Chaillot Paper

November 2008

n°113

Towards a European Defence Market

Erkki Aalto, Daniel Keohane, Christian Mölling and Sophie de Vaucorbeil

Edited by Daniel Keohane

Institute for Security Studies
Institut d'études de Sécurité
European Union
Union européenne

In January 2002 the **European Union Institute for Security Studies (EUISS)** became an autonomous Paris-based agency of the European Union. Following an EU Council Joint Action of 20 July 2001, modified by the Joint Action of 21 December 2006, it is now an integral part of the new structures that will support the further development of the CFSP/ESDP. The Institute's core mission is to provide analyses and recommendations that can be of use and relevance to the formulation of the European security and defence policy. In carrying out that mission, it also acts as an interface between European experts and decision-makers at all levels.

Chaillot Papers are monographs on topical questions written either by a member of the EUISS research team or by outside authors chosen and commissioned by the Institute. Early drafts are normally discussed at a seminar or study group of experts convened by the Institute and publication indicates that the paper is considered by the EUISS as a useful and authoritative contribution to the debate on CFSP/ESDP. Responsibility for the views expressed in them lies exclusively with authors. *Chaillot Papers* are also accessible via the Institute's website: **www.iss.europa.eu**

Chaillot Paper

November 2008

n°**113**

Towards a European Defence Market

Erkki Aalto, Daniel Keohane, Christian Mölling and Sophie de Vaucorbeil

Edited by Daniel Keohane

Institute for Security Studies
European Union
Paris

Institute for Security Studies
European Union
43 avenue du Président Wilson
75775 Paris cedex 16
tel.: +33 (0)1 56 89 19 30
fax: +33 (0)1 56 89 19 31
e-mail: info@iss.europa.eu
www.iss.europa.eu

Director: Álvaro de Vasconcelos

ISSN 1017-7566
ISBN 978-92-9198-131-1
QN-AA-08-113-EN-C
Published by the EU Institute for Security Studies and printed in Condé-sur-Noireau (France) by Corlet Imprimeur. Graphic design by Claire Mabille (Paris).

Contents

n° 113 November 2008

Introduction – Towards a European Defence Market

Daniel Keohane

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. For instance, it took a full six months to find only 16 helicopters and 10 transport planes for the current EU peacekeeping mission in Chad. Moreover, European defence ministries are facing significant budgetary challenges. The cost of defence equipment is rising by six to eight percent a year – whereas defence budgets are static – and the growing number of military 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 cooperation on armaments. Greater cooperation 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.

The case for opening up Europe's defence markets

To achieve more effective armaments cooperation, 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 cooperation shows that none of these goals are

easy to achieve. NATO, the WEU, and more recently the EU have tried to improve multinational armaments cooperation 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 (due to 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 among EU Member States. Greater cross-border cooperation 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 percent of their procurement funds.[1] EU governments spend roughly 30 billion euro annually on purchasing defence equipment. Thus, a single defence market could save defence ministries up to 6 billion euro 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 con-

1. Keith Hartley, 'The future of European defence policy: an economic perspective', *Defence and Peace Economics*, vol.14, no. 2, January 2003, pp.107-15.

vergence 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 of Conduct (CoC) works rather simply: countries that join the CoC vow to open all non-essential defence contracts worth over one million euro to foreign bidders. And the EDA created a website 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 CoC, some 15 Member States posted 227 tenders worth some 10 billion euro on the EDA's website, only two of the 26 contracts awarded were cross-border.[2] One EU official, in conversation with this author, 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 CoC 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 CoC was introduced. 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 CoC. 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.

The European Commission

The difficulty of adhering to a strictly intergovernmental approach is that it may prove inadequate, due to the limitations of agreements like the EDA's Code of Conduct and competing

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

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. As Erkki Aalto demonstrates in Chapter One of this *Chaillot Paper*, Article 296 is vague and difficult to interpret both legally and politically, making it a major obstacle to a more smoothly functioning European defence market. Member States and the European Commission have often disagreed on the exact scope of the Article, and in recent years they have increasingly needed the judgement of the European Court of Justice (ECJ) to resolve their differences.

The European 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 the 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 until the end of 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 CoC, 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. Member States could still refer to Article 296, but they would have to explain why they did not wish to use the new procurement system.

The trade directive aims to liberalise the trade of defence goods within the EU (also known as intra-Community transfers). Currently, as described by Christian Mölling in Chapter Two, 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-sized 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.

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.

The changing transatlantic defence market

In the ongoing debate about the European defence market, as Sophie de Vaucorbeil explains in Chapter Three, 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 budgetary 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 programmes (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 eight joint-ventures with European firms and participates in a number of collaborative programmes 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 European producers of aircraft engines, respectively FiatAvio and MTU Aero Engines. Up to now, Europeans have been more reticent about investing 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 7 billion euro. In May 2008, Finmeccanica acquired the US defence company DRS Technologies for four billion dollars.

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 Defense than to the British Ministry of

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

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 dollars, 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 coastguard ordered 5 more CASA HC 235A (8 in total) from EADS. More significantly, EADS and Northrop Grumman are competing with Boeing to win a 35 billion dollar contract to provide the US Air Force with a new generation of aircraft-refuelling tankers.

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 drawn up the UK-US Defence Trade Cooperation 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 to 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 adopt-

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

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).

ing 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. Plus streamlining Europe's defence markets would also create new incentives to reform the rules for transatlantic defence trade. 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, who would get badly needed military equipment at a better price; and the taxpayers, who would get better value for money.

Interpretations of Article 296

Erkki Aalto

1

[Any opinions expressed in this chapter are the sole responsibility of the author and do not necessarily represent the official position of the Ministry of Defence of Finland. The author wishes to thank the staff of the EUISS and various national and EU officials for their comments and support.]

Introduction

The European Union's Member States spend 200 billion euro annually on defence, of which 15% is used for defence procurement.[1] The money on defence procurement is not spent on a single market (the European Defence Equipment Market) but rather on 27 different national markets. Indeed, the European Union's internal market has not traditionally included defence equipments. The reason for this derives from Article 296 of the Treaty establishing the European Community (EC), which allows a Member State to exempt defence equipments from the common market when its essential security interests are threatened.

Defence was not originally incorporated into the supranational EC Treaty. In 1950 the French foreign minister René Pleven presented a plan whose goal was the creation of an integrated European Army. This initiative led to an agreement on the formation of the European Defence Community (EDC) in 1952 which consisted of several supranational components: a European Army, a common budget and joint institutions. The EDC never became a reality because it was rejected by the French National Assembly in August 1954. One important factor behind the French rejection was doubt concerning the supranational components in the agreement.[2] Integration among the European states moved into the field of economic cooperation in 1957 when the EC Treaty was signed. After the failure of the EDC, the EC Treaty was considered to exclude any notion of a common regime on defence issues. Article 296 EC was considered a manifestation of this general exclusion.[3]

Article 296 EC has thus *de facto* excluded defence cooperation from the European Communities. After the failure of the EDC, the two defence organisations, the Northern Atlantic Treaty Organisation (NATO) and the Western European Union (WEU) acquired roles as the two major arenas of cooperation in the field

1. European Defence Agency, *National Defence Expenditure in 2006*, Brussels, November 2006. Available online at: www.eda.europa.eu.

2. Ulrika Mörth, *Organizing European Cooperation - The Case of Armaments* (Lanham, MD: Rowman & Littlefield, 2003), pp 33-34.

3. Martin Trybus, 'The EC treaty as an Instrument of European Defence Integration: Judicial Scrutiny of Defence and Security Exceptions', *Common Market Law Review*, no. 39, 2002, pp. 1347-72, p. 1355.

of armaments in Europe. Both organisations have been trying to improve multinational armaments cooperation for decades 'with depressingly little success'[4] as one observer has concluded.

The wording of Article 296 EC has remained unaltered in the Maastricht, Amsterdam, Nice and Lisbon treaties.[5] However, the world environment in which the article was formulated has changed. Although each European state still sees it as its duty to maintain its own defence industrial self-sufficiency in armaments as much as possible, the cost of this self-sufficiency has become too heavy since the end of the Cold War. The consolidation of the armaments industry, increasing development costs of complex weapon systems, the fragmentation of defence markets, different regulatory frameworks, dwindling defence budgets, diminishing national control over defence companies, increasing competition with the US and the modest results achieved from the money invested in armaments have urged the Member States, the Commission and the defence industry to find ways to cope with this situation.

Interpreting Article 296 EC is closely linked to the development of the European Security and Defence Policy (ESDP). The use of Article 296 EC as a national security exemption has led to a situation where the Member States make most of their defence purchases on a national basis. This has hampered the development of a proper European Defence Equipment Market and denied both the customer and the industry the benefits of competition, and also hindered the necessary cross-border integration of the European Defence Technological and Industrial Base (EDTIB).[6]

EDTIB is an underpinning of the European Security and Defence Policy because it produces the required capabilities for ESDP. Without a functioning European Defence Equipment Market, EDTIB cannot provide ESDP with the required capabilities at an affordable price.

The two prime actors in the regulatory field of European defence markets, the Member States and the Commission, have switched the focus of the defence market debate to the interpretation of Article 296 EC. This chapter describes the main problems related to the interpretation of the article and considers what new interpretations are available to solve the problems. The chapter, furthermore, seeks to evaluate the legal and political implications of these developments and offers some comments on the future

4. Daniel Keohane, 'The EU and armaments co-operation', CER Working Paper, Centre for European Reform, London, 2002, p. 1.

5. In the Lisbon Treaty Article 296 EC was renumbered as Article 346. The Lisbon Treaty has not yet been ratified.

6. European Defence Agency, 'A Strategy for the European Defence Technological and Industrial Base', 14 May 2007 (approved by Ministers of Defence), at para 10: 'Though comprehensive data are unavailable, we believe that in recent years less than half of defence procurement has been carried out in accordance with the public procurement regulations of the EU internal market; Member States in general have relied on the "national security" exception in Article 296 of the Treaty establishing the European Community to make the bulk of their defence purchases on a national basis. This has had the effect of stunting the development of a proper European Defence Equipment Market – thus denying both the customer and the industry the benefits of competition, and hindering the necessary cross-border integration of the European DTIB.'

regarding these issues. It hopefully also serves as an introduction to the legal debate surrounding Article 296 EC.

The chapter argues that while both the Commission and the Member States have valid arguments in support of their interpretations of Article 296 EC, the European Court of Justice will play a decisive role in interpreting Article 296 EC and therefore *de facto* in laying down the boundaries either for an internal or an intergovernmental market for defence equipment in the European Union.

The chapter is divided into two main sections. The first section will focus on Article 296 EC itself and the problems of the interpretations related to it. The second section will analyse the current interpretations – this meaning the relatively new developments in the past three/four years. At the beginning the Commission's Interpretative Communication and the new defence package will be reviewed. This will be followed by a summary of the main approaches of the Member States to Article 296 EC and by a summary of some of the practical implications of the different interpretations. Finally there will be a brief overview of the current actions involving Article 296 EC that are being brought against Member States by the European Court of Justice.

The interpretation of Article 296 EC – a background

European integration is based on the Customs Union and the Internal Market and its four freedoms. Any restrictions on these freedoms are as a rule prohibited. These principles apply also to defence goods. However, the EC Treaty grants Member States some security and national security exemptions which allow them to derogate from the Treaty under certain conditions.

The EC Treaty and its provisions require frequent interpretation in order to ascertain their correct meaning and to ensure their correct application. This is particularly the case with Article 296 EC which regulates a sensitive field of defence at the borderline of the internal market of the Community and the essential security interests of the Member States. In the first part of this section a brief look at the background and the contents of Article 296 EC will be presented. The main problems of interpreting Article 296 EC will be presented in the second part of this section.

Article 296 EC: what is it?

