without doubt this question needs to be resolved in the negotiations between EADS and CASA.

Fourth sub conclusion : only the big States still have the means to protect their armament industry and by other means than public share-holders.

The withdrawal of public share-holders in the arms industry is today an accepted fact, and its application is simply a question of time in France, as in Italy, Spain and Sweden. It is particularly linked to the state of the market in which the public sector companies are evolving as well as the electoral considerations linked to employment (as in the case of the naval construction sector and land arms in France).

This withdrawal occurred under the pressure of three factors :

- a general redefinition of the role of the State in European countries,
- the requirement to improve the industrial sector's productivity,
- the necessity of transnational, and European consolidations in particular.

Moreover, for reasons of sovereignty linked to supply security, none of the six European States have withdrawn interest in their arms industries and all look for ways and means to keep control.

The principle of the Golden Share is in general little liked in financial circles and so by potential investors, since it can create a State-imposed brake on the free disposal of stocks and shares by the share holders.

A precise country-by-country study would clarify that the meaning of the Golden Share is different from one country to another.

The Golden Share does not exist in Germany no doubt because this country only recently unified, and a modern arms industry as a component of the State power is only a recent phenomenon in this country. There is still reticence in Germany regarding the “military share” without even the existence of the Golden Share that would have precisely an inverse reaction to that wished in the German arms industry.

In Sweden or Spain, this is not a taboo question, but the weakness of the industry, particularly in Europe, does not justify discouraging foreign investors from a sector that is not in itself determinant for Spanish sovereignty.

In Italy, the inverse is true, the Golden Share could be a mechanism favoured by the public authorities, because it is a sector that is important as much in terms of technological acquisition as in the exercising of sovereignty for the Italian State, even if it appears fragile faced with foreign competition.

The French situation is atypical since it mixes cultural elements with objective judgement.

Culturally, there is a tradition of a strong State, particularly in the International scene, that has difficulty accommodating a total privatisation of this sector. This cultural element is clearly demonstrated by the constitutional administration’s decision in 1986 on privatisation regulations. At the same time, the isolation of the companies in this sector due to their nationalism, has rendered the French industry fragile. This fragility is currently fading due to the national restructuring lead by the French State in parallel with a progressive retreat of its share-holding. This does not prevent the French State being well equipped to defend its industry, in its two roles as client and source of R&D funds.

At this level a parallel with British industry can be made. After a notional test period of about ten years, the British State is ready to abandon its Golden Share in companies. In fact, the companies appear sufficiently solid that any attempted take-over bid from the outside or massive retraction of the investors justifying a transfer of assets or a major reorientation of the strategy of these companies, seem out of the question. To resume, the British Government is no longer partisan to the Golden Share for the simple reason that today, it is an instrument that is of no use to it for the control of British arms companies.

The Golden Share does not have the theoretic virtue that was lent to it with regard to State rights over the arms industry. On the contrary, its nature is dependent on the individual country making it difficult to establish a common European policy in this area. So it is particularly interesting to examine the means put in place by the strong States to protect their arms industries other than public share-holding and the Golden Share.

In the UK, it can be demonstrated that the policy of the State as client has played a doubly favourable role for the British arms industry.

In the first place, the country has had the best success in reforming the arms purchase procedures and has managed the reduction of equipment resources in such a manner that today, comparing the same equipment, the British armies are supplied more rapidly and in higher numbers than the French armies.

In the second place, this rationalisation of the purchase procedure has equally had an effect on the trade joint venture programmes in that, even if there is no European standard for materials, the materials chosen by the British, or at least the major technological options, will tend to become the standard in the other European countries for obvious reasons of cost (case of Storm-Shadow/Scalp stand-off missiles, BVRAAM/Meteor air-air missiles, and possibly future military telecommunication satellites).

The strong State as client tends to naturally favour its own arms industry and thus to reinforce it with respect to the competition. It also tends to impose standards for materials at a national level.

