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**6 December 2005**

**FIFTY-FIRST SESSION**

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**The future of the European naval defence industry**

**REPORT**

submitted on behalf of the Technological and Aerospace Committee  
by Elvira Cortajarena Iturrioz, Rapporteur (Spain, Socialist Group)

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<sup>1</sup> Adopted unanimously by the Committee on 9 November 2005.

**RECOMMENDATION 770<sup>1</sup>**

*on the future of the European naval defence industry*

The Assembly,

- (i) Considering that Europe, with its naval defence industry, is obliged to take account of the co-existence of firms of different nationality, with varying cultures and subject to different rules, and with ties in certain cases to different governments;
- (ii) Taking the view that market pressure alone is not enough to bring about industry consolidation at the European level and that if large-scale reorganisation is to happen, government intervention is necessary;
- (iii) Noting that for mergers across Europe's naval defence industry to be genuinely successful, two essential conditions have to be met: industries need to have the legal capacity to merge with one another and governments have to make it possible for such mergers to work, by bringing standards into line and creating opportunities for technology transfer;
- (iv) Recalling that the LoI (Letter of Intent) addresses these issues and should make their resolution possible;
- (v) Considering the difficulties involved with questions such as operational convergence, synchronisation of procurement and harmonisation of budgets;
- (vi) Taking the view that these questions have been the subject of research over many years, particularly in WEAG (Western European Armaments Group) and POLARM (the EU working group on armaments policy);
- (vii) Noting that no solution acceptable to all players has been found since operational convergence and procurement policy are determined by countries' own military culture, their international areas of interest and national defence budgets and, very often, by purely industrial concerns;
- (viii) Considering nevertheless that such issues are not a structural problem in Europe, where cooperation programmes have already been implemented successfully, but that they are still a major inhibiting factor to industrial cooperation;
- (ix) Considering there is a need for countries to reach agreement on common minimum capabilities, which takes time, and on virtually simultaneous allocation of equipment budgets;
- (x) Stressing that without European programmes, consolidation of the European naval defence industry would be impossible, and that if it is to happen countries must have the same equipment requirements, at the same time, for the same missions;
- (xi) Noting that it is within the European Defence Agency (EDA) that such questions will need to be resolved if a satisfactory outcome is to be achieved for all concerned;
- (xii) Recalling that the report from the Agency Establishment Team (AET) suggests that the Agency's priorities, on start up, should include work on the follow-on to the publication of the Green Paper on Defence Procurement, studies on the European capacities of the Defence Industrial Technological Base (EDITB) and defining with the Letter of Intent (LoI) nations the use and dissemination of selected LoI rules within the EU to constitute a benchmark on how to promote the use of small and medium-sized businesses in the European Defence Equipment Market (EDEM);
- (xiii) Welcoming the idea contained in the report of launching an initiative in the area of the naval defence industry with the aim of assessing the EU supply structure and focussing on the possible impact of national and multinational programmes on industrial structures and policies;
- (xiv) Recalling that the EDA's 2005 work programme envisages an investigation of the scope for adding value to the EDITB through the naval defence industry and that the Agency is also to review

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<sup>1</sup> Adopted by the Assembly on 6 December 2005 at the 8<sup>th</sup> sitting.

estimated future demand and capacity and current national strategies in the sector, and make proposals to the Steering Board,

RECOMMENDS THAT THE COUNCIL INVITE THE WEU MEMBER STATES, AS MEMBERS OF THE EUROPEAN UNION, TO:

1. Make it their common task to resolve difficulties over funding naval defence programmes;
2. Show strong political resolve in helping bring about consolidation of the European naval defence industry, in particular by encouraging:
  - (a) operational convergence, procurement synchronisation and harmonisation of budgets;
  - (b) harmonisation of rules and opportunities for technology transfer; and
  - (c) agreements for developing and implementing European programmes;
3. Ask the European Defence Agency to speed up its studies on the naval defence industry, treating that sector as a priority and taking account of the results of studies carried out in this area by WEAG;
4. Become involved immediately, in cooperation with the industry and the EU, in a European naval defence industry project for the future on which both the latter's survival and the success of the European Security and Defence Policy will depend.

**EXPLANATORY MEMORANDUM**

*submitted by Elvira Cortajarena Iturrioz, Rapporteur (Spain, Socialist Group)*

**I. Introduction**

1. In an earlier report adopted by this Committee on 6 December 2000<sup>2</sup> the Rapporteur noted that rapid consolidation of the American defence industry over the last 15 years had caused political leaders and heads of industry in Europe to go down the road of continent-wide industrial convergence. The process has turned out to be far more difficult than in the United States, where restructuring and mergers have taken place between national firms for motives concerned solely with profit.
2. The move towards consolidation initiated by the US government and propelled forward by private shareholders' desire to see defence groups increase their profitability in the short and medium term, has been further encouraged by the Administration taking a fairly lenient attitude towards anti-trust machinery and offering generous financial incentives. Moreover, the government agreed to reimburse the cost of such mergers if they could subsequently produce a much higher volume of savings for the Pentagon than the initial outlay.
3. Europe on the other hand, and this is particularly true of the European naval defence industry today, has to contend with the existence alongside one another of companies of different nationality, subject to different rules and with ties in certain cases to different governments. Market pressure alone is not enough to bring European companies closer together: to make large-scale reorganisation happen, government intervention is necessary.
4. For mergers across Europe's naval defence industry to be genuinely successful two essential conditions have to be met: firstly, industries need to have the legal capacity to merge with one another and governments have to make it possible for such mergers to work by bringing standards into line, creating opportunities for technology transfer and the like. The LoI (Letter of Intent) addresses these issues and should make their resolution possible.
5. Questions such as operational convergence and harmonisation of procurement and budgets are more sensitive and have been the subject of research over many years, particularly in WEAG (Western European Armaments Group) and POLARM (the EU working group on armaments policy), without any all-round acceptable solution having been found. Operational convergence and procurement policy are determined by countries' own military culture, their international areas of interest and national defence budgets and, very often, by purely industrial concerns.
6. Indeed, operational convergence and procurement standardisation are not a structural problem as such in Europe since cooperation programmes have already been implemented successfully. However, they are still a major inhibiting factor to any industrial cooperation. There is a need for countries to reach agreement on common minimum capabilities, which takes time, and on a virtually simultaneous allocation of equipment budgets. The countries concerned must therefore have the same equipment requirements, at the same time, for the same missions.
7. In short, it is within the European Defence Agency (EDA) that such questions will need to be resolved if a satisfactory outcome is to be achieved for all concerned. This can only be in the medium and longer term. Indeed, the report from the Agency Establishment Team (AET)<sup>3</sup> and Annex A to the report (proposed priorities for early activities) puts forward, in the section dealing with the defence industry and market, measures of a general nature, namely: to work on the follow-on to the publication of the Green Paper on Defence Procurement, to launch studies regarding the European capacities of the Defence Industrial Base, to define with LoI (Letter of Intent) nations the use and spreading of