Due to the historical background of European integration, there is no Community competence[7] for defence in the EC Treaty. However, the Treaty includes legal bases, for example for public procurement and state aid. The crucial question is whether they extend to the defence sector too. It is obvious that defence and armaments also have commercial implications. Public procurement and state aid are all important parts of the EC's internal market and they affect the defence sector just like any other part of industry.[8] The volume of the armaments industry means that it represents a significant part of the industrial base in Europe[9] and therefore also a significant part of the internal market. The very nature of the industry means, however, that it is a special case. The products are not 'washing machines'[10] and the sector affects the very core of sovereignty of the Member States. Therefore it is important to have a mechanism to draw a line between the Community's and the Member States' competences in the sectors of defence where they overlap.[11]

Article 296 EC is this mechanism in the areas of confidential information and armaments. The article has two functions: firstly, to balance the internal market and other interests of the Community with the national security interests of the Member States; and secondly to give a Member State the right to derogate from the general obligation to supply information to the EU when its essential security interests are threatened. In the EC Treaty there are also other security exemptions that have a similar kind of role. The European Court of Justice ruled in *Johnston*[12] that the EC Treaty includes security exemptions which can be found in Articles 36 (now Art. 30), 48 (now Art. 39), 56 (now Art. 46), 223 (now Art. 296) and 224 (now Art. 297) EC.

These security exemptions could be divided into two categories: the first would consist of Articles 30, 39 and 46[13] EC and the second of Articles 296[14] and 297[15] EC. The basic difference between the two categories is that the exemptions in Articles 296 and 297 EC Treaty are more comprehensive than the exemptions in Articles 30, 39 and 46 because they allow derogation from the EC Treaty as a whole and not only from a particular internal market regime.[16] Articles 296 and 297 EC are in the grey area of competences overlapping between the Community and the Member States and therefore they define the limits of the EC Treaty as an instrument of European defence integration.[17] Furthermore, Articles 296 EC and 297 EC are subject to a special review procedure stated in Article

7. A Community competence in a certain policy field must always be expressed in the Treaty. A legal base is a provision in the Treaty that expressly allocates the competence for action on a particular subject matter to the Community. It prescribes the legal instrument to be used, the Community institutions involved in the legislative process, and the required majorities for the legislation to pass. See: Martin Trybus, 'The Limits of European Community Competence for Defence', *European Foreign Affairs Review*, vol. 9, no. 2, 2004, pp. 189-217, p. 192.

8. Martin Trybus, op. cit. in note 3, p. 1347.

9. The European defence industry employs more than 300,000 people and has an annual turnover of over 55 billion euro. European Commission, 'A Strategy for a Stronger and More Competitive European Defence Industry', Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2007)764 final, Brussels, December 2007, at introduction. The defence industry is also more and more regarded as a normal industrial activity and like all other industrial activities it is required to deliver increased efficiency to provide value for money to its customers and to protect shareholders' interests.

10. The former Chief Executive of the European Defence Agency (EDA), Nick Witney, has on several occasions stressed this difference. See for example his speech delivered in Berlin, 12 June 2007 (www.eda.europa.eu). Also the present CE of the EDA, Alexander Weis, states that 'the European market for tanks does not operate in the same way as the market for washing machines.' See press release of 5 December 2007 (www.eda.europa.eu).

11. Martin Trybus, 2004, op. cit. in note 7, p. 194.

12. Case 222/84, *Marguerite Johnston v Chief Constable of the Royal Ulster Constabulary* [1986], European Court Report no. 1651, 15 May 1986. See para 26 of the judgment.

298 EC.[18] It is also worth pointing out that Article 296 EC does not oblige Member States to consult each other, as Article 297 EC does, when a Member State wants to deviate from the Treaty.

Article 296 EC states:

1. The provisions of this Treaty shall not preclude the application of the following rules:
   (a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;
   (b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.
2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.[19]

The article can, indeed, be regarded as a fundamental exception in EC law because it allows a Member State to derogate from the whole Treaty in circumstances where the application of the Treaty would undermine that Member State's security. The (a) part of the first paragraph of the article gives a Member State a right to derogate from the general obligation of a Member State to supply information to the institutions of the Union when its essential security interests are threatened. The (b) part of the first paragraph allows a Member State to take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of trade in arms, munitions and war material. The article, however, also states that these measures should not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes. The scope of the (a) part can be regarded as wider than the (b) part because it is not connected to the list mentioned in the second paragraph.

The second paragraph refers to a list of the products to which the provision of 1(b) applies (this list is reproduced on pages 19-20). It is

13. These exemptions justify restrictions on the basic freedoms mainly on grounds of public morality, policy or public security.

14. See note 20.

15. Article 297 EC: 'Member States shall consult each other with a view to taking together the steps needed to prevent the functioning of the common market being affected by measures which a Member State may be called upon to take in the event of serious internal disturbances affecting the maintenance of law and order, in the event of war, serious international tension constituting a threat of war, or in order to carry out obligations it has accepted for the purpose of maintaining peace and international security.'

16. Martin Trybus, 2004, op. cit. in note 7, p. 200.

17. Martin Trybus, *European Union Law and Defence Integration* (Oxford: Hart, 2005), p. 140. See also: Stacy N. Ferraro, 'The European Defence Agency: Facilitating Defense Reform or Forming Fortress Europe?', *Transnational Law and Contemporary Problems*, no. 16, 2007, p. 592.

18. Article 298 EC: 'If measures taken in the circumstances referred to in Articles 296 and 297 have the effect of distorting the conditions of competition in the common market, the Commission shall, together with the State concerned, examine how these measures can be adjusted to the rules laid down in the Treaty. By way of derogation from the procedure laid down in Articles 226 and 227, the Commission or any Member State may bring the matter directly before the Court of Justice if it considers that another Member State is making improper use of the powers provided for in Articles 296 and 297. The Court of Justice shall give its ruling in camera.'

19. Article 296 (ex Article 223) EC Treaty.

important to point out that the version of the list presented on pages 19-20 is not the only version available of the 1958 list.[20] This list has been made public through a reply to a written question in the European Parliament. The original list has not been officially published in the *Official Journal*. The paragraph also describes the mechanism via which the list could be modified: it requires a unanimous decision in the Council and the proposal to change it has to come from the Commission. The wording of Article 296 EC itself has remained unaltered in the Maastricht, Amsterdam, Nice and Lisbon treaties .

Article 296 EC is thus a powerful tool because it allows a Member State to derogate from the whole EC Treaty when its application would undermine that Member State's security. The article also plays a key role as a balancing mechanism between the interests of the Community and the security interests of the Member States. These two factors make the correct interpretation of the article a sensitive issue.

The problems of interpreting Article 296 EC

The interpretation and application of Article 296 EC have wide implications legally as well as politically. One of the core questions is whether this article makes the creation of an internal market for defence equipments possible. Legally these implications derive from diverging applications of the article which are rooted in its different interpretations.

In the following, six observations will be presented on the interpretation of Article 296 EC. These observations are all interlinked. This analysis is not meant to be exhaustive but rather to highlight the main problems attached to the interpretation.

First, Article 296 EC refers to 'the essential interests of the security' of a Member State. How can these be defined? One does not have to go into an in-depth legal debate to conclude that legally this is impossible. Politically this is possible but you will get as many different answers as the number of people who are answering that question. And this probably is the biggest problem. There is simply no common or European definition for 'the essential interests of the security'[21] of a state. In the end the question is more or less about who will define them. In *Commission vs. Spain*[22] the European Court of Justice concluded that 'the VAT exemptions are not

20. See note 24.

21. It is possible to infer a State's essential security interests for example from its Constitution, legal acts and white papers on defence. But defining them is particularly difficult because 'essential security interests' is a political concept.

22. Case C-414/97 *Commission of the European Communities v. Kingdom of Spain* [1999], European Court Report, Judgment of 16 September 1999, p. I-5585. The case *Commission v. Spain* was the first case dealing specifically with the exemption in Article 296(1) (b) EC. In the case the Court ruled against a Spanish law exempting armament exports from VAT. Spain had invoked Article 296 EC to justify the exemption from VAT.

necessary in order to achieve the objective of protecting the essential interests of the security of the Kingdom of Spain.'[23] The Court therefore ruled that Spain may define its essential interests but that in the present case it had not been necessary for Spain to resort to VAT exemptions in order to secure these interests. This in principle could put the Member States' sovereignty in defining and defending essential security interests in doubt: if a Member State cannot choose the means to protect its essential security interests, what is the point of having them in the first place? This question should be separated from the question of whether the Member State has not acted in good faith when exercising its right to derogate from the Treaty.

The *second* major problem of the interpretation relates to the list mentioned in paragraph (1) (b) of Article 296 EC. This list was drawn up in 1958. As has already been stated, this list has not been officially published in the EU's *Official Journal* and different versions of the list are available in the public domain.[24] In the answer to a written question (E-1324/01) in the European Parliament, the contents of the list were rendered public.

These are as follows:

'1. Portable and automatic firearms, such as rifles, carbines, revolvers, pistols, sub-machine guns and machine guns, except for hunting weapons, pistols and other low calibre weapons of the calibre less than 7 mm.

2. Artillery, and smoke, gas and flame throwing weapons such as: (a) cannon, howitzers, mortars, artillery, anti-tank guns, rocket launchers, flame throwers, recoilless guns; (b) military smoke and gas guns.

3. Ammunition for the weapons at 1 and 2 above.

4. Bombs, torpedoes, rockets and guided missiles: (a) bombs, torpedoes, grenades, including smoke grenades, smoke bombs, rockets, mines, guided missiles, underwater grenades, incendiary bombs; (b) military apparatus and components specially designed for the handling, assembly, dismantling, firing or detection of the articles at (a) above.

5. Military fire control equipment: (a) firing computers and guidance systems in infra-red and other night guidance devices; (b) telemeters, position indicators, altimeters; (c) electronic tracking components, gyroscopic, optical and acoustic; (d) bomb sights and gun sights, periscopes for the equipment specified in this list.

23. Para 22 of the judgment.

24. See for example: Martin Trybus, *European Defence Procurement Law – International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe* (The Hague: Kluwer Law International, 1999), pp. 14-15; See also the University of Pittsburgh's Archive of European Integration at http://aei.pitt.edu/935/01/Article_223_decision.pdf.

6. Tanks and specialist fighting vehicles: (a) tanks; (b) military type vehicles, armed or armoured, including amphibious vehicles; (c) armoured cars; (d) half-tracked military vehicles; (e) military vehicles with tank bodies; (f) trailers specially designed for the transportation of the ammunition specified at paragraphs 3 and 4.

7. Toxic or radioactive agents: (a) toxic, biological or chemical agents and radioactive agents adapted for destructive use in war against persons, animals or crops; (b) military apparatus for the propagation, detection and identification of substances at paragraph (a) above; (c) counter-measures material related to paragraph (a) above.

8. Powders, explosives and liquid or solid propellants: (a) powders and liquid or solid propellants specially designed and constructed for use with the material at paragraphs 3, 4 and 7 above; (b) military explosives; (c) incendiary and freezing agents for military use.

9. Warships and their specialist equipment: (a) warships of all kinds; (b) equipment specially designed for laying, detecting and sweeping mines; (c) underwater cables.

10. Aircraft and equipment for military use.

11. Military electronic equipment.

12. Cameras specially designed for military use.

13. Other equipment and material.

14. Specialised parts and items of material included in this list insofar as they are of a military nature.

15. Machines, equipment and items exclusively designed for the study, manufacture, testing and control of arms, munitions and apparatus of an exclusively military nature included in this list.'[25]

Therefore one must ask what is the legal status of the list made public in relation to the written question? Martin Trybus offers a comprehensive analysis of the list that was rendered public in the answer to the written question in the European Parliament. His first two observations do indeed give some food for thought:

'First, the list contained in this response is shorter and less detailed than those previously in the public domain. [...] Second, *prima facie* category 13 on "other equipment and material" represents an open category where the Council or the Member States could add any type of product they could think of when first compiling the list in 1958. This would undermine the exhaustive character of the list. [...] However, this first impression is only caused by the lack of detail of the list provided by the Council.'[26]

25. *Official Journal*, C 364 E, 20 December 2001, pp. 0085-0086.

26. Martin Trybus, op. cit. in note 17, pp. 145-46.

The doubts about the legal status of the list rendered public by the written answer do not serve legal certainty. Indeed legal certainty is one of the core principles of law stating that the European institutions, the Member States and individuals must be in a position to know what products are in the list and therefore which products could be excluded from the common market.[27] Furthermore, although one can only surmise as to the reasons why the list published in answer to the written question is not the same as the one which is claimed to be the original,[28] one must ask why the European Court of Justice, the Member States and the Commission have not commented on this situation in the European Court of Justice cases where the list has been a subject of debate[29] and why the list was never published in the first place.[30] At the current point in time, one might also expect that this list would be available to the public in all of the EU's official languages. The experts of the Member States' governments and the Commission have been aware of the list and have used it but the list seems to have remained a mystery to many outsiders.