More subtle is without doubt the technological Golden Share created in the name of national legislation of technical document classification that is akin to the policy of security of supplies. If a very strict policy is applied in this domain, it is perfectly possible to protect the national expertise even within transnational companies and whatever the degree of integration in these companies. This protection constitutes a natural security net should there be a rupture of the transnational company, permitting at the same time to reconstitute the national expertise in short, reactive time-frames and even to attain a favourable competitive position. One can thus speak of the technological Golden Share.

Yet at this level the industrial partners of the UK, are generally in agreement in finding the rules decreed by the British ministry of defence extremely severe, even in the absence of a transatlantic agreement in the technological domain in question. The policy lead by France also remains at this very restrictive level.

However, a practice that limits the positive effects of transnational consolidations, including in terms of rationalisation the production costs, should be questioned. This situation negatively influences the profits of the companies, perpetuates duplication of European R&D costs whilst defence budgets are tight. It is not certain that the results of the letter of intention of 6th July 1998 come up to expectations.

In conclusion, we note that today the unique policy that the States have to protect their strategic independence in preserving their arms industry, consists in putting these arms companies in a favourable economic situation that, for a client, is a paradoxical situation.

It is a policy that can only be practised by the biggest countries for whom the defence budgets are the highest. It is a policy that could see the arms industries carrying out political blackmail so as to draw the benefits of this political preoccupation. It is this concern that explains today why the French Arms Directorate (DGA) wants to maintain competition between French or European suppliers as much as possible, or create cost reductions that seem in some ways more imposed than negotiated. It is this same concern that explains that the British government tried to implement a partnership with industry so as to retain control of the costs without necessarily harming the economic interests of industry.

As for the technological Golden Share, even if it is efficient, it is expensive and could favour a kind of “salami” strategy by the Americans. The Americans, through multiple bilateral commercial industrial agreements and the transfer of technology within otherwise impenetrable European countries, could be tempted to secure the loyalty of individual countries in each domain, divide the interests of the Europeans and extend their influence over the whole of Europe. Was this not the objective of the message delivered by the American secretary of State Hamre to the European industrials at the time of the dinner on 25th October 1999?

RECOMMENDATIONS

I. THE STATES' ROLE

Today it is clear that it is not the States that lead the restructuring of the arms industry, neither in principle, nor in method, but they can contribute to creating a favourable environment for it by playing the role of regulator and client. Currently it appears that the greater implication of the countries that have an arms industry, and thus who have a role to play in this restructuring, had a tendency to shift the institutional debate away from the construction of a European Union of arms or of the WEAG, to the more restricted context of LOI with six countries and OCCAR (Joint Organisation in Arms Co-operation) with four countries. However, a closer look at LOI and OCCAR tends to prove that any potential progress relies on universal measures that are not linked to the position of any individual country and so these measures can be applied to the fifteen countries.

The main problem that the arms industry encounters is to evolve in an arena that is not legally unified, with clients who do not necessarily have the same needs at the same time and with purchase rules that differ from one country to another. This situation is a source of complication, of additional cost, and sometimes delays as we can see with the co-operation in matters of armament by programme initiated by the States.

If the States want to facilitate the restructuring they should primarily favour the constitution of European transnational companies, a domain where they can easily act due to their power of regulation.

A) The measures to be taken as the State as regulator.

The most important and urgent measures are to be taken in favour of transnational companies.

1) The necessity to liberalise the transfer of technology within transnational companies

The first measures concern the transfer of technology and expertise within these companies. From the moment that two companies have overcome State reticence in matters of

sovereignty, it seems that the objective should be the free circulation of the technological ownership within the transnational companies and not the inverse, as found today.

Such a measure would have three beneficial effects over the restructuring of the arms industry :

- a) To structurally limit the duplication of R&D costs between the countries,
- b) To limit the cost of arms in permitting a better integration of technology within the companies and thus productivity gains. Being more competitive, these companies would improve their results and this would act as a pledge of pursuit of the activity which in turn would be a guarantee of preservation of the States' interests.
- c) To avoid the creating European over-capacity as we have seen with the practice of "fair returns".

However this liberalisation of the rights of ownership and the transfer of technology must take into consideration a perverse effect : the risk of seeing certain States renounce their responsibility in terms of R&D to their neighbours. This liberalisation also assumes a harmonisation of the export control regulations.

