



Maintaining a Critical Mass for UK Defence



Introduction

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Since the Second World War the UK's defence industry has undergone a number of dramatic changes. In the last decade it has experienced the end of the Cold War and a rapid globalisation of the industry. Yet despite the changes that have occurred the UK has been able to maintain its position as the world's second largest defence supplier.

The aim of this document is to provide an overview of future challenges for the industry and what the UK Government must do to maintain a **"world-class defence industry"**. Amicus believes that a strong UK defence industrial base is vital for the future prosperity of the country.

Currently the UK has the most open defence market in the world and although we are the world's second largest defence supplier we are also the world's second largest importer of defence-related products. It is the very openness of the UK MOD tendering process which has in part been responsible for the decline of the UK defence supply chain. The recently adopted Defence Industrial Policy was considered by some of us to be the first step in addressing this imbalance.

It is no coincidence that, shortly after the MOD placed its order for Hawk trainer jets, other export orders soon followed. The UK armed forces have a reputation for excellence across the globe and it is only logical that other nations will judge the merits of our defence products by the MOD's willingness to supply our troops with them.

This is why it is vitally important that where like-for-like products are competing, factors such as UK jobs, future capability, export opportunities and technology transfer should all enter the procurement process.

The future of the UK defence industrial base is of vital importance not just to those employees working within it but to the whole nation. It is for this reason that Amicus continues to campaign for greater recognition for its members employed within the sector and the vital contribution they make to it.



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1 UK Market – Open and Fair



EH101-Merlin
A truly world class product

The major challenge for the UK defence industrial base is to find a balance between the often very different goals of industry and Government. Industry prioritises investment toward near term, high return and high value programmes that make a sound business case for them. Government, on the other hand, seeks to prioritise investment to ensure a continuing capability to meet any new threat to national security.

This need tends to be cyclical and is difficult for industry to maintain during periods of inactivity. As a consequence UK companies have been drawn to other larger markets such as the United States. But in order to break into the US market, UK companies have had to invest into US subsidiaries.

Often this investment has been a result of the complications surrounding the The International Traffic in Arms Regulation (ITAR) Waiver Process.

Background

- Currently the United States requires approval of exports of components even to a subsidiary of the same company. This process is called an ITAR Waiver. The UK currently does not have an ITAR Waiver. However Canada does and enjoys a free trade with the US.
- The British and American Governments agreed in principle earlier this year texts to permit an (unclassified) ITAR Waiver for the UK. However, agreement by Congress is also required, and Congress is therefore the focus for lobbying and monitoring progress.

Hopes for a breakthrough on the UK-US ITAR Waiver have been pushed into 2004-05, with the adjournment of the Senate. However, no breakthrough will be forthcoming without further significant intervention from the White House.

The anti-waiver movement is strong, within Congress in particular, while support for the ITAR Waiver is believed to be lukewarm in key quarters, especially US industry, which has reservations about waivers in general.

For UK companies competing for military orders in the US the Waiver acts as an unfair advantage for US companies in two ways:

First are the financial implications of having to potentially license thousands of individual components in a competitive tendering process. The second is the potential for delays and burden of additional regulations that will be a factor in any successful bid.



However many UK companies try to overcome this by buying US companies and ensuring that there is no technology transfer out of the US. This trend has triggered an erosion of the UK defence industrial base while at the same time a major expansion of UK defence companies abroad has taken place. In fact many of the larger well-known companies such as BAE-Systems, Rolls-Royce and Smiths Industries have almost as many workers employed within the US as they do within the UK.

This trend, if left unchecked, will lead to a situation where the critical mass of the industry is no longer based in the UK. If it is allowed to happen it means the MOD will be reliant on its future needs being designed and built outside of the UK. It is fair to expect that some final assembly work would remain but the ownership of intellectual property would more than likely remain within the domain of the successful company and its home base.

