

OPENING UP EUROPEAN DEFENCE MARKETS: THE CHALLENGES AHEAD

In principle EU governments agree that they need to open up their defence markets. Governments have already agreed to a defence procurement code-of-conduct proposed by the European Defence Agency, but the EDA cannot force governments to comply with the code. EU governments, therefore, should respond positively to the recent legislative proposals from the European Commission. Plus, in the ongoing debate about the European defence market, the transatlantic defence market should not be forgotten.

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Eurofighters fly over an airforce base in Neuburg, Germany in 2006

It has become a cliché to observe that Europe's armies need many new military capabilities. But EU governments are still doing very little to remedy the problem. European armed forces struggled to fight alongside the US during the Kosovo war in 1999 because they lacked sophisticated equipment. As a result EU governments signed up to a number of "headline goals" to improve their military prowess. But it is hard to find much concrete evidence of real improvements in European military equipment over the last decade. Moreover, the budgetary challenge faced by European defence ministries is great. The cost of defence equipment is rising by six to eight per cent a year – whereas defence budgets are static – and the growing number of operations is consuming money that had been set aside for buying new equipment.

Given that defence budgets are unlikely to rise dramatically, and that the cost of new military technologies is soaring, governments will need to extract more value out of each euro they spend. It therefore follows that they need to pay more attention to improving European co-operation on armaments. Greater co-operation in armaments could lead to significant benefits, including better value-for-money for taxpayers; greater harmonisation of military requirements and technologies, which helps different European forces to work together more effectively; and a more competitive European defence industry.

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The case for opening up Europe's defence markets

To achieve more effective armaments co-operation, European governments need to do a number of things such as pooling more resources, managing joint equipment programmes better, and in particular opening up their defence markets. The history of European armaments co-operation shows that none of these goals are easy to achieve. NATO, the WEU, and more recently the EU have tried to improve multinational armaments co-operation for decades, with depressingly little success. Defence remains the most 'national' of all policy areas, in the sense that the EU's member-states are very reluctant to give up sovereignty to international organisations.

As a result of this protectionism, a number of EU countries do not buy their weapons from foreign defence companies, unless they do not have an indigenous defence industry, or their national companies do not make the product the government needs. Many still tend to favour their national suppliers irrespective of the price or quality of equipment they produce. They can do so legally because defence goods are exempt from the EU's single market rules (because of their sensitivity). But the absence of cross-border competition makes European weapons expensive.

In theory, a more integrated European defence market would allow free movement of most defence goods amongst EU member-states. Greater cross-border co-operation would allow larger economies of scale, increased industrial competition, and thus lower prices, particularly for more advanced equipment. Defence ministries would be able to purchase equipment from the company that offered the best financial and technical package, regardless of its national origin. Keith Hartley of York University has estimated that a single defence market could save EU governments up to 20 per cent of their procurement funds.¹ EU governments spend roughly €30 billion annually on purchasing defence equipment. Thus, a single defence market could save defence ministries up to €6 billion a year.

The European Defence Agency

Europe's six main arms-producing states (France, Germany, Italy, Spain, Sweden and the UK) recognised the logic of harmonising some defence market rules a decade ago. In 1998 they signed an agreement

known as the 'Letter of Intent', which unfortunately did not have a major impact on cross-border armaments regulations, partly because it only aimed to help transnational companies to operate across borders, and did not establish a common market among the signatories.

In 2004 EU governments created the European Defence Agency (EDA), and one of its many tasks is to encourage the convergence of national procurement procedures. In July 2006 the EDA introduced a defence procurement 'code of conduct' to open up the European defence market. The basic idea behind the code is to ensure that defence companies from any country could compete for most defence contracts across Europe, excluding multinational equipment programmes and the most sensitive goods like encryption devices. The code works rather simply: countries that join the code vow to open all non-essential defence contracts over €1 million to foreign bidders. And the EDA created a web site where those contracts are advertised to potential suppliers.

However, the EDA's code is voluntary, and the member-states are not obliged to comply with it. In fact, they have so far shown very little enthusiasm for awarding contracts to outside suppliers. Although within a year of the adoption of the code, some 15 member-states posted 227 tenders worth some €10 billion on the EDA's web site, only two of the 26 contracts awarded were cross-border.² One EU official, in conversation with the authors, perhaps unfairly compared the defence procurement code of conduct to a smoking ban in pubs and restaurants: "The code tells you when you can and cannot smoke, but it doesn't mean you give up smoking".