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<sup>2</sup> See Assembly Document [1719](#) adopted on 6 December 2000: "The consequences of mergers in Europe's defence industries – reply to the annual report of the Council", submitted on behalf of the Technological and Aerospace Committee by Heinrich Kolb, Rapporteur (Germany).

<sup>3</sup> Report by the Agency Establishment Team (responsible for preparing for the establishment of the agency in the field of defence capabilities development, research, acquisition and armaments) to the *ad hoc* preparation group, Brussels, 28 April 2004.

selected LoI rules within the EU as a benchmark for how to promote use of the small and medium-sized businesses (SMEs) in the EDEM (European Defence Equipment Market).

8. More precisely, “and as an example of the Agency’s approach”, the document proposes the launch of “an initiative in the area of Naval Industry with the aim to assess the EU supply structure. The current situation of the defence industry in this area, with overcapacities, subsidies and unclear demand priorities should be addressed. This exercise will focus on the possible impact of national and multinational programmes on industrial structures and policies”.

9. The EDA’s 2005 work programme, adopted by the Steering Board<sup>4</sup> on 22 November 2004, provides *inter alia* that by the end of the year the agency will have investigated the scope for adding value in as many as possible of the following areas: the Naval Defence Technological and Industrial Base (DTIB); review of anticipated future demand and capacity and current national strategies, and to have made proposals to the Steering Board.

10. The present report will look first at the position of the naval defence industry in various countries, specifically France, Germany, Italy, Spain and the United Kingdom, and at any restructuring, reshaping or mergers: also any privatisation in progress or already completed. As well as the problems already referred to, it will look at issues such as the size of the industry in the various countries, the extent to which there is specialisation or otherwise in different types of ships, combat systems etc. and whether industries are state or privately owned.

11. It will then examine current areas of transnational convergence more closely and consider how likely they are to come to fruition. Lastly, there is a need to give thought to what extent it is in Europe’s interest to be reliant on a naval defence industry based on at least two major competitor groups, which, moreover, needs to be able to stand up to transatlantic groupings and at the same time meet countries’ requirements and, it goes without saying, ESDP goals. The major players in the field – the industry, the member states and the European Union itself – must all be involved in a project on which both the survival of the industry and the success of the European Security and Defence Policy will depend.

## *II. The main players*

### *1. Germany*

12. It could be said that Germany is one European country where the process of naval defence industry consolidation has virtually been completed. This process, involving restructuring, merger and privatisation, began in 1999 with the creation of the HDW group from the German company HDW and the Swedish Kockums. In 2002, the HDW group bought out Hellenic Shipyards. The merger of two German firms, Nordseewerke and Blohm und Voss resulted in ThyssenKrupp Werften. The HDW Group and ThyssenKrupp Werften then merged to form Thyssen Krupp Marine Systems (TKMS) in 2004.

13. An external player had a very important part in this whole process, considering the final outcome of this industrial consolidation. This was the US investment fund OEP (One Equity Partner), a subsidiary of the US Bank One. OEP acquired total control over HDW in 2002 with authorisation from the European Commission. The operation was tied in in Europe with a commitment by the United States to procure eight conventional submarines for Taiwan. It should be noted that the United States abandoned submarine construction in the 1950s. It seems likely that OEP decided to acquire HDW in the light of this agreement on the part of the US Government and in view of the sale of HDW to an American firm, Northrop Grumman.

14. The issue stirred public interest and naturally also came to the notice of the German Government which opposed the sale of the submarines to Taiwan and shortly afterwards passed a law making it compulsory for any foreign group wishing to acquire more than a 25% stake in a German company involved in defence-related activities to obtain the authorisation of the government. The

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<sup>4</sup> The Steering Board, chaired by Javier Solana as the head of the Agency, is made up of the Defence Ministers of the 24 participant nations (all EU members excepting Denmark) and a representative of the EU Commission.

matter concluded with the transfer of HDW to the Thyssen Group and the formation of TKMS referred to above. OEP nevertheless retains a place in the new company with a 25% stake.

15. The German consolidation and its successful outcome are the result of a long period of cooperation between the various companies, leading to the creation of TKMS, coupled with strong political will on the part of the German Government to bring about that outcome.

16. Apart from TKMS, whose activity is primarily in the defence sphere but which has much smaller civilian interests, there is Lürssen – primarily a builder of pleasure craft but a company which has also some defence involvement (the 130 Corvette for example) and maintains excellent relations with TKMS. Among parts manufacturers, Atlas, owned by BAe Systems, stands out as by far and away the largest.

17. Several years ago the French company DCN thought of merging with or buying out HDW with the new company remaining under DCN control, but since Germany rejected the plan, it failed. The German industry's position is that there can be no coming together of DCN and the defence naval sector while the French company is not in majority private ownership. Indeed, from a German point of view at least, it is not logical for the German naval defence industry to be subject to French Government control. The (non-negotiable) condition of DCN privatisation for any Franco-German rapprochement encapsulates Germany's position. Once this hurdle is surmounted a second difficulty arises, again as the Germans see things: the French company is not performing particularly well and employs too many people.

18. The German Government for its part, while willing to entertain the idea of the two countries working together more closely, feels this is premature for the present. Its priority is consolidation of TKMS, which needs to be done by reorganising the company, and this will take time. Once done, an all-German solution might be envisaged involving Lürssen and Atlas. In terms of the first of these, the need for a merger or takeover is not at the moment immediately evident, but the idea should not be discarded. Atlas, a high performer in its field (sonar and radar), should be able to maintain its position. Viewed in terms of German interest in this area, the United Kingdom is not a major contender except in relation to Atlas's future. EADS, Lockheed Martin and Thales Deutschland are interested in buying it, while ThyssenKrupp wants to see it back under German control<sup>5</sup>.