From a practical point of view the list can be regarded as a relatively up-to-date document although compiled 50 years ago.[31] The basic and the most fundamental problem, nevertheless, is that the list contained in the response to the Parliament is not legally binding.

The *third* interpretation problem concerns the margin of interpretation of the article. This is directly connected to the problems of defining the 'essential security interests' and the 'legal value of the 1958 list.' In practice, the question regarding the margin of interpretation can be presented in two parts: first, whether Article 296 EC can be interpreted as a general and automatic exemption of the Treaty or whether the derogation should be applied on a case-by-case basis; and second, how to interpret the phrase 'as it considers necessary': can a Member State solely determine its security needs or can the Member States' assessments be subjected to some form of scrutiny?

The Member States have interpreted Article 296 EC as a general and automatic exemption of hard defence material from the application of the Treaty. Indeed, the plain wording of Article 296 EC seems to support this view: the Member States may invoke the provision and deviate from Community law when they judge it necessary for the protection of the essential interests of their security. The major arms-producing states in the EU have

27. Katharina Eikenberg, 'Article 296 (ex 223) E.C. and External Trade in Strategic Goods', *European Law Review*, no. 25, 2000, pp. 117-38, pp.128-29.

28. The list can be found at the University of Pittsburgh's Archive of European Integration at http://aei.pitt.edu/935/01/Article_223_decision.pdf.

29. See note 44.

30. For example in Case T-26/01 *Fiocchi Munizioni v Commission*, the Court analysed the Article 296 (1)(b) and the 1958 list extensively but it did not comment on its legal status. See paras 57, 59, 61-63 of the judgment.

31. See also: Martin. Trybus, op. cit. in note 17, p. 147.

been in favour of a broad interpretation of Article 296 EC, stating that almost all goods used for defence purposes are related to 'essential interests of security'[32] Some foreign ministries have also seen this question as being directly related to the sovereignty of Member States.[33]

The European Court of Justice and the Commission have taken a different stance. The Court noted in *Johnston*[34] that the EC Treaty includes security exemptions which can be found in Articles 36 (now Art. 30), 48 (now Art. 39), 56 (now Art. 46), 223 (now Art. 296) and 224 (now Art. 297) EC. The Court underlined that the Articles:

> 'deal with exceptional and clearly defined cases. Because of their limited character those articles do not lend themselves to a wide interpretation and it is not possible to infer from them that there is inherent in the Treaty a general provison covering all measures taken for reasons of public safety. If every provision of Community law were held to be subject to a general proviso, regardless of the specific requirements laid down by the provisions of the Treaty, this might impair the binding nature of Community law and its uniform application.'[35]

This view of the Court was re-affirmed in *Commission v. Spain*:[36] there are no general and automatic national security exceptions from the Treaty because large industrial sectors outside the application of the common market would put the effectiveness of EC law into question.[37] Therefore the derogation should be applied on a case-by-case basis.

The phrase 'as it considers necessary' is the second challenge in the margin of interpretation. In *Commission v. Spain* it became apparent that the phrase 'as it considers necessary' does not give a Member State the possibility to determine its needs solely on its own and that the Court is empowered to scrutinise the Member States' assessments. The latter is obvious also from the very existence of Article 298 EC.[38] However, the very existence of Article 298 also demonstrates that the 296 exemption was meant to be different and grant more flexibility to Member States than the other exemptions mentioned in Articles 30, 39 and 46 EC.

The word 'necessary' in the judgment of *Commission v. Spain* implies that the Court might have used a proportionality test in its considerations on the phrase 'as it considers necessary'. The basic idea of a proportionality test is to evaluate whether there is 'a reasonable relationship of the relevant interests involved.'[39] In this

32. Daniel Keohane, op. cit. in note 4, p. 17.

33. Helmut Kuechle, 'The Cost of non-Europe in the Area of Security and Defence', a study commissioned by the European Parliament, Directorate-General for External Policies Of the Union, Directorate B, Policy Department, June 2006, p. 43.

34. Case 222/84. *Marguerite Johnston v Chief Constable of the Royal Ulster Constabulary* [1986] ECR 1651. Para 26 of the judgment.

35. Ibid. The Court has restated its interpretation in cases: C-285/98 *Tanja Kreil v. Federal Republic of Germany* [2000] ECR I-69 and C-273/97 *Sirdar v. The Army Board* [1999] ECR I-7403.

36. Case C-414/97 *Commission of the European Communities v. Kingdom of Spain* [1999], p. I-5585. See also *Kreil* and *Sirdar*

37. Martin Trybus, 'On the application of the E.C. Treaty to armaments', *European Law Review*, vol. 25, no. 6, December 2000, p. 665.

38. See note 18.

39. Martin Trybus, op. cit. in note 17, p. 134.

case, the question was whether Spain acted within the ambit of its discretion and whether it acted arbitrarily or in bad faith. The Court, however, might take into consideration that when dealing with matters of national security, the level of the Court's scrutiny should be low.[40] In *Commission v. Spain* this meant that: first, the decision to exempt exports from VAT was a policy choice and as such came under the remit of the executive and legislative branches of government; second, the government activities in the military field are supported by the military whose judgments cannot easily be substituted by a court of law; and third, in the constitutional system of the EU defence and military security matters are primarily attributed to the Member States and not to the Union. Thus, 'if the Court applied a proportionality test, it only considered the Spanish law to be disproportionate because it represented a clearly unsuitable and manifestly inappropriate measure to ensure national security.'[41]

The question of proportionality is a difficult one and the basic problem there – as in the whole interpretation of Article 296 EC – is to what extent the Community can scrutinise and review a Member State's actions that have been undertaken on the basis of essential national security interests. It is, indeed, challenging to draw a line here because these interests vary in different Member States. Especially in real political terms it is quite hard to imagine that in this sensitive field the judges in Luxembourg would overrule a decision made by a government and its military staff – based on essential security interests – in a case where the use of the Article 296 exemption would not clearly be unsuitable and manifestly inappropriate.

The *fourth* interpretation problem concerns the burden of proof. The Court laid the burden of proof in *Commission v. Spain* on the Member States by stating that 'it is for the Member State which seeks to rely on those exceptions to furnish evidence that the exemptions in question do not go beyond the limits of such cases.'[42] It remains unclear on which legal grounds the Court came to such a conclusion. Indeed, this part of the judgment has been criticised by scholars.[43] Defence is still a competence of the Member States and the task requires flexibility to fulfil this responsibility in a sensitive policy field.

The *fifth* problem of interpreting Article 296 EC relates to the amount of the European Court of Justice's case law available.

40. Ibid., p. 153. Trybus continues: 'The Court will only consider a measure disproportionate when it (1) is clearly unsuitable to promote national security and national security is put forward in bad faith; (2) when the Member State has arbitrarily chosen a measure which is more detrimental to the internal market than necessary: or (3) when the balance between the two interests is manifestly not present.'

41. Ibid., p. 154.

42. Para 22 of the judgment.

43. See Martin Trybus, op. cit. in note 17, p. 158 and Elena Bratanova, 'Legal Limits of the National Defence Privilege in European Union', Paper 34, Bonn International Centre for Conversion (BICC), 2004, p. 19. The Court has also previously been criticised when dealing with Article 296 EC for going too far and for the lack of 'a certain sense of reality.' See Katharina Eikenberg, op. cit. in note 27, p. 138.

Indeed, one can question how developed it is because the Court has dealt with Article 296 EC in only a few cases.[44] The case *Commission v. Spain* was the first case dealing specifically with the exemption in Article 296(1) (b) EC.

Two observations on a lack of case law should be made. First, the law is unclear, because there simply have not been enough cases. One can only speculate why the Commission has not been active in its role as the 'Guardian of the Treaty.'[45] Second, because of the lack of interpretation by the Court, the exemption granted in Article 296 EC has arguably been abused by the Member States in two ways: the first one was to extend the exclusion to goods that are not on the 1958 list; the other one was to protect the national defence equipment markets, thereby leading to separate markets for warlike products.[46]

The *sixth* problem of interpreting Article 296 EC concerns the indirect[47] effects of interpreting the article. The first challenge is the question of dual-use goods and whether they are covered by the article. The Member States have been in favour of including the dual-use products under the article.[48] This approach is questionable because they are not covered by the 1958 list and therefore the exemption from the Treaty is not possible.[49] But how to define what is a dual-use product?[50] The same kind of problem occurs in the field of state aid because many defence-related companies manufacture both strictly military and non-military products.[51] The second challenge is the principle of parallelism[52] in EC law. If the Commission has the competence in regulating the internal market of defence equipment in the area where Article 296 EC would not apply, it might have the same external competence. This means that the external trade of defence goods could be a part of Community competence under Article 133 EC. The third challenge is that the interpretation of Article 296 EC will also have an effect on the scope and the competences of the Community policies in: standardisation, defence-related industries, intra-Community transfers, competition, defence procurement spending, the export-control of dual-use goods and defence research. The fourth challenge is that the interpretation will also have an influence on the institutional balance and the pillar structure. The second pillar (the Common Foreign and Security Policy, CFSP) has included a provision on armaments cooperation since the signing of the Amsterdam Treaty (Article 17 (1)(d) now Article 17(1)(c)

44. In addition to the case presented in this chapter, the Court has dealt with Article 296 EC in C-285/98 *Tanja Kreil v. Federal Republic of Germany* [2000] ECR I-69 and C-273/97 *Sirdar v. The Army Board* [1999] ECR I-7403. In Case C-367/89, Richardt [1991] ECR I-4621 the Court, following the opinion of Advocate General Jacobs (Para 30, Opinion of Mr. Advocate General Jacobs delivered on 8 May 1991, Criminal proceedings against *Aimé Richardt and Les Accessoires Scientifiques SNC*, Case 367/89), did not deal with Article 296 EC. Furthermore, the Court also considered it unnecessary to deal with Article 296 EC in Case C-70/94, *Frtiz Werner Industrie-Ausrüstungen GmbH v Germany* [1995] ECR I-3189 and in Case C-83/94 Criminal Proceedings against *Peter Leifer* [1995] ECR I-3231.

45. See for example: Martin Trybus, op. cit. in note 3, p. 1355. 'Perhaps the Court did not want to jeopardize the acceptance of its judicial activism in other areas by avoiding this politically particularly sensitive provision. However, the provision was not the issue in many cases. Thus there was probably also a reluctance of the Commission to bring an action in cases involving Article 296(1) (b) EC. This reluctance could have been motivated by the search for a "clear case". The Commission might have wanted a safe chance to win a precedent that provides a narrow interpretation to limit the application of the provision in practice.'

46. Martin Trybus, op. cit. in note 3, p. 1355.

47. One should take into account the indirect effects of the different interpretations of Article 296 EC when considering correct interpretation of Article 296 EC in order to avoid unwanted or unintentional side-effects.

48. Katharina Eikenberg, op. cit. in note 27, p.121.

49. Martin Trybus, op. cit. in note 17, p. 149.

50. See: Council Regulation (EC) No 1334/2000 of 22 June 2000 setting up a Community regime for the control of exports of dual-use items and technology.

51. Elena Bratanova, op. cit. in note 43, p. 13.

Treaty on European Union, TEU). The interaction between Article 17 TEU and Article 296 EC leads to a curious legal situation where 'it depends on the circumstances of each individual case where a Member State invoked Article 296 (1) (b) EC, whether the EC Treaty covers armaments, whether they are not covered by the EC Treaty but by the CFSP, or outside both the EC Treaty and the CFSP.'[53]

In conclusion, EC law and its provisions are always subject to interpretation. Article 296 EC is not an exception in this sense. What makes it special is its nature as the balancing mechanism between the interest of the Community and the essential security interests of the Member States. The remarks presented in this section highlight the problems of interpreting Article 296 EC. The problems can be detected in the different applications of the EC law in different Member States. Therefore, it can be argued that due to different interpretations the law regarding Article 296 EC is not clear.

Concluding remarks

The first conclusion of this section is that Article 296 EC is a safety net for the Member States in the areas of confidential information and armaments. They can invoke it when their essential security interests are threatened. From the Community's perspective the article is a fundamental exception to the EC Treaty and not only to a specific internal market regime like Articles 30, 39 and 46 EC.