How to avoid creating positive discrimination for the countries not financing R&D?

Today it seems risky, since we are in a transition period, to be able to ensure that all the countries buy the same products at the same time or even that they finance studies of R&D at the same time. The risk of liberalisation of the transfer of technological expertise within transnational companies is to see certain countries systematically buy off-the-shelf European products so as to pay the lowest price for them. In the end there is a risk of R&D financing running dry in Europe since each will have the interest of buying cheaper off-the-shelf products developed with the funding of just a few countries and in benefiting of the transfer of technology via transnational companies.

So as to avoid this drift, we can imagine a mechanism relying on different rules in accordance with the conditions in which the States are going to buy the materials from the transnational companies.

Each European country that buys material off-the-shelf conceived by a European transnational company where that country is represented, would participate in the R&D financing of the programme. This share is given to the State or States that have financed the initial R&D at the outset. If the country wants to finance an evolution of the programme, it would be exempt

from giving this share of R&D knowing that it had supplied the transnational company with research funds.

Every European country that buys the same material off-the-shelf but for whom the company is not a member of the transnational company, would pay the price of the material fixed by the company that is selling it. In this case the eventual transfer of technology should not give rise to a subsequent constitution of competitive manufacturing capacity. Civil compensations or the transfer of production lines should be left to the free choice of the transnational company.

It is necessary that the implementation of these mechanisms be centralised so as to avoid unnecessary red-tape, thus the application of these rules should be done within the transnational companies that will become increasingly integrated European entities in the near future.

2) The necessity to achieve export harmonisation

In the absolute, the harmonisation of arms export policies of the members of the European Union, in its procedures as well as in its export authorisation criteria, is a necessity in the context of a common policy. The States must address this task rapidly in order to achieve it as soon as possible.

Until this has been attained, it is necessary to put in place a transitory mechanism that will not handicap the transnational companies and that will not create economic discrimination between the national entities of the transnational companies.

One can imagine that in the context of these transnational companies, the application of the Debre-Schmitt agreement, created by the French and the Germans, that leaves export control to the exporting countries. Any other mechanism leading to the imposition of export legislation in the different countries would have no political justification and inversely would handicap the European arms industry. In the context of good conduct, the consultation procedure foreseen should be led, from the initial stages of the exportation, between the countries represented in the transnational companies so as to engage a dialogue between the countries responsible for the conception of materials to be exported.

It is also necessary to ensure that during this transition phase the States for whom the export legislation is the strictest do not suffer discriminatory industrial and economic consequences. It is thus necessary that in transnational companies, exports are imputed to each company proportionally corresponding to the industrial and economic distribution resulting from

internal activity so as not to modify the economic and industrial equilibrium of the company due to more supply export legislation in certain countries.

B) The measures to be taken as the State as client.

1) The necessity to unify the procedures of materials purchase

One of the difficulties that the companies encounter in their restructuring comes from the fact that they are doing battle with States for whom the procedures for running the programmes are not unified and for whom the contract approval procedures are not identical. This imposes a specific problem for the co-operation programmes obliging the technical teams to increase the number of meetings or stages of approval of the programmes. In the best case, such an addition of administrative procedures, delays the co-operation programmes and entails additional costs in terms of personnel and travel expenses that puts a strain on the State and company budgets. In the worst case, this situation can lead to the pure and simple failure of such programmes.

It is thus imperative that OCCAR from the outset carries out a qualitative leap in integrating totally the programme management and purchase procedures that would become totally independent of the National Armaments Directorate. It is thus necessary to spell out the procedures and the common documents within OCCAR for the running of the arms programmes and to put in place programme teams that would have full authority over the management of co-operation programmes. It is also necessary to unify contract approval procedures.

Of course the established rules within OCCAR, as much in terms of running the programmes as purchase procedures, would be in time taken over in each country.

It seems up to the countries, particularly those with an arms industry, to lead the negotiation with this ambitious objective at the risk of limiting the beneficial effects of industrial restructuring.

2) The necessity to limit the negative effects of monopoly situations

Europe finds itself faced with a dilemma in the arms domain. The big continental manufacturers of arms systems evolve in a market that is too narrow and in the face with American competition that is too big to be able to do battle with equal forces. The temptation

is thus enormous to establish a monopoly in the European market so as to guarantee shareholders high benefits.