19. Finally, according to the Germans, France – a country that has aspirations to being the driving force behind the consolidation of Europe's naval defence industry – is faced with three main choices: firstly to team up with the United Kingdom, which might seem rational given the British and French aircraft-carrier programmes; or possibly with Italy as the multi-mission frigate programme could bring the two countries together. However, the mixed military and civilian character of the Italian shipyards would not find favour with the French authorities who will not entertain the idea of civilian alongside defence yards in the same company.

20. A third possibility would be to team up with Germany, whose principal production, like that of France, is frigates and submarines. It is worth noting that at present the two countries are not engaged in any naval cooperation programmes. When the possibility of Germany abandoning its F 125 frigate construction programme and joining the French-Italian European Multi-Mission Frigate Programme (FREMM) was raised, the answer came back that this was not foreseen. Apart from the arguments already referred to, Germany feels that the process of consolidation should happen through merger rather than takeover. EADS would therefore be a relevant marker. There is a need also to avoid any kind of monopoly situation and in particular to encourage competition within Europe.

21. TKMS has 9 300 employees (set to fall after reorganisation of the company, to somewhat under 9 000) and a turnover of 2.2 billion euros. Its current involvement is with the F 124 air-defence frigate (three units), the U 212 A submarine (four units) and five K 130 frigates.

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<sup>5</sup> *Defense News*, 27 June 2005

## 2. Spain

22. Spanish state-owned shipyards have undergone a painful process of restructuring and reorganisation over the past 20 years. Although the number of people employed in the shipyards stood at 40 000 in 1984, today, following agreements signed recently between the Spanish Government (through SEPI – Sociedad Estatal de Participaciones Públicas) and the trade unions, that number is due to fall to 7 000. Moreover, these agreements mark the end of an era when no account was taken of European Commission regulations on public subsidies.

23. In 1990, a community directive set in train a process calculated to put an end to such national government and EU subsidies and other forms of support to shipyards. In 1995, the Spanish Government and trade unions signed a three-year Strategic Competitiveness Plan, implementation of which led to drastic job cuts, coupled with the provision of state financial aid. This form of assistance, which did not comply with European law, was approved by the EU Commission as an exceptional measure.

24. In point of fact, the Commission decided that this form of public subsidy would be the last granted outside the limits authorised. When the Plan came to an end in 1998, although compliance with it had been rigorous, Spain's shipyards were 850 million euros in the red. The evolution of the market and aggressive competition from South Korean shipyards prevented the planned objectives being achieved. The People's Party Government therefore decided to merge Spain's civil shipyards (AESAs) with its military yards (BAZAN) to create IZAR.

25. Between 1984 and 1999 the AESA Group suffered losses of some 2 450 million euros. The BAZAN group also sustained a 635 million euro loss over the same period. The merger was supported by substantial Spanish Government subsidies. At an inquiry in May 2004, the European Union declared the subsidies illegal and forced the IZAR group to repay some 400 million euros pending the result of an inquiry by the EU Commission into a further 1.2 billion euro tranche of the subsidy which the Commission also considered illegal.

26. Lastly, the decision to merge the civil and military yards unleashed a volley of criticism on the part of those who considered that it endangered the future of the military yards. The coming to power of the new government in March 2004 marked a return to the *status quo ante*.

27. In point of fact, in 2004 the Spanish Government and trade unions signed a three-point agreement, ratified by the European Commission on 19 January 2005. This involved first regrouping the various centres for defence work in IZAR (at Ferrol, Cartagena, San Fernando and Cadiz) and those where civilian work was done (at Fene and Puerto Real) plus the company's central offices in Madrid, into a new company: Navantia.

28. This new company, essentially given over to military naval construction work but which may also build civilian ships to a value of up to 20% of overall turnover<sup>6</sup> will employ 5 532 staff, including 1 000 engineers employed in R&D. The initial aim is to achieve annual sales figures of 1.4 billion euros: 900 billion in the domestic market and 220 million in export markets, 280 million in the civilian sector and 90 million in R&D. The order book at 2 March 2005 was worth 3.6 billion euros.

29. At the launch of the new company, the Chairman and General Manager, Mr Gómez Jaén, laid emphasis on Navantia's major technological capability, with large numbers of engineers involved in R&D. He stressed the company's strong international outlook and its intention to position itself as a strategic partner within a possible European naval defence consortium. He also announced that Navantia would develop its global activity in the defence sector in view of the fact it would be taking on work in design, development, production, integration, logistical support, propulsion systems and delivering ships that are fully operational.

30. Last but not least, Mr Gómez Jaén envisaged that the company would promote a policy of selective cooperation all round with other national and with foreign companies and would be open to collaborative projects in high technology design where its products might be more competitive.

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<sup>6</sup> *El País*, 3 March 2005.

31. The second area covered by the government/trade-union agreement concerns the sale of the other IZAR centres involved in civilian production (Gijon, Sestao, Manisas and Seville) and the third and last deals with early retirement provisions for some 40% of IZAR staff, an operation that will cost the government a total of 1.2 billion euros.

32. One very important aspect of international cooperation undertaken in Spain's naval defence shipyards has been between the Spanish and Netherlands navies. In the early 1990s, it was decided between them that they would build two military auxiliary ships jointly. The rare success of this project in a field where cooperation is normally not the order of the day has unfortunately not attracted much attention from the experts. The Dutch ship *Amsterdam* and the Spanish ship *Patino*, twin vessels in almost all respects commissioned between June and September 1995 were the product of a coordinated engineering process involving two shipbuilding firms (Royal Schelde and Bazan/Izar) and joint procurement of the main equipment components.

33. The two navies repeated the experiment shortly afterwards with amphibious ships: the *Rotterdam* was commissioned, again by Royal Schelde, in 1998 and the *Castilla* and *Galicia* by IZAR in 1998 and 2000 respectively. These vessels were designed and built according to much the same principles as in the case of the auxiliary ships referred to. The success of those programmes shows that cooperation in the naval defence sector is not necessarily doomed to fail.