The second conclusion is that Article 296 EC is about law and politics. On the one hand, the article is a part of supranational EC law, but on the other hand it is highly political because it touches the very core of the Member States' sovereignty in the field of defence. Indeed, the article plays a dual role: it represents first of all historically an implication that defence was not meant to be a part of the EC Treaty, but it is secondly also the balancing mechanism of the interests of the Community and the essential national security interests of the Member States.

The third conclusion, which is derived from the second one, is that Article 296 EC should be analysed in its political and economic context. As we have seen, the wording of the article has not changed. However, the economic and political realities around the 'world of Article 296 EC' have changed. The Member States do not have the money to sustain their own defence industry and the

52. This is a controversial concept in EC law. The basic idea in parallelism is that when the Community has the competence to act internally, it has the same competence also externally.

53. Martin Trybus, op. cit. in note 17, p. 163.

defence industry is facing ever-increasing global competition. These factors are directly linked to what kind of military capabilities the Member States are able to produce. Indeed, the Member States are facing a dilemma: whether to retain their full legal sovereignty (maintain Article 296 EC and its interpretation intact) or to collaborate with the others more in order to face the present challenges. As such the 'world of Article 296 EC' is a classic example of a situation where the legal rules have remained unchanged for a long time but the real world has developed in a different direction. The link between reality and the legal rules has become more tenuous.

The fourth conclusion of this section is that concerning Article 296 EC the law is not clear. The starting point is clear: the wording of the article has not changed in 50 years. But as has been demonstrated, there are many things that are open to debate or contestable in the Court's case law. And furthermore, the application of the article seems to vary a lot in the Member States. One of the roots of the problem dates back to 1958 when the list attached to the article was left unpublished. This was followed by an intentional/unintentional lack of control over the interpretation and the application of the article on the Commission's part. During the first 25-30 years the Member States' interpretation of the article was largely regarded as definitive. The Commission tried from the late 1980s onwards to correct this course of events which led to a legal controversy: on who does the burden of proof fall?; who interprets the word 'necessary'?; what is the margin of interpretation?; and what are the effects of the article on other sectors such as state aid? Furthermore, the Amsterdam Treaty added an extra challenge – a second pillar cooperation in armaments – making it unclear whether or to what extent it was an issue pertaining to the first pillar.

The fifth conclusion is that in relation to Article 296 EC defining the relationship between law and politics must be done by interpretation of the article. This means that 'essential security interests' have partly become legalised. In interpreting the article, the debate seems always to start from the core question: what are the essential interests of security and who can define them? Indeed, up to what level can the Community control Member States in assessing the 'essential security interests'. From the judgment of *Commission v. Spain* we can see that the exemption from VAT was not regarded as necessary for the essential interests of security. But if the question at hand were, for example, to be about

the meaning of security of supply to a Member State's essential security interests, would it be acceptable and if so to what extent?

Finally, the sixth conclusion of the section takes the form of a question: who has the power of interpreting Article 296 EC? There is an obvious answer to this: according to Article 220 EC the main task of the Court is to ensure that in the interpretation and application of the Treaty the law is observed. It is the European Court of Justice who will ultimately decide what kind of role defence will have in supranational EC law. However, as has already been demonstrated, the case might in reality not be so straightforward. The Court does not exist in a vacuum and it also has a tradition of taking the political realities of Member States' defence profiles into account. As has previously been pointed out, we are not talking about washing machines but about sovereignty and defence.

A step change: new interpretations of Article 296 EC

As illustrated in the previous section, the interpretation of Article 296 EC is a delicate business. This section describes the present situation regarding the interpretation of Article 296 EC. New interpretations have emerged during the past 3-4 years although they have been formulated as a part of longer processes. The year 2004 can be seen as a turning point. First, the Commission issued a Green Paper on defence markets which also created a new political momentum. Second, the European Defence Agency started its work in the field of the European Defence Equipment Market. This has had a major impact on the development of the European Defence Equipment Market (EDEM). Third, in the same year the draft Constitutional Treaty was proclaimed. This is important because Article 296 (in the draft Constitutional Treaty III-436) remained unaltered in the draft as it has done in the Lisbon Treaty (Article 346). By 2004, moreover, judgments had been delivered in the few early cases of the European Court of Justice on Article 296 EC.

The first part of this section deals with the Commission's Interpretative Communication on Article 296 EC and the new defence package. The Communication expresses the Commission's view on the interpretation of the article and it is not legally binding. Nevertheless, it still potentially carries a lot of legal and political weight. The defence package was introduced in December 2007 and it includes two legislative proposals and a statement of policy

objectives. The second part of this section describes the developments in the positions of the Member States. This refers mainly to the European Defence Agency's Code of Conduct on Defence Procurement (agreed by the Member States). In the third part of this section some comments are presented concerning the practical implications of these developments. Finally the fourth part of the section will offer a preview of the cases which involve Article 296 EC, and are currently under consideration by the European Court of Justice (ECJ).

The view from the Commission: The Interpretative Communication and the defence package

The Commission published a Green Paper on Defence Procurement in 2004. This was derived from one of the initiatives based on the Communication on 'European Defence – industrial and market issues. Towards an EU defence Equipment Policy'[54] and it aims to contribute to the gradual creation of a European defence equipment market which is more transparent and open between Member States, as well as to consider the possibility of Community action in the field.[55] This Green Paper led to a public consultation where the Commission received 40 contributions from 16 Member States, the institutions and the industry.[56]

In December 2005 the Commission published the results of the consultation. The Commission concluded that the current legislative framework on defence procurement is not functioning properly and appropriate initiatives therefore have to be taken in order to improve the situation which is almost unanimously regarded as unsatisfactory. The Commission concluded that two actions were necessary: first, to issue an Interpretative Communication on the application of Article 296 EC and second, to start work on a directive on defence procurement.[57]

The consultation process itself can be regarded as a success because it showed that the Member States and other stakeholders were willing to discuss sensitive issues. As one scholar has commented, the process can been seen as a 'radical development because it brought for the first time into the public domain the discussion of an area in which secrecy and lack of transparency is a common ground.'[58]

The Commission adopted the Interpretative Communication in December 2006. The objective of the Communication is to pre-

54. European Commission, 'European Defence – industrial and market issues. Towards an EU defence Equipment Policy', COM (2003) 113 final, Brussels, 11 March 2003.

55. European Commission, Green Paper on Defence Procurement, COM(2004) 608 final, Brussels, 23 September 2004, at p. 3.

56. See: http://ec.europa.eu/internal_market/publicprocurement/dpp_en.htm.

57. European Commission, 'Communication from the Commission to the Council and the European Parliament on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives', COM(2005) 626, Brussels, 6 December 2005, at pp. 9-10.

58. Aris Georgopoulos, 'Commission's Communication on the Results of the Consultation Process on European Defence Procurement', *Public Procurement Law Review*, no. 4, 2006, pp. 119-122, at '4. Comment'.

vent possible misinterpretation and misuse of Article 296 EC in the field of defence procurement. The Commission states that the Communication 'can neither give an interpretation of Member States' essential security interests nor determine *ex ante* to which procurement contracts the exemption under Article 296 TEC applies or not.' The main purpose is to give guidance on the correct interpretation and the application of the article. The Commission sees the clarification of the existing legal framework as a necessary first step towards greater openness in European defence markets. The Commission also draws attention to the ongoing work on the directive on defence procurement and to Member States' activities regarding the Code of Conduct on Defence Procurement in the context of the EDA and sees these as complementary to the Communication. Furthermore, the Commission draws attention to the fact that the final word on Article 296 EC lies with the European Court of Justice.[59]

Three general observations can be made regarding the Communication. First of all, the Commission has now stated its position publicly and has to enforce it. Otherwise the Commission's view will not be regarded as a credible alternative. Second, the Communication is formulated so that the responses to the consultation process support the Community activities in the area.[60] It should be remembered that the Communication is also a policy paper of the Commission. Third, the Communication can be seen as a reaction to but also as a means to gain the initiative *vis-à-vis* the EDA's Code of Conduct for defence procurement agreed by the Member States.[61]

The third observation needs a bit more clarification. It seems to be the case that the Commission and the EDA interpret the scope of Article 296 EC a bit differently and this might lead to competence problems.[62] An example could be highlighted:

> 'Member State A which is also a participating Member State in the Code of Conduct for Armaments Procurement decides to exempt a defence contract for the purchase of tanks from the EC Treaty by means of evoking Art.296 EC. Then Member State A decides to include a contract opportunity notice for the same contract on the electronic bulletin board – the electronic portal where a participating Member State of the Code of Conduct may announce contract opportunities. The question that arises is whether the publication of the contract opportunity on the electronic bulletin board contradicts

59. European Commission, 'Interpretative Communication on the Application of the Article 296 of the Treaty in the Field of Defence Procurement', COM (2006) 779 final, Brussels, 7 December 2006, p. 3.

60. Although the Communication is legal in its nature, it is also a policy document.

61. Aris Georgopoulos, op. cit. in note 58.

62. Aris Georgopoulos, 'The Commission's Interpretative Communication on the Application of Article 296 EC in the Field of Defence Procurement', *Public Procurement Law Review*, no. 3, 2007, pp. 43-52, paragraph 2.6. Analysis.

> the claim of protection of the essential security interests for not using the EU rules? This is an accurate observation which would enable the Commission to challenge the decision of the Member State to use Art.296 EC in the first place. The same would be the case for every defence contract announced on the electronic bulletin board.'[63]

This example shows that the Commission's and the EDA's relationship is bound to face some problems when the Commission has to enforce the policies mentioned in the Interpretative Communication. It is also likely that the Commission's Communication will diminish the present scope of the EDA's Electronic Bulletin Board[64] because the scope of the article will also be reduced due to the stricter conditions for its application. The EDA might end up in this situation of being between a rock and a hard place because the Member States will most likely not automatically accept the Commission's Communication and on the other hand the Commission will have to make its case heard in order to appear as a credible alternative. Therefore, the EDA have to find a balance between the Member States' will and the Commission's stance.

The Commission's Communication has a dual role. On the one hand it is meant to warn the Member States about the consequences of their policy but on the other hand it is also meant to give guidance for interpreting Article 296 EC. The Communication is presented in six parts: (i) Legal basis; (ii) Security interests and Treaty obligations; (iii) The Field of application; (iv) Conditions of application; (v) How to apply Article 296; and (vi) The Role of the Commission. The starting point of the Communication is that the current legislative framework is not functioning properly. It is easy to accept this conclusion. However, the Commission's views on some issues remain debatable or unclear.

Legal basis. The Commission states that according to existing EU law defence contracts fall under internal market rules and the exemptions to this are authorised only when all the conditions are met. The Commission emphasises that Article 296 (1) (b) is the part of the article that is connected to military procurement and that this provision also covers possible confidentiality requirements related to it. Article 296(1)(a) EC, on the other hand, goes beyond defence, aiming in general at protecting information which the Member States cannot disclose to anyone without undermining their essential security interests.[65]

63. Ibid., at 2.6. Analysis.

64. See note 87.

65. European Commission, op. cit. in note 59, p. 4.

The Commission emphasises that Article 296 EC (1)(a) is not to be used instead of (1)(b). The Commission argues on the one hand that the same conditions apply to both paragraphs (a) and (b), but on the other hand it is stated that the (b) part is meant to be the part which is connected to armaments and covers all confidentiality criteria. This argument has one flaw: the (a) part can be invoked whether the case is about armaments or something else. This, however, involves the same restrictions as Article 296 EC as a whole: Article 298 EC procedure. The Commission's argument that only the (b) part could be applied to armaments does not have a solid basis.

Security interests and Treaty obligations. The Commission recognises that it is a Member States' responsibility to define and protect its security interests. However, the Commission underlines that the Treaty contains strict conditions for the use of this derogation and according to the case law of the European Court of Justice any derogation from the rules must be interpreted strictly.[66]

The field of application. Article 296 (1)(b) EC encompasses measures which are connected to the production of or trade in arms, munitions and war material and are specified in the list mentioned in paragraph 2 of the article. The Commission underlines that the article is not intended to apply to activities relating to products other than the military products identified on that list. The Commission estimates that the 1958 list is sufficiently generic to cover recent and future developments. Furthermore, Article 296(1)(b) EC can also cover the procurement of services and works directly related to the goods included in the list, as well as modern, capability-focused acquisition methods. Only the procurements which are designed, developed and produced for specifically military purposes can be exempted from EC rules on the basis of Article 296(1)(b) EC.[67]

The Commission sees the 1958 list as sufficiently generic. However, the Commission does not address the real issue: what is the legal status of the list? As we have seen previously, this list has never been officially published and different versions of it are still in the public domain. One would have expected that this issue which is so fundamentally connected to the interpretation of Article 296 EC would have received more attention in the Communication.