In high technology sectors such as aerospace the inability to transfer new technologies into the UK will eventually lead to a situation where the MOD will no longer have the option to buy within the UK. To demonstrate this effect we need only look at the Future Lynx programme.

A failure by the MOD to purchase the Augusta-Westland Future Lynx in the near term will lead to the UK losing its helicopter capability. Westland's site at Yeovil has a highly skilled workforce, which has the ability to design and develop world-class products. However a failure by the MOD to select the Future Lynx will lead to large-scale redundancies and losses within its highly skilled workforce. Without Future Lynx the EADS NH90 is likely to be selected rather than Westland's world-class Merlin to meet land-based lift requirements. With no land-based role Merlin is unlikely to be required for the amphibious role alone. Unlikely but possible, despite the high regard Merlin is held in globally.

Many of the skills that will be lost will be irreplaceable, therefore leading to a loss of technological expertise. Eventually this could lead to the whole site closing and the UK becoming reliant on its helicopter capability being supplied from abroad. In addition prime contractors on big programmes tend to buy from their local supply chains.

This is just one example of the importance that a MOD contract has on the supply chain. It is with this in mind that Amicus believe's that while it is right that the MOD should look for value for money and for the best equipment for its forces, it must also consider the long-term capability of the UK defence industrial base when making decisions.

2 Ownership of UKDI

UK aerospace is rapidly approaching a situation where foreign ownership is equal to that of UK companies

Many overseas companies have either located in the UK or purchased UK defence companies through mergers and acquisitions. This rapid consolidation process within the defence industry has proved to be an emotive issue for both the Government and industry itself.

The main argument against foreign ownership has been the damage this may do to the UK's future defence capability. But Amicus believes a failure to maintain current employment levels and lack of investment are of equal threat. Many foreign companies now have a substantial footprint in the UK and in many cases their investment has acted as a back fill for the increasing investment by UK companies abroad.

Figures from the UK aerospace industry highlight this trend. In 2002 companies located in the UK and owned by overseas parents generated a total of £6.00bn in turnover and employed 35,511 people.

UK-owned companies based in the UK generated £0.14bn of turnover and employed 79,745 people in 2001.

UK-owned companies in the USA generated £3.62bn and employed 25,924 people (2001). This year's figures however demonstrate a continuation of this trend.

As the graph opposite demonstrates, UK aerospace is rapidly approaching a situation where foreign ownership is equal to that of UK companies. In principle this is fine but Amicus believes that greater safeguards should be built into the defence industrial policy.