34. Navantia is currently involved in two international consortia: AFCON and Scorpene. AFCON builds military surface ships and cooperates with the American firms Lockheed Martin and Bath Iron Works. AFCON was set up in the 1990s following a decision by the Spanish Defence Minister to install the US AEGIS anti-air defence system in F-100 frigates, a decision which, at the time, did not go down very well in some European countries, especially as it came after a year's cooperation with Germany and the Netherlands on the European TFC (Tri-lateral Frigate Cooperation) frigate.

35. In actual fact, the Spanish Minister of Defence had noted that the R&D costs associated with the APAR radar, the anti-air defence software and the modification of the Standard 2 (SM2) missile were way in excess of funds available and consequently the decision was taken to adopt a tried and tested combat system, thus eliminating the risks of overruns and delays and the extra development costs otherwise involved.

36. The Spanish F-100 frigate programme based on the US AEGIS system gave rise within the framework of the AFCON agreement to other similar programmes like the F-310 frigates for Norway and the SEA 4000 programme for Australia in which Navantia has extensive involvement.

37. The Scorpene consortium was born of the resolve of two companies: Navantia and the French DCN to combine their strengths and design, build and market a new generation of conventional Scorpene-class submarines by sharing non-recurring costs and bringing their procedures and industrial cultures into line. At the moment, the first two submarines in this class, for Chile, are at the sea-test stage and the third and fourth, for Malaysia, are under construction.

38. Navantia's order book<sup>7</sup> at present consists of the following: 6 frigates under construction at Ferrol – the Méndez Núñez (F-104) for the Spanish Navy and five others for the Royal Norwegian Navy and the strategic projection ship, again from the Spanish Navy. The Cartagena naval ship yard is working on eight submarines, four S-80 class for the Spanish fleet and four Scorpene class: the *Carrera* and the *O'Higgins* for Chile and two others for Malaysia. Finally, last December, the San Fernando yard received an order for twelve LCM-IE (mechanised landing craft). The Puerto Real yard for its part is to fulfil an order for a military logistical support ship from the Spanish Navy.

39. Navantia also has a stake in the industrial grouping which is the lead contractor for the development and construction of the first two units of the new Littoral Combat Ship for the United States Navy and is working on a feasibility study for a strategic projection ship for the Australian Navy.

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<sup>7</sup> Source: *Revista Española de Defensa (RED)*, March 2005.

40. Finally, last July, the Pentagon gave the green light for the sale of Tomahawk missiles to Spain. A few days later<sup>8</sup>, the Ministry of Defence announced the Spanish Government's choice of the US company Lockheed Martin as Navantia's technology partner for the production of the S-80 submarine's core combat system. According to the Spanish authorities, costs and the fact of being able to meet the technical conditions were the reasons for this choice, but it was thought in other circles that traditional ties of friendship and cooperation between the Spanish and US navies had carried greater weight.

41. The arrival in power of the new Spanish Government in May 2004 and its immediate decision to pull Spanish troops out of Iraq caused tension between the US and Spanish Governments and gave rise to the suggestion<sup>9</sup> that the Spaniards would look more favourably on procurement of MDBA missiles and the combat system on offer from DCN and Thales.

42. The implications of that decision are more strategic than economic, if only because it will enable Navantia to compete on the conventional submarine world market, which over the next 10 years is likely to mean roughly 10 units or some 8 billion euros. From an operational point of view, the Ministry of Defence believes that choice will increase its operational capability given the leading edge technology features of the submarines and the fact of their being perfectly adapted to current theatre requirements.

43. Setting up Navantia should not be seen simply as the final stage in a restructuring process or a return to the *status quo ante* but primarily as an absolutely essential condition for its being able to position itself advantageously for integration of the European naval defence industry. In fact, Navantia has publicly announced that it may take part in informal discussions on such a development which in its view is already underway. Its Chairman has stated that Navantia is open to industrial alliances between partners on an equal footing, but wants no truck with situations or policies that smack of subordination or are likely to cause imbalance and hinder cooperation.

### 3. France

44. The main player in France's naval defence industry is DCN (Direction de Construction Navale) which is government owned. DCN possesses key competences in engineering, assembling and integration, particularly in the fields of conventional and nuclear submarines (Cherbourg) and heavily armed surface ships like frigates and destroyers (Lorient). DCN's focus is on project management, while offering exclusively or through cooperation the whole array of trades and technologies required to meet the Navy's new needs.

45. A second player in the field of project management is Thales Naval France, manufacturer of the new intelligence gathering ship *Dupuy de Lôme* for the French Navy and of frigates *inter alia* for Saudi Arabia. Lastly France is also home to the Alstom/Chantiers de l'Atlantique yards at Saint-Nazaire, producing large ships. DCN and Alstom are jointly engaged in building two 20 000 tonne plus LHD class helicopter carriers.

46. DCN and Thales have activities that are complementary and are linked by ties of cooperation that go back some time. In 2002, they formed a common subsidiary, Armaris, whose main objective was to place contracts for and to market defence-related products with which both groups were involved both in France and for export<sup>10</sup>. This partnership was further strengthened in June 2004 by the formation of a new joint venture (65% DCN, 35% Thales) to manage the second French aircraft-carrier programme.

47. Currently, naval equipment programmes underway in France<sup>11</sup> include an aircraft carrier, for delivery in 2015, two Horizon air-defence frigates for 2006 and 2008 and a third to be ordered in

<sup>8</sup> *El País*, 27 July 2005.

<sup>9</sup> *Defense News*, 6 December 2004.

<sup>10</sup> See the information report by Jean Lemièrre on Europe's naval industry ("Rapport d'information sur l'industrie navale en Europe", Commission de la Défense Nationale et des forces armées, Assemblée Nationale, 30 June 2004).

<sup>11</sup> *Op.cit.*

2007, 17 multi-mission frigates, the first for delivery in 2008, two projection and command ships (BPC) to be commissioned this year and next (2006), four SNLE-NG (*Sous-Marins Nucléaires Lanceurs Engins de Nouvelle Génération*) new generation submarines and a programme of Barracuda class attack submarines to replace France's Rubis class submarines from 2012.