The European States are not interested in seeing their companies weaken and they want to maintain an industrial and technological defence base that would bolster up a Europe of defence. At the same time a monopoly can be embarrassing for these States.

An economic embarrassment in the sense that there would be a great temptation for the company in a monopoly situation to impose its technological and strategic choices and particularly its costs and profit margin.

A political embarrassment in the sense that a company with a monopoly in Europe would symbolise the closing of the European market. This would sanctify the creation of a European fortress faced with an existing American fortress and may lead to tension in transatlantic relations, that even France does not wish.

In the UK, one of the aspects of Smart procurement seems to have taken into consideration this risk so as to limit the negative effects of monopoly by optimising the management of arms programmes. This remains, however, a solution that does not endeavour to structure the supply, and is limited in view of the size of the questions posed. At this level the question is posed to know if the States can let European industry lead its restructuring or is it necessary to fix the limits for either political reasons, or economic reasons linked to the respect of free competition, as is the case of non defence companies. From the moment that Europe decides to fix restructuring legislation, even for reasons reflecting the “common right” (to respect free competition) or traditional reasons (to exercise a role of regulator in the arms domain) Europe will then lead an industrial policy in armament as is the case today in the USA.

One of the solutions could be to encourage the European companies, depending on their circumstances, either to co-operate, to have a relationship of programme manager with the equipment manufacturer, or to be in competition.

This situation could be envisaged if one considers that there are no real frontiers between the jobs of combat vehicle manufacturers (military tanks, ships and planes), arms systems manufacturers and equipment manufacturers. Thus it is possible that two European transnational groups will emerge : combat vehicle/arms systems manufacturers, and equipment/arms systems manufacturers, and that could according to circumstances function according to the three modes as discussed above. It would even be possible to create capitalistic links between these two groups without going as far as a merger, and that could reinforce and simply avoid the issues of BAE and GEC being asked to renounce their merger.

These two groups could work together perfectly in partnership with American companies on invitations to tender, the American partner being the leader in the USA and the European company being leader in Europe. For example, this can be seen in the call to tender of BVRAAM where MBD allied to Boeing to reinforce its offer to the British. It is equally the case between Raytheon and Thomson-CSF on ACCS. This mechanism doesn't solidify a transatlantic rivalry of benefit to no-one, thus maintaining competition in Europe and guaranteeing financial interests and control of companies. A system of flexible transatlantic co-operation would also allow, in a later phase, a calm consideration of the technological transfer question, supply security and the harmonisation of sensitive arms and technology exports. These are presently subject to enormous differences.

II) IN THE DOMAIN OF COMPANIES

The attitudes of the different States that wish to conserve a certain autonomy in the arms domain and the weakness of the small countries' arms industries, prevent capitalistic mergers in accordance with the classic method encountered in other industrial domains. In this sector it is not possible to assist in a take-over bid or for a company to take control of another without national capacity diminishing. Competition can only work between companies of equal force when each hopes to obtain the power of co-decision. This difficulty explains, more than any other phenomenon, the fact that the restructuring leading to the merger of Aerospatiale - Matra/DASA, took place in a national rather than European context.

The paradox is that from the moment that everyone, including France, accepts the necessity of the withdrawal of public share-holding, and that everyone recognises the need to obtain a certain dilution of share-holding, the resulting absence of pertinent means of control for the States over the arms industry and particularly over their strategies becomes a problem, with the exception of the States where companies are in very strong positions.

To attempt to recover the equality of power between States, subterfuges are sometimes employed to artificially overestimate the power of the national share-holding considered the weakest in the merger project. The mechanism consists, when it is possible, of conserving this grouped share-holding whilst in parallel diluting the strongest national share-holding (e.g. certain merger projects with the Italians, offer made by BAE to Thomson-CSF, simple acquisition of a stake by BAE in Saab in Sweden). When the companies and the States are in

similar ranks, an approximation is allowed consistent with parity of the companies. One can thus analyse the merger Aerospatiale-Matra/DASA. Also in this case the uncoupling of the economic rights and the right to vote is witnessed (each partner having identical weight even if they have got rid of some of their shares).