66. Ibid., at pp. 4-5.
67. Ibid., at p. 5.

Conditions of application. The Commission re-states that military equipments are not automatically exempted from the EC rules. The word 'necessary' and the existence of Article 298 EC confirm that Member States do not have absolute freedom in their decision not to apply the rules of the internal market. The Commission points out that according to the Court the burden of proof lies in the hands of the Member States. Furthermore it is highlighted that only *essential security interests*, and not any other interests, like industrial and economic interests, although connected with the production of and trade in arms, munitions and war material, can justify by themselves an exemption on the basis of Article 296(1)(b) EC. As an example the Commission gives indirect non-military offsets,[68] which according to the Commission do not serve specific security interests but general economic interests, and are therefore not covered by Article 296 EC.[69]

The Commission has attached some conditions to 'essential security interests'. The Commission admits that it is the prerogative of the Member States to define these interests. The Commission, however, stresses the meaning of the word 'essential' which does not include other security interests. This is a valid point but it still means that the Member States retain the right to define the content and the scope of 'essential' as well as the content and the scope of 'security interests'.[70] A further problem is that the Commission states that only essential security interests, and not any other interests, like industrial and economic interests, can justify by themselves an exemption on the basis of Article 296(1)(b) EC. It seems to be unclear what will happen if the measures are linked both with essential security interests and also with other economic and industrial interests, for example the use of indirect military offsets.[71] From a practical perspective, the Commission is making a valid point on security interests. As Martin Trybus has pointed out:

> 'It is nebulous how the national security of Member States would permanently be compromised in a common market for hard defence material. Most of them are allies in NATO, they co-operate in most major weapons development programmes, and there is no piece of major defence equipment without foreign components. National security appears to be a mere excuse to protect non-competitive industries.'[72]

68. Offsets come in different types, the most basic division being as follows. Direct offsets: transactions that are directly related to the defence items or services exported by a defence firm - the supplying prime company . Indirect offsets: offset transactions that are not directly related to the defence items or services exported by the supplying prime company. These are further subdivided into defence(-related) indirect offsets and non-defence(-related) indirect offsets. See: FOI and SCS report, 'Study on the effects of offsets on the Development of a European Defence Industry and Market', July 2007, at p. 3. Available at: www.eda.europa.eu.

69. European Commission, op. cit. in note 59, pp. 6-7.

70. In this context it should be noted that the Commission has in its Communication somehow missed one important case: *Commission v Belgium* Case C-252/01. The case was about Belgium having failed to place a notice in the Official Journal of the European Communities with regard to a public services contract involving coastal surveillance by means of aerial photography. Although the case did not directly involve Article 296 EC, the Court approached the case in a similar way to the way that it would most likely approach a case dealing with Article 296 EC. The Court tried to establish whether the national decision – special security measures and therefore exempting the directive – was manifestly unsuitable for the protection of the concerns of security. The following comment summarises the judgment: 'The Court overcame effortlessly the arguments of the Commission and aligned wholeheartedly with the position of Belgium. In addition Advocate General Alber held that it is up to the national governments to assess and define the security interests of the state. Furthermore the assertion of the Member State that special security measures are required for the execution of a procurement contract should be sufficient for the Court if there is not a case of manifest doubt.' Aris Georgopoulos, op. cit. in note 62, at '2.6. Analysis'.

71. Aris Georgopoulos, op. cit. in note 62, at '2.6, Analysis'.

72. Martin Trybus, op. cit. in note 17, p. 152.

The Commission considers that in relation to the conditions of application of Article 296 EC, the Member States' security interests should also be considered from a European perspective.[73] This is one of the innovations of the Communication. It expresses a clear political opinion of the Commission. Legally, it might not be entirely accurate to say that there is a growing convergence of national interests of the Member States. Nor is the argument of the common vision of a European Defence Equipment Market and a European Defence Industrial and Technological Base (EDTIB) without problems because Denmark does not participate in the work in the framework of the EDA. Furthermore, it is not necessarily true that the promotion of EDITB is only assisted if the first pillar public procurement rules are followed because this can be done under the second pillar, in the context of the EDA too. It is also interesting that the Communication does not mention the security of supply or intra-Community transfers.

How to apply Article 296. The Commission states that Article 296 EC should be applied on the basis of a case-by-case assessment. The contracting authorities would thus have to evaluate: first, which essential security interest is concerned?; second, what is the connection between this security interest and the specific procurement decision?; third, why is the non-application of the Public Procurement Directive in this specific case necessary for the protection of this essential security interest? The first step of this assessment procedure is highly challenging because it would require a list of the essential security interests. In practice, this kind of list would be very difficult to draw up due to the fact that most of the essential security interests are policy decisions. This also makes the evaluation of the two other steps demanding.

The role of the Commission. The Commission's role is to ensure that the conditions for exempting procurement contracts on the basis of Article 296 TEC are fulfilled. The Commission might request the Member States to provide the necessary information and prove that an exemption is necessary for the protection of their essential security interests. This claim is based on the Court's case law and on Article 10 EC (cooperation in good faith). The Commission also states that it is a Member State's duty to provide the necessary information on their procurement acquisitions at the Commission's request. This means that Member States are not

73. European Commission, op. cit. in note 59, p. 7.

required to provide information every time they invoke Article 296 EC. This is, as one scholar points out, in direct contrast with what was considered to be the Commission's position, namely that Member States should notify the Commission of their intention to use Article 296 EC.[74] The Commission seemed to have adopted a realistic point of view because it would be hardly likely that Member States would always give prior notice of their plans to invoke Article 296 EC. On the burden of proof question, the Commission underlines the Court's line: the burden of proof lies with the Member States.

At the end of the Communication, the Commission states that when a Member State sees that an application of the Community directive would undermine the essential interests of its security, general references to the geographical and political situation, history and Alliance commitments are not sufficient.[75] This claim is in line with demands for a case-by-case analysis. But the problem here, however, is that the European Union's Member States have different kinds of defence solutions which are based on different threat scenarios and security interests. The defence solutions also have a direct effect on the procurement acquisitions and therefore the Commission's statement seems to be too exacting.

The Commission introduced a defence package in December 2007. This package presents two legislative proposals – a directive on defence and sensitive security procurement, a directive on intra-EU transfers of defence goods – and a Communication on European defence industry.[76] The overall aim of these proposals is to establish an open and competitive EDEM. The defence and sensitive security procurement directive proposal aims to limit the use of Article 296 EC. The goal of the directive on intra-EU transfers is to reduce the obstacles to the circulation of defence-related goods and services within the internal market.

The package does not bring any major new elements to the discussion on the interpretation of Article 296 EC. The package emphasises the Commission's will to develop EDEM and its stance already taken in the Interpretative Communication. Two issues should, however, be pointed out. First, the defence and security directive does not comment the legal status of the 1958 list. The proposal includes a reference to a 'decision defining the list of products (arms, munitions and war material) to which the provisions of Article 223(1b) – now Article 296 – of the Treaty apply. Minutes of 15 April 1958: 368/58.',[77] but it does present the con-

74. Aris Georgopoulos, op. cit. in note 62.

75. European Commission, op. cit. in note 59, p. 8.

76. European Commission, 'Proposal for a Directive of the European Parliament and of the Council on the Coordination of Procedures for the Award of Certain Public Works Contracts, Public Supply Contracts and Public Service Contracts in the Fields of Defence and Security', December 2007; European Commission, 'Proposal for a Directive of the European Parliament and of the Council on Simplifying Terms and Conditions of Transfers of Defence-related Products within the Community', Brussels, December 2007; European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'A Strategy for a Stronger and More Competitive European Defence Industry', COM(2007) 764 final, Brussels, December 2007.

77. European Commission, 'Proposal for a Directive of the European Parliament and of the Council on the Coordination of Procedures for the Award of Certain Public Works Contracts, Public Supply Contracts and Public Service Contracts in the Fields of Defence and Security', December 2007, at Article 1 and footnote 21.

tent of the list or mention where this list is available or whether it is officially published. The list is the key question in the proposal because it defines the scope of the proposal in Article 1. Second, in political terms to call the three initiatives a 'defence package' might create some extra tensions when it comes to the reviewing of the proposal. It is possible that in some Member States the terms 'European Commission' and 'defence' do not fit easily into the same sentence.

To sum up, the Commission has tried to attain two goals in its Interpretative Communication: first, to clarify the existing law around 296 EC; and second to politically create space for Community competence in the area of 296 EC. From a legal viewpoint, the Communication can be judged as helpful but not totally clear. Many questions, for example concerning essential security interests, remain unanswered. Politically it is hard to say yet whether the Commission has achieved its goal where this issue is concerned. The document is a very sensitive one and much depends on how rigorously the Commission will enforce its Communication. The defence package does not introduce any major new elements into the discussion on the interpretation of Article 296 EC.

The view from the Member States: the Code of Conduct on Defence Procurement

The Member States play a triple role in the defence markets: they are customers, owners and regulators. The Member States are the biggest customers of the defence industry and they give guidance to companies by setting military requirements. The Member States are also still by far the biggest owners of the defence industry although the companies increasingly operate as normal companies that are driven by the private shareholders' interest. So far, the Member States have enjoyed a relatively free hand in regulating the defence markets. The interpretation of Article 296 EC has been a guarantor of this. Indeed, the Member States' point of view regarding the interpretation of Article 296 EC has remained largely the same in the past 50 years although the Community has enlarged and deepened.

The Member States have four options concerning Article 296 EC: abolishing it, amending it, leaving it as it is or adjusting its interpretation. The political likelihood of abolishing it is still 'close to zero.' This statement is also confirmed by the fact that the

article has remained unaltered in the treaties of Maastricht, Amsterdam, Nice and Lisbon. The second option would be more feasible but would require lengthy and most likely very challenging discussions on the 1958 list and the scope of Article 296 EC. The third option- to secure the *status quo* – would be easy: this is, however, economically no longer viable. Therefore, the fourth option has become the most tempting.

As we have seen, the Member States have on several occasions stressed that it is their prerogative to define their essential security interests and therefore the scope of Article 296 EC. However, they have in the past few years more often stated that the fragmented defence markets have constituted an obstacle to achieving a European Defence Equipment Market and noted that the European Market has to be more open in order to develop a European DTIB.[78] It is noteworthy that while the Member States have not been willing to change their interpretation of Article 296 EC, the industry has become the driving force for developing the market.

In many responses garnered from the Member States during the consultation process set up by the Commission, the Member States were in favour of an Interpretative Communication but much more sceptical about a directive. This was because the clarification of the interpretation of Article 296 EC was considered useful but a directive was not seen as a tool which would provide a flexible means of improving the defence market. However, the answers were varied and, as the Commission pointed out, it was difficult to draw a general conclusion or identify a single general trend because the answers did not follow the traditional dividing lines between big and small, producing and non-producing Member States.[79] It seemed to be the case that the Member States wanted to have a clearer framework in the area of Article 296 EC but to open up the market in an intergovernmental way.

The desire to open up the markets while not changing the interpretation of Article 296 EC ultimately led to a Code of Conduct on Defence Procurement which was adopted in November 2005. This agreement was reached in the framework of the European Defence Agency. The basic idea of the Code is to open up defence markets in the 'Article 296 area.'[80] The Member States agreed that the Code is a voluntary, non-binding intergovernmental regime for defence acquisitions whose value is over one million euro. In other words, it is not legally binding, there are no sanctions for non-compliance (except peer pressure) and a subscribing Member State can with-

78. See note 6.

79. European Commission, Communication from the Commission to the Council and the European Parliament on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives, COM(2005)626, Brussels, December 2005, pp. 5-8. In this context, one could highlight the overall differences in market thinking, e.g.: 'France brings forward the idea of competition within Europe and purely European co-operation on defence matters without taking into account a global defence procurement market. The British, however, insist on a global competition, even if it should happen through bilateral links or a "coalition of willing"'. Elena Bratanova, op. cit. in note 43, p. 24.