48. In regard to DCN's status, a law was adopted by the National Assembly in December 2004 whereby DCN is to open up its capital and set up subsidiaries. The Rapporteur, Jérôme Chartier, stressed in his presentation that the aim was to enable DCN to enter into joint ventures. The new act would, he argued, allow DCN to form capital investment ties both upstream and downstream and thus open up its capital to private sector partners, potentially European ones<sup>12</sup>.

49. Mr Chartier noted that there was a need to give a strong signal to those partners indicating France's determination. A number of alignments were being envisaged, he suggested, both internally (DCN's close ties with the Thales group makes the latter the ideal partner) and at the international level, for the law would allow DCN to make alliances across the naval defence construction sector with other (European) partners, which would be impossible for it without public limited company status.

50. Finally, the Rapporteur explained that DCN's current status prevented its transferring assets to the Armaris subsidiaries it holds jointly (50/50) with Thales. Opening up its capital means that Armaris can be "decoupled" at European level. In his view, the law is merely a tool-box, as the way DCN will go has not yet been decided.

51. The passing of the law has in fact made it possible to set in train discussions between DCN and Thales, the outcome of which is likely to be made public by the end of the current year (2005). The French newspaper *Le Monde*<sup>13</sup> reported that French Defence Minister, Michèle Alliot-Marie, had stated that a merger between the naval side of the electronics group Thales and DCN was back on the agenda.

52. According to the Lemièrre report<sup>14</sup>, initially DCN's "ships and systems" business (Cherbourg and Lorient yards) would be tied in with Thales Naval France in a joint company. It was not until later on that DCN's operational maintenance side (at Toulon and Brest) might be integrated into the new company. The matter of the parts manufacturing businesses based in Saint-Tropez, Ruelle and Indret which had entered into partnership with other groups such as WASS, MDBA and Rolls Royce still had to be discussed.

53. Seemingly the arrangements for supervision and management of the new company are still to be defined. This will be done once it has been set up and DCN and Thales's respective capital shares in it have been determined. It should be borne in mind that among Thales's present shareholders, the French Government owns 31.3%, Alcatel 9.5%, Dassault 5.7%; private investors 50.9% and 3.2% of shares are held by the company.

54. The French newspaper *La Tribune*<sup>15</sup> reported that DCN, heartened by its good 2004 result, felt it was in a favourable position to participate in any reshaping of the defence naval sector. Its Chairman, Mr Poimboeuf, stated that the planned convergence involving Thales Naval France business and the Armaris joint subsidiary was not an easy project to carry forward but that it made complete sense in terms of strategy.

55. According to *La Tribune*, the resultant new company will be worth some two billion euros of sales and some 5 500 jobs. With a cash flow of 200 million euros and own capital of almost 800 million, DCN is valued at between 3 and 5 billion euros and posted net results of 209 million euros in 2004. To maintain profits the company is counting mainly on getting three programmes for the French Navy off the ground: the FREMM Franco-Italian Frigates, the Barracuda nuclear-powered attack submarines and the second French aircraft carrier.

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<sup>12</sup> <http://www.assemblee-nationale.fr>

<sup>13</sup> 14 March 2005.

<sup>14</sup> *Op. cit.*

<sup>15</sup> 25 April 2005.

56. These tasks out of the way, DCN says it is poised for the creation of an efficient “Euronaval” sector<sup>16</sup>. It maintains that, since the late 1990s, the company’s reach and tasks have been clarified and limited to industrial activity, also that resources and staff have been redirected towards strategic occupations and that, in short, there has been much done all round to improve both the company’s methods of operation and competitiveness, all of which goes to show that its strategic vision is to become a European company with a strong foothold in world markets.

57. DCN’s views<sup>17</sup> on the possibilities of a rapprochement with other European naval defence undertakings apart, the French company considers the risk of an incursion by US companies on the European and international markets. It notes that the two leading contractors in the naval sector, Northrop Grumman Ship Systems and General Dynamics, have up to now been content with their domestic market, however, it is not impossible that they might break in to compete on foreign export markets, such as Europe, particularly in view of the major European projects that are at present underway. Indeed the DCN document points out that emergent cooperation with one European player or another could become a Trojan horse, as some of them may prefer to ally themselves with an American contractor in the hope of a lead-in to the North American market, rather than taking part in European consolidation.

58. Finally, DCN feels that as far as Europe’s navies and Europe’s position in the naval defence sphere are concerned, another economically viable and strategically desirable option to the creation of a single pole would be the coexistence, temporarily or for the foreseeable future, of two major European contractors. Over and above that number, it observes, European project leadership would be weakened, as would its capacity to provide a cost-effective response to the needs of its navies and to competition from the United States in European and export markets.

59. The French company does not hide the fact that the process of building a European naval defence industry will be a long and complex one, given the numerous possible scenarios and players, and their at times conflicting interests and limitations. In order to deal with such complexity, DCN notes that it will be necessary to proceed by stages and that alternatives need to remain open in case of possible setbacks.

60. According to Mr Lemièr<sup>18</sup>, bringing the main European groups closer together is a priority aim – the more so as conditions are particularly favourable to this at present in view of their order books, making it easier to overcome any national insularity, and the numbers of joint programmes, now higher than ever before. This situation should, in his view, facilitate closer industrial partnerships.

61. In your Rapporteur’s view, and in the light of the possibility of a group being formed that is the naval equivalent of Airbus, the best arrangement from an industrial and economic point of view would be a Franco-German grouping (TKMS-DCN and Thales). The two groups are engaged in head-on competition in the conventional submarine market and also the surface ships’ segment. Mr Lemièr points out that rapprochement should mean major savings in terms of development and manufacturing costs and margins. A second stage could involve extending this partnership to the Italians (Fincantieri) and the Spaniards (Navantia). The British (BAe Systems) are inclined towards the US market and their apparent lack of interest in any future European consolidation process for the time being suggests they are not in contention.

62. As to the arrangements for a possible Franco-German alliance, the Rapporteur considers, firstly, that it is essential to guarantee that jobs and production capacities will be maintained and, secondly, that it would be possible to create a partnership covering work upstream of shipbuilding by setting up a joint company with teams covering the areas of naval architecture, development, engineering and commercial activities. Lastly, it would entail a gradual reproduction of the process adopted in the aeronautics sector when Airbus was set up.