But the importance of the code lies as much in its principle as its practice. The idea of more open European defence markets has been around for decades, but with little or no progress until the code. Never before have so many European governments agreed that they should open up their defence markets to each other. And the EDA should continue to build on the growing member-state participation in the code. For instance, EU governments could encourage further industrial consolidation by extending the EDA's code-of-conduct to future multinational programmes (they are currently exempt) within ten years. This would help increase the transparency of the tender procedure for multinational programmes and encourage more joint tenders and competition for contracts, which should help keep prices down.

1. K.Hartley, 'The future of European defence policy: an economic perspective', *Defence and Peace Economics*, vol.14, n°2, January 2003, p.107-115.

2. 'A successful first year of operation of the Code of Conduct on Defence Procurement', European Defence Agency, *EDB Newsletter*, November 2007.

The European Commission

The difficulty of adhering to a strictly inter-governmental approach is that it may prove inadequate, due to the limitations of agreements like the EDA's code of conduct and competing national interests. A European institution should be involved in running a more open defence market. The European Commission would like to take on the task of regulating a European defence market. Currently, defence goods related to the 'essential interests of security' – as stipulated in Article 296 of the EU treaties – are one of the notable exclusions from the Commission's regulation of European industry. The Commission's role in the defence market is confined to 'dual-use' products that are components of both civilian and military equipment. But the defence market would benefit from the Commission's experience in policing the single market for commercial goods and services.

However, given the sensitive nature of the defence market, some arms-producing countries are reluctant to give much new regulatory power to the Commission. The main arms-producing countries in Europe have traditionally adhered to a strict interpretation of Article 296. This has prevented the Commission from having a meaningful involvement in the defence market, with the result that governments can protect their national companies from foreign competition.

But this may be changing due to two factors: the defence budget crunch; and the Commission's new approach to defence market rules. The Commission is not proposing to change Article 296, as appeared to be the case with its past legislative initiatives. Instead the objective of Commission's new 'defence package' is to set up a new legal framework for security and defence related procurement and intra-EU trade of defence equipment. The legislative aspects of the 'defence package' contain two proposals for directives on procurement and trade. These texts are currently being examined by EU governments and the European Parliament, a process which will continue during 2008.

The procurement directive would establish four types of procedures to help streamline national procurement procedures. These are: restrictive calls for tender; negotiated procedures with publication; competitive dialogue; and negotiated procedure without publication. The proposal seems both fair and sensible, because it strikes a balance between opening defence markets to allow more industrial competition and the sovereignty imperatives related to defence procurement that governments worry about. Moreover, the text includes not only defence but also security equipment tenders. This is important for two reasons: first, because the frontier between 'defence' and 'security' equipment is blurring. Second, because the EDA code of conduct does not cover security items. Like the code of conduct, the procurement directive would encourage the opening of European defence markets, but with a broader

approach (including security products) and it would be legally binding.

The trade directive aims to liberalise the trade of defence goods within the EU (also known as intra-community transfers). Currently, intra-community transfers follow the same rules as those regulating exports of European defence goods to governments outside the EU. Each year, between 11-12,000 export licences are requested for defence transfers between EU governments, and almost all get clearance. However, this fragmented system causes extra costs and many delays, undermining European industrial competitiveness. More broadly, such practices constitute a barrier to creating a more integrated European defence equipment market, as they affect both large transnational defence companies and small and medium-size enterprises further down the supply chain.

Practically, the Commission proposes to replace the current system of individual licences (whereby an individual licence is required for each transaction), by a system of general licences covering several different transactions for those intra-community transfers where the risks of undesired re-exportation to third countries are firmly controlled.³ Member-states are likely to agree on this directive in some form, because although it aims to harmonise the rules and procedures for intra-community transfers, it leaves governments room for manoeuvre. Governments would still have the responsibility to allocate licences, and in no way would it give the Commission the competence to regulate defence exports to countries outside the EU.

The changing transatlantic defence market

In the ongoing debate about the European defence market, the transatlantic defence market should not be forgotten. Indeed, any opening of the European defence market should be complemented by a reform of the transatlantic defence market. This is because slowly but surely, the importance of the transatlantic defence market is growing for both governments and industry. Governments on both sides of the Atlantic face hard budgets trade-offs – even in the US, defence expenditures are under stress because of the huge Federal budget deficit, the economic downturn and increasing competition from domestic spending programs (Social Security, Medicare, and Medicaid).