80. European Defence Agency, Steering Board Decision on an Intergovernmental Regime to Encourage Competition in the European Defence Equipment Market, Brussels, 21 November 2005.

hold from the Code when it so wishes. The Code is also a sign of a trend where politically-sensitive issues – that concern the core of state sovereignty – are regulated and governed in the EU via a more flexible 'soft' law.[81]

Although the main consideration in this subsection is not to analyse the Code itself – rather than what the Code means for interpreting Article 296 EC – a few remarks should be made. The Code is constructed on the basis of five principles. First, the Code is voluntary and non-binding and no legal commitment is involved or implied. Second, fair and equal treatment of suppliers will be applied. The transparency of the Code and transparent and objective standards are the key to this. Third, the Code tries to establish mutual transparency and accountability. The Agency is meant to be the instrument to achieve that. It will collect data on how the Code is implemented in the subscribing Member States (sMS). Fourth, mutual support is one of the cornerstones of the Code. The sMS recognise that the regime will depend on strong mutual confidence and interdependence. Each sMS government will therefore do everything possible, consistent with national legislation and international obligations, to assist and expedite each others' contracted defence requirements, particularly in urgent operational circumstances. Fifth, the Code offers mutual benefits for all. One single portal will offer opportunities and increase transparency.[82] These five principles clearly show that the Code of Conduct is more oriented towards creating transparency and mutual trust than to forcing Member States to open up defence markets.

The very fact that an agreement was finally reached on creating the Code was in itself seen as a major success. The Head of the Agency described the adoption of the Code as a landmark decision.[83] Now, in 2008, the Code has started to show some promising results,[84] having already led to more mutual transparency and accountability. The Code of Conduct's most crucial shortcoming, however, is its non-binding character. The only way to enforce the Member States to publish their procurement notices is peer pressure which does not guarantee open competition. The Code's success might have some side effects because it seems likely that a successful EDEM under the Code of Conduct will virtually eliminate the possibility for radical far-reaching interpretation of Article 296 EC by the European Court of Justice.[85]

The Member States' views on interpretation of Article 296 EC have thus remained pretty much the same. The adoption of the

81. Ulrika Mörth & Malena Britz, 'European Integration as Organizing: The Case of Armaments', *Journal of Common Market Studies*, vol. 42, no. 5, pp. 957-73, p. 970.

82. European Defence Agency, 'The Code of Conduct on Defence Procurement of the EU Member States Participating in the European Defence Agency', 21 November 2005.

83. The Head of the Agency, Javier Solana, described the agreement on the code as a 'landmark decision', at European Defence Agency, 'EU Governments Agree Voluntary Code for Cross-Border Competition in Defence Equipment Market', 21 November 2005, Press Release.

84. Over 200 contract opportunities to the value of over 10 billion euro.

85. Aris Georgopoulos, 'The European Defence Agency's Code of Conduct for Armament Acquisitions: A Case of Paramnesia', *Public Procurement Law Review*, no. 2, 2006, pp. 51-61, at pp. 59-61.

Code confirms that Member States see themselves as the principal actors in the 296 area and do not relinquish any of their rights including those enshrined in Article 296 EC.[86] The contract notices published under the Code are displayed in the EDA's Electronic Bulletin Board[87] which offers good examples on how the Member States see the scope of Article 296 EC. The range of products include for example: fireman helmets with integrated communication systems,[88] military police vans,[89] medium-range air defence missile systems,[90] commercial satellite communications services[91] and combat suits.[92]

From an internal market perspective one can see some problems in the EDA's Code of Conduct. The Article 296 area is still a field of business that is shrouded in mystery to some degree, where the normal EC standards for example on free access to the courts will not apply. This is, as one expert points out, the price for the progress achieved by the EDA achieving a single set of rules applying to the EU defence market.[93] One could also criticise the Code for not being strong enough to ensure fair competition. Indeed, the Code does not provide tools for example to guarantee a level playing field between state-owned and private companies.[94]

The EDA and the Commission state that their market initiatives are complementary. This can be seen as true up to a point. Their overlapping also links them together. It could be stated that

> 'a failure of the Code of Conduct would have immediate negative effects on the possibility for the adoption of a European Defence Directive. This is because the danger of failure of the new regime lies with the potential lack of commitment and political will on the part of the Member States. In such a case the chances for the adoption of a first pillar instrument in the field would be close to none. Ironically enough a successful Code of Conduct may give rise to questions concerning the necessity of a European Defence Procurement Directive.'[95]

One could conclude that the Member States have thus not changed their interpretation of Article 296 EC. What they have changed is their policy. The Code of Conduct on Defence Procurement is a sign of this development. The Member States recognise the need from a political point of view to create a European Defence Equipment Market but in their view it should be created on an intergovernmental base. This point of view is in direct con-

86. Ibid., at p. 52.

87. See: http://www.eda.europa.eu/ebbweb/

88. European Defence Agency, Electronic Bulletin Board, EDA-903.

89. European Defence Agency, Electronic Bulletin Board, EDA-1244.

90. European Defence Agency, Electronic Bulletin Board, EDA-630.

91. European Defence Agency, Electronic Bulletin Board, EDA-804.

92. European Defence Agency, Electronic Bulletin Board, EDA-881.

93. Barbara Rapp, 'Defence Procurement and Internal Market', Institut für Strategie- Politik-Sicherheits- und Wirtschaftberatung, Berlin, 2006, p. 3.

94. Hartmut Küchle, 'The Cost of non-Europe in the Area of Security and Defence', a study commissioned by the European Parliament, Directorate General for External Policies Of the Union, Directorate B, Policy Department, June 2006, p. 48.

95. Aris Georgopoulus, op. cit. in note 85, pp. 58-59.

tradiction with that of the Commission and creates a delicate balance between the Code and the stance that the Commission has taken in its Interpretative Communication.

Two visions of EDEM

The two different point of views – the Commission's and the Member States' – regarding the interpretation of Article 296 EC are also starting points for two different visions of the European Defence Equipment Market. In practice, the Commission thus aims at an option where the defence equipment market would become a part of the internal market, with some minor exceptions. The Member States' interpretations of Article 296 EC indicate that the defence equipment market would remain intergovernmental in nature with some exceptions on the internal market side.

These views may be summarised in two separate charts (see below) by dividing the defence equipment market into four segments:[96] (i) highly sensitive items; (ii) complex weapons systems; (iii) warlike items which do not or not necessarily concern essential security items; and (iv) non-warlike items. This division might appear a bit too simplistic but it helps to analyse the developments.

EDEM segments: situation in 2008

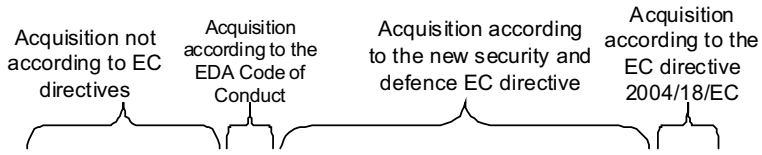
	Acquisition not according to the EC directive 2004/18/EC		Acquisition according to the EDA Code of Conduct	Acquisition according to the EC directive 2004/18/EC
Segment	Highly sensitive items (Nuclear weapons etc.)	Complex weapons systems (Combat aircrafts etc.)	Warlike items (Rifles etc.)	Non-warlike items (Boots etc.)
Use of Article 296 EC	Article 296 EC invoked always	Article 296 EC invoked always	Article 296 EC invoked always	Article 296 EC invoked sometimes
Impact	No open competition	Open competition sometimes	Open competition often	Open competition often

96. See Burkard Schmitt (ed.), 'Defence procurement in the European Union – The Current Debate', Report of an EUISS Task Force, EUISS, Paris, 2005, pp. 18-19.

The EDEM segments situation in 2008 roughly corresponds to the present situation which reflects the Member States' interpretations of Article 296 EC. The highly sensitive and complex weapon systems are exempted from the common market by Article 296 EC and there is no open competition. In the case of warlike items, in some cases of complex weapon systems and often in the case of non-warlike items, there is open competition.

The internal market option, which is described in the next chart, would mean that in the case of non-warlike items, warlike items and often in the case of complex weapon systems there would be open competition and the acquisitions would be carried out according to the EC directives. The new security and defence directive, if adopted, would cover the warlike items and some parts of the complex weapon systems and non-warlike items. The civilian 2004/18/EC directive would cover some of the non-warlike items. This would mean that the scope of the EDA's Code of Conduct would diminish dramatically and would be useful only in some rare cases of complex systems where a Member State has invoked Article 296 but would like to use open competition as a method.

EDEM segments: internal market option



Segment	Highly sensitive items (Nuclear weapons etc.)	Complex weapons systems (Combat aircrafts etc.)	Warlike items (Rifles etc.)	Non-warlike items (Boots etc.)
Use of Article 296 EC	Article 296 EC invoked always	Article 296 EC invoked as an exception	Article 296 EC not invoked	Article 296 EC not invoked
Impact	No open competition	Open competition often	Open competition always	Open competition always

In sum, the two different stances on the interpretation of Article 296 EC point towards two different options for EDEM: the intergovernmental market and the internal market option. The intergovernmental market option would maintain the present *status quo* whereas the internal market option would change the present European defence equipment market situation drastically. The internal market option would mean Community legislation in the defence equipment market and a more active enforcement role for the Commission, for example in the area of state aids. This would increase competition in almost all of the market segments. On the other hand, it would *de facto* curtail the scope currently enjoyed by the Member States to secure their essential security interests.

The cases under consideration in the European Court of Justice

The main task of the European Court of Justice is to ensure that the law is observed in the interpretation and application of the Treaty.[97] The cases involving Article 296 EC may be referred to the Court in four ways: by the infringement procedure according to Article 226 EC; by the failure to act procedure according to Article 232 EC; by the preliminary ruling procedure according to Article 234 EC; or by the procedure laid down in Article 298 EC, which is directly connected to the national security exemptions of Articles 296 and 297 EC.

As was concluded in the first section of this chapter, there have not been many cases dealing with Article 296 EC. What is now interesting is the fact that the Court is currently considering five cases[98] which are all closely connected with Article 296 EC. It is therefore likely that the Court's rulings in those cases will give some further guidelines on the interpretation and the application of Article 296 EC.

In addition to the pending five cases, the Court has recently delivered a ruling in the *Commission v. Italy* case,[99] which dealt with the awarding of helicopter contracts without prior publication of a notice.[100] Italy defended its actions by invoking Article 296 EC and stating that the purchases of helicopters meet the legitimate requirements of national interest foreseen by Article 296 EC. Italy submitted the argument that the helicopters in question are 'dual-use goods', that is to say, goods capable of being used for both civil and military purposes.[101] The Commission submitted that the helicopters are intended for essentially civil use and that Italy has

97. Article 220 EC.

98. Case C-284/05, *Commission v. Finland, Official Journal*, 29 October 2005, pending. Case C-294/05, *Commission v. Sweden, Official Journal*, 3 September 2005, pending. Case C-372/05, *Commission v. Germany, Official Journal*, 26 November 2005, pending. Case C-409/05, *Commission v. Greece, Official Journal*,14 January 2006, pending. Case C-38/06, *Commission v. Portugal, Official Journal*, 25 March 2006, pending. The case summaries can be found in the *Official Journal*.

99. Case C 337/05, *Commission v. Italy*, 8 April 2008.

100. The Italian government has allegedly for a long time directly awarded to the firm Agusta contracts for the purchase of helicopters to meet the requirements of several ministries and departments without any tendering procedure and therefore failed to fulfil its obligations under the directives on coordinating procedures for the award of public supply contracts.

101. Para 49. Case C 337/05, *Commission v. Italy*, opinion of the Advocate General delivered on 10 July 2007.

not demonstrated that the situation in the present case constituted a measure necessary to protect its essential interests, such as security, which is an indispensable condition laid down by Article 296 EC. Therefore Article 296 EC is not applicable.[102] The Court concluded in its judgment that Article 296 (1)(b) cannot properly be invoked because the helicopters in question are for civilian use and possibly for military use.[103]

Four comments on *Commission v. Italy* could be made. First, Article 296 EC did not play a major role in this case due to the fact that the case mainly concerned civil goods. This fact was also admitted by Italy. Second, the important message in this case was the Court's clear statement that a Member State's right to invoke Article 296 EC was not unlimited. Third, from a political point of view it is important to note that the Court ruled against a long-standing commercial practice in a sensitive security field. Fourth, the Court did not, however, provide further clarification regarding the correct interpretation of Article 296 EC.