63. Clearly any European integration process should envisage a pooling of everything to do with development, advanced engineering, marketing and strategic procurement; also that at the level of

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<sup>16</sup> DCN “Pour un pôle européen industriel naval de défense”, May 2004.

<sup>17</sup> *Op. cit.*

<sup>18</sup> *Op. cit.*

production, there will be endless political and employment constraints preventing site closures and lay-offs, since these are areas already affected by various national restructuring processes.

#### 4. Italy

64. Fincantieri is Italy's main shipbuilder, engaging in both civilian and defence businesses. The defence naval construction yards are located around Genoa. There are also government owned yards (at Taranto, La Spezia and Augusta) specialising in the repair and maintenance of defence ships.

65. Fincantieri's business consists of three sectors: passenger, transport and fighting ships. In 2004, it achieved sales of 2 170 billion euros and profits of 101 million euros (as against 2 336 billion in sales and 93 million in profits for 2003)<sup>19</sup>.

66. The company achieved particularly good results in the defence area in 2004, both commercially and in terms of design and production, with work starting on the second Italian aircraft carrier *Cavour* and the second U212 A submarine *Scire*. These two units incorporate leading edge design and technology and are central to the process of renewal of the Italian Fleet and a crucial element in strengthening cooperation between the company and the Italian Navy.

67. Fincantieri Defence is also responsible for upgrading the frigates *Lupo* and *Orsa* for the Peruvian Navy. For the first time, the Italian Navy has sold two of its boats to a foreign navy and Fincantieri Defence has ventured into the "second hand" market.

68. Lastly, Fincantieri Defence has a strong presence at international level thanks to its contracts with the Maltese Navy to build a large patrol boat and with the Indian Navy for its share in the construction of an aircraft carrier, India's Air Defence Ship. The company is also involved in the United States Navy's Litoral Combat Ship (LCS) programme, for which Lockheed Martin is project manager. Additionally, Fincantieri also signed a contract last year with the Italian Navy to develop a medium-sized submarine project as part of a cooperation programme between Italy and Russia involving Rubin, Russia's largest submarine engineering firm.

69. Fincantieri's current work includes the *Cavour* aircraft carrier programme, the two Horizon class frigates and the U 212 A class submarine. The agreement between Italy and France for the European Multi-Mission Frigate Programme (FREMM) was to have been signed early in October 2005. Owing to difficulties, seemingly caused by the resignation of the Italian Finance Minister, signature was put off until a so far unspecified date. It has become clear, latterly, that the defence budget was at the root of the problem. The 2006 budget is currently being discussed in the Italian Senate. The government is anticipating a reduction, forcing it to cut back on all current defence programmes. It is expected that the solution will be the same as with the Eurofighter programme: loans using spread payments<sup>20</sup>.

70. The programme envisages a total of 27 frigates, including 17 for France and 10 for Italy. However, in principle the contract is to be signed only for nine of them: eight for France and one for Italy. The industry regards this as the most important naval defence programme since the second world war<sup>21</sup>. The agreement is to be signed initially by the main contracting parties: Armaris (DCN and Thales) for France and Orizzonte (Finmeccanica and Fincantieri) for Italy. It will then be countersigned by OCCAR (the Organisation for Joint Armament Cooperation) on behalf of the two national procurement agencies: France's DGA and Italy's Navarm.

71. France has allocated 3.5 billion euros to development and construction of the frigates. Italy's contribution is 1 billion euros towards its first ship and its share of development. A decision was expected on the engine tender at the Franco-Italian summit meeting on 4 October 2005 but was deferred at the last minute<sup>22</sup> without explanation. As the American General Electric and Rolls Royce of the UK were both candidates, their governments had each subjected France and Italy to strenuous

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<sup>19</sup> Source: Fincantieri 2004 Annual Report.

<sup>20</sup> *Defense News*, 17 October 2005.

<sup>21</sup> *Defense News*, 26 September 2005.

<sup>22</sup> *Le Monde*, 6 October 2005.

lobbying to make the decision go their way. It seems that in the end General Electric (GE) will carry the day.

72. GE has teamed up with an Italian partner, Avio, hence Italy's industrial interest in the American bid. France also seems inclined towards this solution. Jean-Paul Hébert, a defence specialist at the Ecole des Hautes Etudes en Sciences Sociales, Paris, notes that it "sends a highly significant signal in transatlantic relations"<sup>23</sup>. And indeed, at the moment, EADs is working hard to win a contract from the US Air Force for aerial tankers. It is also on the cards that following signature of the Franco-Italian agreement France, through Armaris, may renew contact with the Greek Navy and invite it to join the FREMM programme. Armaris would offer technology transfer to allow Greek yards, owned by the German TKMS, to install their own combat systems in the eight frigates Greece needs. It is worth noting too that Germany and Italy are cooperating in the construction of the U 212 A submarine.

73. Fincantieri belongs to the state-owned group Fintecna (Finanziaria per il Settore Industriale dei Servizi Spa) formerly IRI. Fincantieri Chief Executive, Giuseppe Bono recently announced<sup>24</sup> the forthcoming stock market flotation of the company. The percentage holding to be retained by the Italian Government is still to be decided but it is clear that the latter, for strategic reasons, will keep a controlling or "golden" share. This partial privatisation should go through in the next few months, and by early 2006 at the latest. Fincantieri and Finmeccanica have set up the joint-owned company Orizzonte Sistemnavali mentioned earlier (51% Fincantieri, 49% Finmeccanica), producing the combat systems for the Horizon and FREMM programmes.

74. Fincantieri has begun to look into the possibility of separating out its civilian and defence businesses but the Italians seem in no hurry to make a move. The condition imposed by Italian naval yards of keeping the two apart gives rise to a number of problems for other European countries interested in mergers. Given the amount of work around in the civilian sector at present, Italy does not feel such a separation is necessary. The problems Spain encountered in merging its civilian and defence sectors are a warning to the Italians about the future consequences of such a move.

75. The Italians in short, think that consolidation is acceptable only if it helps sort out a country's problems. If it proves inevitable any sacrifices entailed need to be shared by all the partners so that the situation does not arise where one country becomes the project manager and the others mere subcontractors.