American companies have long won many European defence contracts – witness the number of F-16s owned by EU governments. And they have been increasing their activity in Europe. Lockheed Martin has established 8 joint-ventures with European firms and participates in a number of collaborative pro-

3. This encompasses: purchases by armed forces of other EU member-states; transfers to certified companies of components in the context of industrial cooperation; transfers of products necessary for cooperative programmes between participating governments.

grammes with European partners such as the Joint Strike Fighter and the MEADS air defence system.⁴ Between 2001 and 2003, General Dynamics acquired three European companies: the Spanish Santa Barbara, the German EKW, and the Austrian Steyr. Aside from outright acquisitions and joint programmes, Americans are increasingly investing in European defence companies. In 2002, the US private equity fund, One Equity Partner (OEP) acquired 75% of German shipyard Howaldtswerke Deutsche Werft (HDW) and its propulsion technology. In 2003, the US private equity group Carlyle and the US buy-out group Kohlberg Kravis Roberts & Co acquired two Europeans producers of aircraft engines, respectively FiatAvio and MTU Aero Engines. Up to now, Europeans have been shy to invest in US defence companies, partly because of legal and political barriers, but this is also slowly changing. Between 2001 and 2005, European companies acquired 67 US defence firms, collectively worth €7bn. In May 2008, Finmeccanica acquired the US defence company DRS Technologies for \$4 billion.

European defence companies are also selling more products than before in the US. UK-based BAE Systems has penetrated the US so successfully that not only does it sell more to the US government than any other non-US company, but it also sells more to the American Department of Defence than to the British Ministry of Defence.⁵ Winning US government contracts is not easy for European companies. For example, they have little choice but to open a US-based subsidiary and sign up to the so-called Special Security Arrangements to penetrate the US market, which requires giving up certain rights (limited technology transfers, little say on the industrial strategy).⁶ But some of these investments are starting to pay off. In July 2008, Eurocopter won a contract potentially worth \$150 million, with the US Department of Homeland Security, to provide helicopters to the US Customs and Borders Protection (CBP). The CBP already has 53 Eurocopter helicopters in their fleet. Other examples include: the contract won by Finmeccanica to provide the US Marine One presidential transport fleet with a US (US 101) version of AgustaWestland EH101 Medium-Lift Helicopter, and the US coast guard ordered 5 more CASA HC 235A (8 in total) from EADS. More significantly, EADS and Northrop Grumman are competing with Boeing to win a \$35bn contract to provide the US Air Force with a new generation of aircraft-refuelling tankers.

4. <http://defence-data.com/ripley/pagerip2.htm>.

5. David Robertson, 'Milestone for BAE as its trade with America outstrips MoD business', *The Times*, Times Newspapers, 10/08/2007.

6. European companies opening a subsidiary in the US to penetrate the market have to comply with the Special Security Arrangement (SSA). According to the SSA, the board of the company must only be composed of both American citizens and nationals from the parent company's country. However it also means only American managers can participate when issues related to national security are raised. In addition, the SSA requires the company to be run under American law and by American citizens.

Reforming transatlantic rules

Like their European counterparts, the US government also has difficulties striking the right balance between security and competitiveness in its defence procurement laws. The International Traffic in Arms Regulations (ITAR) in the US, along with the absence of any binding EU policy on export controls, has strangled EU-US defence trade. Because the ITAR is not sufficient for encouraging more defence trade with allies, the Bush Administration has coined the US-UK treaty which has yet to be ratified by the US Senate.⁷ This bilateral treaty offers privileges to British entities only. The danger is that such a restriction could lead to a two-tier European defence market with non-British firms lagging behind. Also, in its current form, this treaty may not do very much boost transatlantic cooperation because it does not cover multinational programmes such as the Joint Strike Fighter.

Ideally, the next US administration would consider enlarging the UK-US Treaty on defence equipment to all EU governments, and grant all European defence and security companies a 'licence-free label'. But that would require EU governments to first agree to streamline their defence market legislation, for example by adopting the Commission's directive proposals. This would encourage the next US administration to treat 'Europe' as one market, rather than sticking to its current government-by-government approach. For the US, what matters in a globalising world is the security of their exports and transfers of technology. The US cannot consider extending the UK-US treaty (or any waivers from licensing of defence items) as long as the EU does not have its own common binding rules.

Conclusion

In different ways the European Defence Agency and the European Commission are trying to break up a highly protectionist defence market, which should help improve many defence ministries' bottom lines. If both the EDA and the European Commission manage to convince EU governments to open up their defence markets, those benefiting would include the defence industry, which would become more competitive; the armed forces, that would get badly needed military equipment at a better price; and the taxpayers, who would get better value for money. Plus streamlining Europe's defence markets would also help to reform the rules for transatlantic defence trade. European defence companies would profit from gaining better access to the world's largest defence budget – and they could in theory pass on part of the profits to European governments in the form of lower per-unit costs for European defence equipment.

7. The UK and the US signed a treaty in June 2007 to soften defence procurement rules within their "security community" (it mainly consists in streamlining the licence approval process and in providing licensing exemptions for unclassified items for certain pre-approved firms).