The five pending cases[104] all have similar elements and deal with the Community's own resources. The Commission brought the actions against Finland, Sweden, Germany, Greece and Portugal before the Court on the basis that they failed to establish and credit the Community's own resources according to the Community Customs Code in connection with the import of war materials between the years 1998-2002 and also by failing to pay a late payment interest fee thereon. In other words, the five countries did not pay customs to the Community budget from the military goods that they imported during those years.[105]

The summaries of these cases do not give full details of the proceedings but they offer an overview of the main arguments presented by the Commission . The Commission seems to have built its case on five main arguments. First, the Member State in each case has not paid customs and should now be ordered to do so, and in addition be subject to an interest rate. Second, Article 296 EC does not justify exemption from customs. Third, Article 296 EC deals with strictly limited exceptional situations. Fourth, the Member States bear the burden of proof when invoking Article 296 EC. Fifth, Council Regulation (EC) No 150/2003 (3) suspending duties on defence equipment cannot be applied retroactively (it entered into force on 1 January 2003).

The Commission's arguments most likely reflect some of the issues that the Member States have counter-argued. In the sum-

102. Para 53. Case C 337/05.

103. Case C-337/05, *Commission v. Italy*, para 47-49. See also C-157/06 *Commission v. Italy*, 2 October 2008, in which the Court ruled that Italian legislation authorising the derogation from the Community rules on public supply contracts in respect of the purchase of light helicopters for the use of police forces and the national fire service, without any of the conditions capable of justifying that derogation having been satisfied, is not consistent with the Community law.

104. Case C-284/05, *Commission v. Finland*. Case C-294/05, *Commission v. Sweden*. Case C-372/05, *Commission v. Germany*. Case C-409/05, *Commission v. Greecec*. Case C-38/06, *Commission v. Portugal*.

105. See: Katharina Eikenberg, 'Article 296 (ex 223) E.C. and External Trade in Strategic Goods', op. cit. in note 27, pp.131-32. 'The Community has a common customs tariff which is meant to be exhaustive. If tariff reductions were to occur, they would have to be approved under Article 26 (ex Article 28). Article 296 (ex Article 223) prerequisites of applicability are not met. According to the Commission, the imposition of customs duties on imported military equipment is not inconsistent with the interests of national security and thus does not trigger the Article 296 (1)(b) (ex Article 223 (1) (b)) exception. [...] Contrary to the Commission, Member States consider Article 296 (ex Article 223) to be applicable and to allow them to waive the duties of the common customs tariff on military equipment. According to their opinion, the impact of customs duties is significant. In the case of F-16 components, for instance, the additional costs for the three countries involved were estimated to be about $100 million. [...] If national governments were to pay these high duties their capacity to purchase arms and military equipment would be considerably reduced. This could amount to a threat to their internal and external security.'

maries not much information is given about the arguments put forward by the Member States. Finland and Sweden are mentioned explicitly. Finland argued that it disputes in their entirety the obligation to provide information, the obligation to pay and the obligation to pay default interest. The first argument is interesting because it seems to indicate that Finland has invoked Article 296 (1)(a). This seems to be the case also where Germany is concerned, where Germany refused to provide detailed information relating to the actual imports. The Swedish government states that Article 296(1)(b) EC gives Member States the right to unilaterally grant exemptions from duty for imports of war material and of dual usage goods (civilian and military) on grounds of defence economics, to protect military secrecy and to comply with international agreements made regarding the guarantee of military security.

In *Commission v. Germany* the Commission raises some further arguments relating to Article 296 EC. First, it states that 'the Member State must also establish that under the particular circumstances there was a *concrete threat* to state security.'[106] The argument of a 'concrete threat' is a new one and it will be interesting to see how the Court will consider it. Second, the Commission underlines that other Member States levy duties on such imports without making the objection that this is a threat to their national security and therefore it would be unjust for those Member States if such an exemption were to be allowed.[107] This is a valid argument but the Court might also consider the fact that essential security interests are not similar in every Member State. Therefore, in practice, some measures could be justified in one Member State but unjustified in some others. Third, the Commission argues that *military secrecy* cannot justify such a breach of Community law since safeguarding of the confidentiality of sensitive data on the part of the Community institutions is a procedural issue which cannot exempt the defendant from its substantive duty to pay the appropriate own resources to the Community.[108] It remains to be seen whether the Court will consider this issue and the link between Article 296 (1)(a) and military secrecy. Fourth, in *Commission v. Portugal*[109] the Commission argued that '[t]he defendant has not demonstrated that the payment of duties at low (or nil) rates would *substantially* harm the defence of the country within the meaning of Article 296.'[110] The claim therefore encourages the Court to evaluate how much harm/what kind of harm the pay-

106. Case C-372/05, *Commission v. Germany*, pending. Italics added for emphasis.

107. Case C-372/05, *Commission v. Germany*, pending.

108. Case C-372/05, *Commission v. Germany*, pending. Italics added for emphasis.

109. Case C-38/06, *Commission v. Portugal*, pending.

110. Case C-38/06, *Commission v. Portugal*, pending. Italies added for emphasis.

ment of duties at low (or nil) level would cause to the defence of the country. Once again it will be interesting to see what the Court will decide on this issue.

The five customs cases in particular offer the Court the possibility to rule on the correct interpretation of Article 296 EC. The case descriptions available show that it is almost impossible to judge these five cases without considering the limits of Article 296 EC. This also means addressing the limits of sovereignty of the Member States in the area of defence. It is notable that the Commission seemed to have used, especially in *Commission v. Germany*, arguments that allude extensively to political standards. Furthermore, it seems to be the case that the Member States have invoked both Article 296 (1)(a) and (b) which also makes the evaluation of Article 296 EC even more likely.

Most likely, the most difficult question in these cases will be the relationship between essential security interests and the interests of the Community. The question of the use of a proportionality test[111] might therefore come up in the internal considerations of the Court. As has already been concluded, the basic problem with this test is to what extent the Community can scrutinise and review a Member State's actions that have been conducted on the basis of essential national security interests. An academic, Aris Georgopoulos, has developed a new modification of this test called a 'test of manifest unsuitability.'[112] The aim of the test is to limit the wide discretion enjoyed by the Member States without violating the hard nucleus of Article 296 EC. With the manifest unsuitability test the Court of Justice could examine whether the discretion granted to the Member States in the article has been exercised beyond its legitimate limits. The main difference between the two tests could be illustrated by the phrases 'the Emperor is naked' (test of manifest unsuitability) as opposed to 'the Emperor is not properly dressed' or 'the Emperor is not wearing the necessary clothes' (classic proportionality test). This might be one option in approaching the cases that the Court is considering. Thus the Member States would have a wide discretion to use Article 296 EC and only in clear cases could the Member States' activities be reviewed and scrutinised.

The Court has two main options available to it when dealing with these cases. The first one, 'the *status-quo* option' is to consider these cases as pure Community's own resources cases and to avoid as much as possible touching on the issue of Article 296 EC. In this

111. The basic idea of a proportionality test is to evaluate whether there is 'a reasonable relationship of the relevant interests involved.' See notes 39, 40 and 41.

112. For more on this, see: Aris Georgopoulos, 'Defence Procurement and EU Law', *European Law Review*, vol. 30, no. 4, 2005, pp. 559-72, pp. 568-71.

scenario, the Court would just rule on the issue of customs but assign a minor role to the arguments on 296 EC. The second option would be to consider these as major cases pertaining to the interpretation of Article 296 EC and to define the limits of the Member States' competences in the field of defence.[113] Whatever the ruling in this latter scenario, it could lead to a political reaction from the Member States.

In sum, the European Court of Justice is dealing with important cases in the area of 296 EC at the moment. Especially in the five customs cases all the aspects of Article 296 EC seem to be invoked. If the Court considers it necessary, it has therefore a good opportunity to rule on the correct interpretation of Article 296 EC.

Concluding remarks

The Commission's Interpretative Communication has clarified the existing law around Article 296 EC but nevertheless left some questions hanging. The consultation and preparation process towards the Communication can be regarded as useful for bringing clarity to the interpretation and the application of Article 296 EC. The open questions remain partly due to the fact that the Communication is also a policy paper by which the Commission tries to formulate its political goals in a legal form. The most challenging of the open questions is how to deal with the issue of 'essential security interests'. The Commission develops the Court's views in this regard and underlines the conditions accompanying the concept. It rightly points out that it is still the Member States who define the concept. The Commission, however, tries to put some legal restrictions on what is essentially a political concept. Oddly, the Commission has not in its Communication commented on the *Commission v Belgium* case,[114] where the Court ruled that exempting a directive was permissible in order to protect security concerns. The second open question is the legal status of the 1958 list. Most surprisingly, no comments are offered on this in the Communication although the list is not legally binding. A third issue is the policy document nature of the Communication. A good example of the policy arguments is the reference to a European perspective which is not legally very convincing. The introduction of the defence package stresses the Commission's will to proceed in improving EDEM but it does not introduce any major new elements regarding the interpretation of Article 296 EC.

113. In this connection it is worth pointing out that the Court has made several courageous landmark decisions in different areas of EC law. It is somewhat peculiar that some of those fundamental rulings did have a weak or non-existing legal base. See for example: Case 26/62, *van Gend en Loos v. Nederlandse Administratie der Belastingen*, [1963] ECR 1 (direct effect of Treaty provisions); Case 6/64, *Flaminio Costa v. ENEL*, [1964] ECR 585 (supremacy of EC law); Case 22/70 *Commission v. Council (ERTA)* [1971] ECR 263 (implied external competences); Case 11/70, *Internationale Handelsgesellschaft v. Einfuhr und Vorratstelle für Getreide und Futtermittel,* [1970] ECR 1125 (fundamental rights).

114. Case C-252/01. See note 70.

The Member States have not changed their interpretation of Article 296 EC. The basic legal reason for the Member States' thinking is their starting point: the wording of Article 296 EC has remained unaltered in all the Treaty changes. The Member States most likely regard this fact as guaranteeing their interpretation and application practices. In fact, they have not given up their right to define essential security interests – sometimes even quite broadly – but they seem to have realised that without more open markets they cannot afford to maintain their defence. The Member States have, therefore, changed their policy. The Code of Conduct on Defence Procurement is the result of this situation. As far as can be ascertained, it seems to have worked out relatively well. The most important shortcoming of the Code is its non-binding character. This might create some problems in the long run due to non-compliance.

Indeed, from the Member States' side we have seen developments in policy but not in the interpretation of Article 296 EC. The Commission has tackled the interpretation and (therefore of course) the policy too. This fact might create tensions between the Code of Conduct and the stance that the Commission has taken. If the Commission were to challenge some of the contract opportunities that are posted in the EDA's Electronic Bulletin Board, this might have the reverse effect: the Member States would not even advertise their opportunities there in future. Indeed, this might upset the delicate balance we see at the moment.

These two points of view regarding the interpretation of Article 296 EC are also the basis for the two different views of the European Defence Equipment Market. It seems to be evident that there is no common understanding of the correct interpretation of Article 296 EC. It also seems that the Member States and the Commission are not able to solve the problems of the interpretation although the review process of the Commission's defence package might offer a new opportunity for this. The Member States are reluctant to give up their broad interpretation of the article and the Commission is now bound by its Interpretative Communication. Someone else has to strike the balance. Therefore, the final decision in defining the correct interpretation of Article 296 EC and *de facto* the limits of EDEM lies with the Court of Justice.

The Court is dealing with potentially important cases in the area of Article 296 EC. The five customs cases, especially, offer the Court an opportunity to show the right way forward for the inter-

pretation and application of Article 296 EC. However, the Court's job is not going to be easy. It might have to consider many sensitive aspects of EC law and the balance between that and national sovereignty. In the end, the Court might choose the easy way out and rule these cases as mainly standard Community's own resources cases. But on the other hand, this would be an opportunity to develop a new look at Article 296 EC. The European Court of Justice now has the wherewithal to define the limits of EDEM. *De jure* the Court, of course, only deals with the cases that have been presented to it. But *de facto* it will decide on much more than that. The five cases brought before the Court are important because it seems that in them all the elements of Article 296 have been invoked.