The most convenient mechanism remains the constitution of joint ventures that in general allow the different partners to conserve the power of co-decision just like the mechanism that we can see in the GIE (Association for Developing Commercial Interests). This joint venture can be constructed on the 50/50 model when there are two share-holders, or according to a more complex mode as in the new missile company Matra-BAE Dynamics or Finmeccanica, where despite a percentage of stakes in the company of 25% inferior to that of EADS and of BAE (37.5% each), a power of co-decision of 50/50 was attributed within Alenia New BAE systems.

However, everyone is conscious of the limits of joint ventures in terms of productivity gains. In addition, the multiplication of joint ventures does not favour coherent strategies of mother companies and opposes the need of open communication and transparency wished by the share-holders and those who represent them within the companies.

The difficulty to lead the European restructuring comes from the fact that the arms companies now function with the logic of private sector corporate governance, but the States are not ready to accept the consequences in terms of power within the transnational companies resulting from the classic economic mechanisms of company consolidation.. Moreover, it is the weakest States that will want to defend the mechanism of the Golden Share as demonstrated by the proposition of the Italian government to conserve such an arrangement in Finmeccanica.

Faced with this difficulty, the Golden Share seems an ill-suited mechanism if it relies on the transfer of assets and all the more so since it questions the principle of freedom of shares for the share-holders. Currently it doesn't seem possible to recognise power in the daily life of a company, specific to the State as share-holder, without challenging the principles of corporate governance.

The problem arises mostly in the principal acts of a company: transfer of assets, major capital or trade alliances, major collaborations and investments. It is thus necessary to devise mechanisms of public and private inspiration where the States will see their interests safeguarded and the companies will be able to function with maximum efficiency. Since our starting point is the principle of free access to technologies in the context of transnational

companies, the main problems affect the principal acts that the companies are called to perform during their existence as well as the act of distributing jobs.

a) Distribution of the power and strategy of the companies

On the first point, the agreement passed between Aerospatiale-Matra and DASA is symbolic since the main attributes of joint ventures that were destined to mark out the equal rights of the States were commuted to the group level, transposing to equal rights of the principal share-holders : principle of the parity of share-holders of the two countries, power of co-decision for the main decisions.⁷⁶

It is difficult to interpret this agreement. Some could see a system of restrictive co-management requiring an accord between the parties at all times. Others will see a mechanism that allows both parties to agree in the case of discord since no-one can impose their point of view on another. It is certain in any case that the integration of management seems to be a regression with respect to British joint ventures where the principle of unanimity of the directorate is adopted even if the share-holders have equal rights.

At this stage it seems that this mode of organisation of a transnational company can only be transitory. It is certainly an obligatory point of passage to ensure better integration in the collaborative functioning of the company. It supposes that the actors always have in mind the necessity to find compromises that won't hinder rapid decision making and a clear company strategy in terms of objectives. It is a point requiring clarification for directors of the British companies and their share-holders who may be alarmed by the apparent complexity of such a mechanism.

As for the question of the evolution of the share-holding, the companies Aerospatiale-Matra and the French State demonstrated a tendency seen developing in trade joint ventures and that can be qualified as a modern form of the Golden Share : it is the pre-emptive right in this agreement carried between French share-holders, and between French and German share-holders. This pre-emptive right safeguards the share-holders and the French State without questioning the freedom of the private share-holders to withdraw should they wish. In the

⁷⁶ At the time of two interviews given on 18th October 1999 to the paper "Les Echos" and 21st October 1999 to "Paris-Match", the director of Aerospatiale/Matra, Philippe Camus, clarified the domains where there would be the power of co-decision. These domains are mergers and rapprochement with partners, and investments greater than 500 million euros. In these cases, the power of co-decision was presented as the right of veto for the French share-holders. The company organisation included a chief executive officer of each nationality. Thus Philippe Camus explained that "in the absence of an agreement at the operational management level of EADS, the question will be escalated to the board of directors then to the presidents of the two share-holding companies, that is, Jurgen SCHREMPP and Jean-Luc LAGARDERE." This rule of co-decision can thus be extended to all domains in the functioning of the company and its power is in the hands of industry.

case of EADS, this pre-emptive right is matched with the obligation of the key share-holders to stay in the company until 2003.