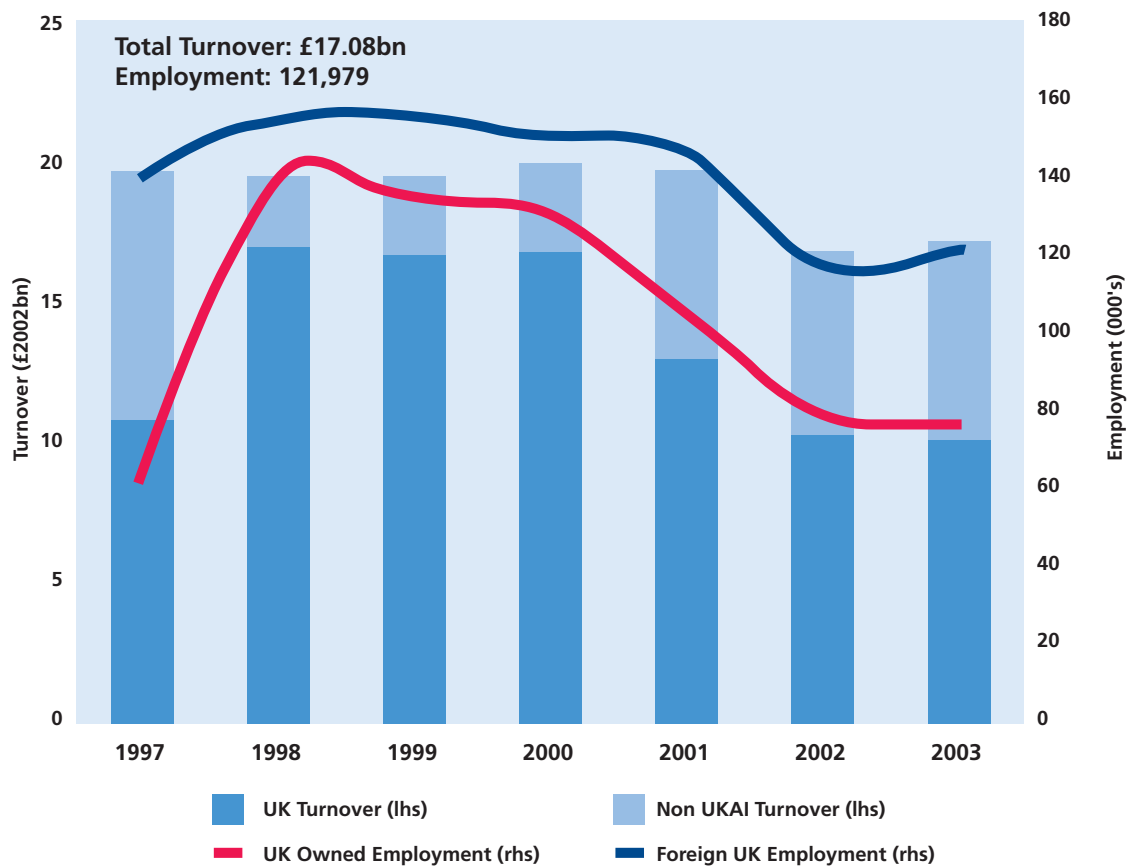
Key issues, such as through-life contracts, are vital as this is where the industry learns by doing. Lessons learnt from through-life contracts are important as they help the industry to improve the products it offers and at the same time develop the relationship needed to successfully compete for future contracts.

The defence industrial policy must also insure that the UK supply chain has adequate exposure to new technologies. Ensuring UK defence procurements allow for technology transfer into the UK can only serve to do this.

JSF – a huge programme but how many jobs will it create in the uk?



Turnover and employment in the aerospace industry



3 Export Credit Guarantee Department (ECGD)



ECGD is vital for the Civil Market

The UK defence market is one of the most open markets in the world and the UK Defence Industry (UKDI), as well as being the second largest exporter of defence products is also the second largest importer. This means the UK has a record second to none for having open and fair markets. Amicus welcomes the Government's recent review of the ECGD's role.

Amicus believes that future changes made as a result of the review must strengthen Britain's role as a global leader and not undermine it. We must also acknowledge that other export credit agencies, such as the US Export-Import Bank and Coface in France, are ramping up support for their respective countries.

The UK's defence industries' ability to compete depends on a strong ECGD. According to the most recent ECGD Annual Report, £3.5bn of ECGs were issued or renewed in 2002/03, of which 50% were linked to defence. In 2001/02 the figures were £3.3bn and 31%. Total ECGD exposure as of March 31st 2003 was £14.6bn of which defence accounted for 22%.

The final report of the Commission on the Future of the United States Aerospace Industry concludes (CFUSAI) "**Financing plays a critical role in the ability of customers to procure military and commercial aircraft.**" It goes on to state, "**Continued funding for Ex-Im Bank is important to the US Aerospace industry.**" In a highly globalised sector such as defence the UK must match its competitors.

Secretary of State for Trade and Industry Patricia Hewitt stated in a recent interview, "The ECGD will have a continuing role in complementing the private sector to ensure that finance is available for worthwhile aircraft exports. In the period since September 2001, during which the commercial appetite for aircraft finance has diminished, the ECGD along with its French and German partners, has issued guarantees to support deliveries of over 60 new aircraft and perhaps more importantly in that same period it has underwritten support for some 61 aircraft."

If this support had not been available in its current competitive form the UK would not have had the benefit of these orders and so lost many high value jobs.