76. Mr Bono<sup>25</sup>, moreover, stated recently that Europe built too few ships for naval industry consolidation along the lines of what happened in the aerospace industry to be practical. He has suggested that countries begin by putting together their engineering and marketing efforts with each country continuing to operate its own shipyards.

### ***5. The United Kingdom***

77. The main British producer in the naval defence sector is BAe Systems Naval Ships. The group was set up in 1999 as a result of a merger of the British firms BAe, Vickers Shipbuilding and Engineering Limited, Yarrow and Kvaerner Govan. With just over 2 500 employees, an opening order book of approximately £1.7 billion and sales of roughly £0.4 billion, BAe Systems Naval Ships describes itself as a "prime contractor and systems integrator for both UK MOD and export customers". BAe primarily builds surface ships and nuclear submarines.

78. The Vosper-Thornycroft (VT) Group plc ranks second in the British military naval construction sector. It builds surface ships, frigates, corvettes, patrol boats, Fast Attack Craft and Mine C vessels for the Royal Navy and for export (to Egypt, Greece, Iran, Kenya, Libya, Oman and Qatar). Other programmes, like the Type 45 Destroyer for the Royal Navy are being built in cooperation with BAe Systems.

<sup>23</sup> *Defense News*, 26 September 2005.

<sup>24</sup> *Jane's Navy International*, October 2005

<sup>25</sup> *Defense News*, 27 June 2005.

79. According to Martin Edmonds<sup>26</sup>, the restructuring of the British naval defence industry occurred in the absence of a global industrial strategy on the part of the government. Restructuring and reorganisation were on an *ad hoc* basis, driven by both commercial opportunities and political preferences. Professor Edmonds emphasises that the naval shipyards are located, purely coincidentally either in constituencies where employment depends heavily on that sector or in areas where unemployment would lead to serious political difficulties.

80. The major effort, in the first place in restructuring and subsequently in reorganisation and modernisation, was accompanied by several government initiatives like the Smart Procurement Initiative (SPI) under which contracts were regarded more as a partnership between the customer (the government) and the shipbuilder than a legal bond between two traditionally separate contracting parties.

81. There has nevertheless been recent movement. Indeed, although the United Kingdom has long been acknowledged to have a very open procurement market, today “Britain is alarmed about local industry’s declining capability to produce and support future key requirements of the armed forces”<sup>27</sup>. The Ministry of Defence (MoD) has responded by announcing a plan for developing a defence industrial strategy to identify those technological capacities properly speaking that are vital in the long term to the armed forces.

82. The UK Minister for Defence Procurement, Lord Drayson, has made clear that this is in no way a move in the direction of a “Fortress Europe”-type defence policy. Nor does it resemble the efforts of the US Congress to pass a “Buy American” Act. “I don’t mean” Lord Drayson stressed in a recent statement<sup>28</sup>, “to convey any of those things (...) there will be areas where appropriate sovereignty requires on-shore supply. There will be some [capabilities] we can procure from the local market. And there will be a third category [that] can be procured in cooperation with partners – continental European or American”.

83. Lord Drayson also indicated that he anticipated that the list to which the issue of sovereignty was likely to apply would be a very short one (indeed, currently the concept only applies to nuclear energy and cryptographic equipment), adding that of course the UK would “continue to include foreign-owned companies operating within the UK within this”<sup>29</sup>. One sector concerned in regard to “local sourcing” would be shipbuilding and warship support. Finally, the Minister made clear that the whole issue of procurement as understood to date would undergo changes throughout 2006.

84. The organisation of the naval defence industry in the United Kingdom differs considerably in a number of respects to that in most continental countries. The Lemièrè report<sup>30</sup> states that the function of prime contractor for ships and submarines is at present carried out in the UK by a systems electronics firm, BAe Systems. The firm achieved its policy of vertical integration by acquiring naval shipyards. Thus it can offer fully-fitted ships inclusive of combat, weapons and detection systems – and also maintenance, another area of activity in which it is involved.

85. BAe Systems Naval Ships is a private enterprise in which the British Government retains a “golden share”. One of its projects is currently the type 45 Air Defence Destroyer, with BAe again as prime contractor, in partnership however, as mentioned earlier, with the VT group. The Royal Navy has ordered six ships, two Landing Ships Logistic (LSD A) and three F 2000 off-shore patrol vessels (ready for acceptance) for the Royal Brunei Navy; also two CVF aircraft carriers (Oil and Gas Alliancing Delivery Model) for the Royal Navy itself.

86. At present the UK Government is holding talks with the industry on possible restructuring. This might take the shape of a merger or alliance – the precise form has yet to be determined. Restructuring ties in directly with the Defence Procurement Agency’s plan to find a manager or integrator for its MARS (Military Afloat Reach and Sustainability) programme. All the projects discussed above form

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<sup>26</sup> “UK Shipbuilding: A new Direction?” M. Edmonds, *Global Defence Review 2001*, pp. 92-94.

<sup>27</sup> “UK ponders which defense sectors to shield”, *Defense News*, 3 October 2005.

<sup>28</sup> Lord Drayson’s speech, Royal United Services Institute (RUSI) London, 12 September 2005.

<sup>29</sup> *Defense News*, *op. cit.*

<sup>30</sup> “L’industrie navale en Europe”, *op. cit.*

part of this programme. Some companies have already indicated that the MoD should reschedule its naval construction timetable to meet longer term demand<sup>31</sup>.

87. In that connection, the MoD asked the think tank RAND Europe to study the UK naval industrial base and make recommendations for solving its problems. The results of the study<sup>32</sup> indicate *inter alia* that globally there is a construction capacity in excess of what is required to meet both civilian and defence requirements and that all market sectors are awash with competitors fighting over a relatively small number of contracts. The document notes that “the more demanding standards to which military shipyards are accustomed and their need to carry higher office overhead will not well support attempts by them to enter the commercial market. Such endeavours would also fly in the face of a historical trend towards greater specialisation by shipbuilders in military or commercial markets only”.

88. The study also states that given the UK’s industrial infrastructure, it would be possible to concentrate on the commercial market by building passenger and other complex ships but that this market segment has already been taken by other European shipbuilders, under threat in their turn from competition from Asia with much lower cost production. As a result, shipbuilders are turning towards defence export markets, a sector in which the United Kingdom could have one or two advantages. The problem is, however, that British ships are larger, more complex and expensive than second tier navies, the major potential importers, want to buy.