At this stage it is difficult to qualify the presence of the State as excessive and not in the common interest, since the pre-emptive right is recognised between private share-holders and does not question the free disposition of the share-holders. On the other hand, their capacity of intervention in company strategy, even if it does not interfere with the daily management of the company since it is limited to three well identified cases, renders the French State into an active share-holder justifying the maintenance of a share-holding of 15%. At this stage, it is clear that whether or not a State maintains a share-holding, the important issue is its capacity to dispose of a power of co-decision (and not decision) on the future alliances of the company and its major industrial orientations. It is certain that the French State must give clarifications to the private company directors as well to the governors of the State for which they are country nationals, about the manner in which it counts using the rights that are granted to it. Overall it is a point that requires discussion at the highest level between the principal European countries with arms industries since these rights have only one justification, that of the constitution of a Europe of defence according to the political and economic objectives that the States fix at the industrial and technological base of defence.

b) the question of the division of labour

Globally, the principle of "fair return" within transnational companies can be considered acceptable as long as three conditions are met .

- 1) It must be applied to a large volume of activity that would imply going beyond the context of a simple trade joint venture of transnational companies. In effect, whatever the split of share-holding within a company resulting from a trade joint venture, if the company only has a few products and one of the countries decides not to participate in the conception of a new product, there is a risk that the theoretical division would be dramatically reassessed. At any time one of the partners could ask for the complete transfer of the responsibility in its country or simply ask for the closure of an industrial site situated in the country not participating in the programme. The larger the domain of activity, the easier it is to find compensations in terms of responsibility and the distribution of industrial sites. It is within the company that this equilibrium must be found and not by way of intergovernmental accords (MOU - Memorandum of Understanding) between States at the time of launching the programmes. History proves that the MOU generates

rules that are too rigid, and that the system encourages Governments, responsible to their electorate, to maximise their orders and thus the work comes back to them.

- 2) On the other hand, within the company this division should be decided upon by authorities that are not linked to the economic results of the company so as to respect the preoccupations of the State as client which are different to the company and the shareholders. (It should not be forgotten that the consolidation of companies in a monopoly unbalances the producer/client relationship for the benefit of the producer). However, the decisions must always aim for the most rational distribution of tasks for the companies.

On this question, it seems unnecessary to associate the State to these objectives even within the company - by share-holders' pacts for example - due to the risk of the States putting too much pressure on companies in order to protect employment. On the other hand, the transnational companies could set-up a type of contract of objectives with the States where they are established, obliging them to set-up a balanced distribution of jobs between countries according to their financing. These agreements or this multilateral agreement would have the merit of removing from the company the eventual conflicts of interest between the States concerning employment. In any case it does not appear possible that a State share-holder could evoke this question within a company whilst the other States are not represented. These rules, decreed in the name of public interest, would be acceptable for the share-holders in the sense that they inscribe themselves in a general context permitting the arms companies to be more competitive in a quasi-monopoly - elements particularly favourable to the creation of value as well as the permanence of the activity exercised in Europe.

Summary of industrial restructuring

Indisputably under the pressure of the markets, industrial restructuring is well advanced in Europe to such a point that certain commentators estimate that it is complete. It is true today that two major companies are consolidated, that there should no longer be any problem privatising Airbus and that in the domains of missiles and space, the consolidations are practically complete.

At the industrial level only two questions can be posed today :

- 1) Will the States of Sweden and Italy, along with company share-holders in their countries, be satisfied with trade alliances concluded by much larger companies, EADS and BAE, despite the fact that their powers of co-decision are recognised?

- 2) Will the share-holders of BAE be satisfied with the conclusion of multiple trade alliances, transforming this company into a holding, or will they wish to conclude a major alliance at the top that can be done with EADS or a European company?

As far as the relationships that the States maintain with the companies in their countries, there is still a long way to go, so it seems necessary to create a context favourable to genuine cross-border activity in the domain of defence at the European level.

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