Both industry and Amicus accept in principle that ECGD will become a trading fund. Amicus believe that this move will allow the role of ECGD to become more transparent while it becomes increasingly important to export success.

However we would also highlight the following areas of concern:

■ The amount of funds available to the department

The Treasury has indicated that the funding available for ECGD will be £1.7bn down, with no ability to apply for more. This would give other nations such as the US an unfair advantage, which is explained below in the following quote from the CFUSASI.

Summary

Amicus acknowledges that in order for the UKDI to maintain a truly world class manufacturing sector, unions and industry will have to be globally competitive. We believe we can achieve this but only if the government provides the right environment for UKDI to flourish. Amicus states unequivocally that the UKDI can neither flourish nor compete globally bound in the fiscal shackles of an ECGD any less favourable than that which currently exists. For the Treasury or any other Department of HMG to maintain other wise is nothing short of hypocrisy.

“Export-Import Bank loan guarantee applications are rigorously reviewed for commercial viability and risk before they are approved. Nonetheless Ex-Im Bank has congressional appropriated funds to cover losses from high risk projects that exceed program fees.”

■ **Appropriate method of calculating capital allocation to individual transactions**

This will have obvious implications for premium levels but also calls into question the ability to allocate sufficient capital to ‘large and lumpy deals’ such as those associated with defence and aerospace products.

■ **Level of Return on Capital Expenditure (ROCE) to be imposed on the trading fund**

The level of ROCE set must be competitive in the global marketplace. During the consultation process a figure of 6% was quoted but subsequently this has changed to 11%. The importance of a competitive level for the UK is similar to that of a credit card, the most successful have the lowest interest rates and the greatest flexibility.

■ **Transferring budgetary responsibility, for the trading fund to the DTI, including liability for catastrophic losses**

Setting the level of ROCE at an inappropriately high level would absorb a level of resource disproportionate to the risk. In addition the DTI may not have the benefit of the spread of the existing portfolio to absorb catastrophic losses or the ability or capital to trade through a downturn.

■ **Reluctance to provide support to rich markets**

This is of particular concern to new programmes with long lead times and high asset acquisition costs where even the best of credits will require the comfort of an ECA supported backstop before having the confidence to place an order, e.g. Singapore Airlines/A380.

■ **Mechanism to review in a case of market**

Once the new trading fund is established there must be a mechanism in place that can monitor the effects that the new fund is having on the UK’s ability to remain competitive. The highly skilled nature of the defence industry means that we must be able to react quickly if employment numbers are adversely affected as a result of the new fund.

Amicus believes this could be achieved by establishing an interim panel of industry, trade union and government officials to monitor the new ECGD. The panel would also have the ability to recommend and implement changes should the UK market start to fail.

■ **Promotion of the Department’s value to the UK economy and our trading partners**

The ECGD underpins a number of truly world-class industries and should itself be seen as world-class. A greater awareness of what the Department helps to achieve should be available. The panel referred to above would also ensure that there is greater awareness of what the ECGD brings to the UK economy and be able to continually benchmark the UK with alternatives offered by other leading nations.

4 Conclusions



Future Carrier has raised concerns over skills shortages within UK shipbuilding

Amicus recommend that UK government adopt the following approach:

■ An increase in defence spending to match the growing commitment of the MOD

Defence spending has relatively low percentage rises when compared to other Government departments. At the time of increasing international uncertainty and conflict this is not only unwise but also unacceptable.

Government Department Spending Real Terms Increase from 97/98 to 05/06

Department for International Development	61%
Home Office	60%
Education	51%
Health	50%
Defence	3%

■ Improvements to the Defence Industrial Policy

Including a greater focus on technology transfer and through-life contracts.

■ Maintaining a competitive ECGD

Establishing a tri-partite committee to monitor the current situation, with the authority to act in case of market failure.

■ ITAR Waiver

Continue to work for a blanket exemption for UK industry similar to that enjoyed by Canada.

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