89. Lastly the study considers that investment is needed in the development of new designs and technology, by the industry of course, but also by governments, provided that such investment complies with EU regulations. RAND Europe feels that “any such investments will be risky because the probabilities of payoff will not be high, but externalities might accrue to domestic military shipbuilding and to other UK industries”.

90. The Defence Procurement Agency recently announced<sup>33</sup> that a decision on the MARS project integrator would be delayed until the end of December 2005. The DPA’s intention is to build an industrial alliance capable of managing the project to deliver on time and within budget. Other bidders included the American General Dynamics UK and Raytheon Systems and Amec, BAe Systems, Houlder Offshore, KBR, Maersk, Thales and VT Group. This is the first time the British have planned the integrator/alliance procurement route from the outset.

### III. Conclusions

91. One recommendation of the Assembly’s report on “European Defence – the role of naval power”<sup>34</sup> asked the governments of the WEU nations to “take the necessary action to coordinate and strengthen the capabilities of the European naval construction industries”. An earlier report<sup>35</sup> had also recommended encouraging naval cooperation at technical and industrial levels. This report also pointed out that one problem in regard to cooperation consisted of the various different national procurement systems based on different regulations and working methods.

92. Indeed, the difficulties of cooperation in the naval sector, whether purely on the defence side or at the industrial level, relate to the somewhat different cultures of both, consolidated over centuries, and to the questions already raised in the introduction to the present report: operational convergence, procurement synchronisation, harmonisation of defence budgets, in short the inexistence of European programmes.

<sup>31</sup> *Defence News*, 23 May 2005.

<sup>32</sup> “Differences between military and commercial shipbuilding: Applications for the United Kingdom’s Ministry of Defence”, John Birkler *et al.* RAND Europe. [www.rand.org](http://www.rand.org)

<sup>33</sup> *Defense News*, 16 October 2005.

<sup>34</sup> See Assembly Document 1813, adopted on 3 June 2003, “European Defence – the role of naval power” submitted on behalf of the Defence Committee by John Wilkinson, Rapporteur (United Kingdom).

<sup>35</sup> See Assembly Document 1606, adopted on 6 May 1998, “European naval cooperation – frigate programmes”, submitted on behalf of the Technological and Aerospace Committee by MM González Laxe and Arnau Navarro, Rapporteurs (Spain).

93. The French DCN (Direction de Construction Navale) has developed a concept of a European Joint Project based on the emergence of a real maritime security need. This presupposes firstly that the naval programmes for first rank platforms (aircraft carriers, frigates with large combat systems and submarines) are already either off the starting block or well under way, which means that no further programmes of substantial size will get off the ground in the next 20 years. It observes next that no transnational consolidation process has begun yet and that no consolidation can take place without there being one or several European, or at any rate multinational programmes.

94. In DCN's view, such programmes could usefully form part of the gradual drift in the shipyards away from hull construction towards combat systems integration. For the French, the most productive area for a formative European programme would be maritime security. Other possible areas for joint projects that DCN suggests are mine warfare and a logistical support fleet.

95. This proposal is worth serious consideration but also raises a difficulty, namely: if the various programmes and contracts are continually deferred, as mentioned, as in the case of Italy, the United Kingdom and France, it is unlikely that governments will take further decisions about new programmes. A case in point is the FREMM Franco-Italian programme which has fallen well behind schedule in both Italy and in France<sup>36</sup>. Indeed the order for the contract of 27 ships, worth 11 billion euros, over 10 years, should have been signed in 2004 for production to commence in 2005. Signature of the contract for the French nuclear submarines has also been deferred and the French Ministry of Finance has frozen 500 million euros worth of credits intended for the purpose.

96. The idea of a Naval EADS, a Naval EURO, or a Naval Airbus has long been under discussion and the French, German and Spanish Governments have tended to support it during the course of the last twelve months, but some directors of the German TKMS made known last June that they were in no hurry at all for such a merger<sup>37</sup>. Without the involvement of the German component the idea is unrealistic.

97. Lastly, it cannot be stressed too much that without European programmes the task of creating one, two or three major European naval groups would be impossible, and for that to happen countries must agree on their equipment needs (and on a common schedule) for like missions. In that connection the necessary organisation already exists in the form of the European Defence Agency (EDA) and other instruments like the LoI and OCCAR<sup>38</sup>.

98. At a recent meeting of the EDA Steering Board in the United Kingdom, Defence Ministers reached agreement on the Agency embarking on *ad hoc* projects as soon as possible. Nevertheless, as the introduction to the present report states, the matter of consolidation of the European naval defence industry is not an EDA priority. During the Ministerial Meeting its strategic objectives<sup>39</sup> were discussed and the ministers asked the EDA to prepare formal proposals with a view to taking a decision at the next meeting on the transformation of military capabilities to meet ESDP requirements.

99. As Mr Solana said at the time: "In the end, this transformation can only be done by national governments. The EDA will do everything it can to help but the Agency does not deliver capabilities in itself. Its participating Member States will have to. But they can now use the EDA instrument to support their efforts to improve Europe's defence performance".

100. In point of fact it is within EDA that the whole issue of consolidation of the European naval industry must be discussed. The Agency is capable of overcoming and resolving the numerous difficulties that stand in the way. It must first take a decision to treat it as a priority, but this will be to no avail if governments are not themselves resolved on moving forward towards consolidation. As a study published by the International Institute for Strategic Studies<sup>40</sup> suggests: "If companies are given clear, coordinated requirements stretching out into the future, and clear rewards and penalties, industry

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<sup>36</sup> *Le Parisien*, 26 October 2005.

<sup>37</sup> *Defense News*, 27 June 2005.

<sup>38</sup> LoI: Letter of Intent: OCCAR the Organisation for Joint Armament Cooperation.

<sup>39</sup> European Defence Agency, Press Release, Brussels, 13 October 2005.

<sup>40</sup> "Consolidating Europe's Defence Industries", IISS, Volume 11, Issue 4, June 2005.

will shape itself into a group of forward-looking and competitive companies, to the benefit of taxpayers and shareholders”.