Timing is crucial in these developments. First, there is a more favourable political momentum to create an EDEM than ever before. So, judgments imposing stricter conditions on the interpretation of 296 EC would most likely not face such fierce opposition as they might have done some years ago. Second, the Commission has now presented a draft directive on defence procurement and a draft directive on intra-Community transfers. These are bold initiatives and would welcome all the support possible from the interpretations of the Court. Third, the EDA's Code of Conduct is gradually establishing itself as the main mechanism for EDEM. This means also that the broad interpretation of Article 296 EC will be more strongly established. If a new 'correct' (if the Court so decides) view is not presented soon, it will become politically very hard to overrule the Member States' established views later on. Then the Code of Conduct will be more than an interim solution, it will become a permanent structure.

We will thus see at least three developments in the future: first, how rigorously the Commission will enforce its Communication; second, what decision the Court will reach in those cases with which it is presently dealing; third, how the Member States will respond to all this.

Conclusions

The first conclusion is that interpreting Article 296 EC is the key to the European Defence Equipment Market. This is the case due to the fact that the law in the area of Article 296 EC is not clear. The

wording of the article has not changed in 50 years but the economic realities have changed in the past 15 years. This has led to new interpretations of the article which have made the situation legally confusing. The new interpretations present two different kinds of point of view – internal market versus intergovernmental market – on how to form a European Defence Equipment Market.

Secondly, legally both the Commission and the Member States have a point in their interpretations of Article 296 EC. So, legally there is a valid case for both the internal and the intergovernmental options of the market structure. Politically it seems that the Member States and the Commission are not at the moment able to solve the problems of interpreting Article 296 EC and therefore cannot come to an agreement on the market structure.

Thirdly, timing is crucial in the interpretation of Article 296 EC. There are mainly two reasons for this. First of all there is a political window of opportunity at the moment to move ahead with EDEM. The decision-makers, however, need to know soon what is the correct interpretation of the law and on what basis they should proceed with their work. The other reason is that time is running out for the European defence industry. The technological and industrial bases in Europe are lagging behind developments in the US. If something has to be done to the market structure in order to boost a *European* DTIB, it must be done soon.

Fourthly, the European Court of Justice now needs to decide what the correct interpretation of the Treaty is. The Court decisions will guide the way to shaping the market structure and to delineate the contours of the EDEM. Of course, even then the Member States have, if they wish, the possibility to do as they like by changing the Treaty to categorically exclude all defence equipment. Therefore, the role of the Luxembourg judges is not an easy one: they have to strike a legal balance between the internal market and the essential security interests of the Member States.

Fifthly, the Court of Justice basically has two options at hand when dealing with the cases involving the interpretation of Article 296 EC. First, it might avail of the opportunity to enforce stricter criteria on interpreting Article 296 EC. This would mean in practice that the defence equipment market would become a part of the internal market, apart from a few minor exceptions. Second, the Court could conclude that the present law prescribes the limits and in the present cases the Court might clarify the borderline. This would mean in practice that the defence equipment market

would remain intergovernmental in nature with some exceptions on the internal market side.

Sixthly, whatever the Court's rulings in the present cases dealing with Article 296 EC are, they are bound to have direct implications on what kind of defence equipment market there will be in Europe in the future. The internal market scenario would mean a drastic change in the current EDEM situation whereby the intergovernmental option maintains the present *status quo*.

Seventh, it must, however, be remembered that where there is a sufficiently strong political will, then law will be adopted accordingly. There is still the option that Member States and the Commission could find a common ground in the interpretation of Article 296 EC, for example when reviewing the Commission's defence package. At the moment this option seems to be unlikely. There is also the possibility that Member States might want to reformulate Article 296 EC in such a way that it would copperfasten the total exclusion of defence equipment from the internal market. This is not likely due to the economic realities and the fact that industry is pushing the Member States in a different direction.

Options for an EU regime on intra-Community transfers of defence goods

Christian Mölling

2

Introduction

[The author would like the thank Martin Bayer, Thomas Beer, Mark Bromley, Michael Brzoska , Pierre-Arnaud Lotton, Claudia Major, Michele Nones, Burkard Schmitt, Kristina Soukupova and Louise Uvenfeldt for their comments and support. Any errors and omissions are the responsibility of the author.]

The importance of the whole issue of intra-European transfers of defence-related goods has only recently come to prominence. By proposing a directive on defence procurement, the EU Commission has taken a further step in its initiative towards establishing a regime on intra-European transfers of defence-related goods. In doing so, the European Commission has highlighted the significance of such a regime as an essential development that will lead to a more effective European defence market and strengthen its industrial base. However, while the Commission insists on the economic-industrial necessity of simplifying intra-European transfers, EU Member States fear that that this may undermine their own national security. While they realise the potential benefits of such a regime in the light of the rising costs of defence equipment, Member States fear losing effective control over the export of defence products produced in their countries. Others dread the loss of security of supply for their national suppliers and manufacturers. Hence, Member States find themselves faced with a serious dilemma. To find a way out of this impasse, i.e. to mediate between economic-industrial and security considerations, constitutes the major challenge for the emergence of a viable transfer regime.

Today the EU's defence sector is still exempted from common procedures and rules for procurement and competition. Instead, the regulations of individual Member States apply. This mainly nationally-based structure generates not only serious negative effects in economic terms due to the fact that it reflects less and less the reality of internationalised markets and production; it also has far-reaching policy implications for the European Security and Defence Policy (ESDP). This is because it hinders the effective build-up of military capabilities which are essential to reinforce and widen the range of political options. So far, Member

States have been unable to agree on a more integrated defence economic policy. The European defence sector remains fragmented in terms of both markets and regulations. Hence, there is increasing economic and political pressure for both the ideas of establishing a more integrated European defence market and undertaking subsequent steps via regulatory policies to consolidate such a development.

In this context, the issue of intra-European transfers of military goods is one of the most urgent questions to be addressed at the EU level. Such transfers play a crucial role in that they affect cooperation among European companies, their transnational production lines, fair competition in the EU market as well as more cost-effective procurement. Therefore, they impact upon the policy options of the EU and its Member States as well as upon defence companies in terms of disproportionate and costly burdens and obstacles.

However, to date no general EU framework exists for regulating and simplifying intra-European transfers of military goods. Shipments of military goods are generally considered as exports, whether they take place between EU Member States or are dispatched outside the EU zone.

One suggested solution to alleviate these problems is the creation of a regime for the intra-European transfer of defence-related items. This would basically make it possible to deliver such items inside EU borders without regular state intervention. Such a transfer regime could also ensure an EU-wide security of supply.

As the Commission's proposal for a 'transfer regime' and potential subsequent steps to implement it puts the spotlight on the Member States, debates on the necessity and effectiveness of such a regime will increase within governments and parliaments as well as among the wider public. However, relatively little is known about the matter. This chapter sets out to explain the relevance and rationale of the proposed regime, the related economic and security-relevant arguments for and against it and how these might be integrated into an effective framework. It aims to offer guidance through the ongoing process and to evaluate to what extent the proposed regime offers solutions for the existing problems. More precisely the chapter aims to:

- show the relevance of the issue in the wider context of the European Defence Equipment Market (EDEM) and describe the current state of play.

- elaborate on the economic and security perspective, setting out the criteria for the viability and efficiency of a potential regime.
- evaluate the main options of an intra-European transfer regime for defence goods, especially regarding security of supply and re-exports.

Current state of play and the need for change[1]

The EU's 27 defence markets

Within the EU's internal market, common standards and procedures guarantee the free movement of goods, capital, individuals and services. The internal market creates a homogeneous trading area within the EU's territory without any state impediment such as duties or transfer licences. It is flanked by a number of regulatory policies (e.g. merger control, state aid regulation, procedures on public procurement) and legislative instruments like 'Regulations' or 'Directives'.

In contrast, there is no unified EU defence market, but a complex structure characterised by 27 national marketplaces, controlled by 27 national policies, regulations and related procedures. Because of its inherent security dimension, this area has traditionally been seen by the Member States as their own *domaine réservé*. Consequently, it was *de facto* excluded from the EU integration process. This exemption is reflected in Article 296 of the Treaty of the European Union, according to which a Member State '... may take measures as it considers necessary ... for the protection of the essential security interests ... connected with the production or trade of military items ...'[2]

Although Article 296 principally allows using market instruments wherever possible, the Member States have regularly resorted to the derogation clause in order to escape Community procedures. This practice and the absence of a binding EU framework have led to the current fragmentation of the defence market in terms of demand, regulatory framework and supply.

The demand side for defence items is primarily nationally defined. Member States, often sole demanders, have structured their national industrial infrastructure by their specific military planning, the resulting procurement and with respect to other domestic issues like jobs.[3] Member States have created their individual national regulations to organise procurement, supply and

1. The following excellent overviews of the topic are available: Hartmut Küchle, 'The cost of non-Europe in the area of security and defence', Study for the European Parliament's Subcommittee on Security and Defence, Brussels, June 2006; Keith Hartley, 'Defence Industrial Policy in a Military Alliance', *Journal of Peace Research*, vol. 43, no. 4, 2006, pp. 473-89; Burkard Schmitt, 'The European Union and armaments. Getting a bigger bang for the Euro', *Chaillot Paper* no. 63, EU Institute for Security Studies, Paris, August 2003; Burkard Schmitt, 'Defence Procurement in the European Union – The current debate', Report of an EUISS Task Force, EU Institute for Security Studies, Paris, May 2005.

2. Treaty on European Union, Article 296b. See: http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html.

3. Joachim Rohde, 'Rüstung in Europa Zwänge und Optionen zur Optimierung europäischer Rüstungsprozesse', SWP-Studie 2004/S 25, Berlin, June 2004, p. 17.

exports etc of military goods. These rules differ significantly among Member States. Besides, national procurement policies favour domestic suppliers for several reasons. Exceptions have only been approved among the participating states for large multinational procurement projects (e.g. Tornado, Eurofighter) or through bilateral/multilateral agreements (e.g. Framework Agreement related to the 'Letter of Intent').[4]

This also forced the complete supply chain to adapt to this structuring along the lines of national policies. Put simply, the supply chain consists of two groups of companies: system integrators and suppliers. System integrators produce complete systems, e.g. tanks or vessels, out of subsystems and components. These are produced and delivered by suppliers. System integrators and suppliers are affected by the national structuring in different ways: system integrators are often large transnational defence companies (TDC) such as Thales or EADS. They have set up local national branches for their operative business. These branches cater for the respective domestic demands. Consequently, even though a certain degree of internationalisation has taken place in Europe, the TDC do not offer a 'Europeanised' portfolio of products or reflect a homogeneous EU approach. The suppliers are mainly small and medium-sized enterprises (SMEs). They are usually bound to the national demand of their base country and the business of the system integrators as they mostly lack representations or even production sites in other countries.

In terms of procurement, Member States rely heavily on their national suppliers. On the one hand, this has led to protected national markets. Here competition is rather limited, especially on major systems. Sometimes only one or two domestic competitors exist. On the other hand, these national markets are too small for national suppliers to survive. Given the small production lots, economy-of-scale effects are comparatively marginal. Consequently, although governments pay unnecessarily high prices per item, the revenues for the companies are small because of the small customer base and quasi-monopolistic structures on the demand and supply side.

In terms of competition, national procurement policies and subsequent procedures have led to a discrimination against non-national suppliers. Except for TDCs, smaller companies very rarely possess branches or production sites in other Member States. Thus, their access to markets is obstructed, because they

4. Jocelyn Mawdsley, 'The European Union and Defense Industrial Policy', *BICC Paper* no. 31, July 2003, p. 16. See also Burkard Schmitt, 'The European Union and armaments. Getting a bigger bang for the Euro', op. cit. in note 1.

cannot act as a privileged domestic supplier. Furthermore, there is a lack of transparency with regard to the national demand. Obtaining information about the national markets is costly. This means that overheads act as a disincentive to potential offers. Therefore, endeavours to enter foreign markets become rather unattractive.

Additionally, due to a lack of general and reliable EU-wide transfer arrangements, foreign suppliers cannot guarantee security of supply (SoS)[5], i.e. the on-time delivery of spare parts and components, unless they can operate under the umbrella of an additional agreement. This is due to Article 296 which allows the state to intervene in transnational supply chains. Consequently, especially for second- and third-tier producers, exports into other Member States or bidding on tenders entail enormous administrative efforts and financial risks. Conversely, this inability to provide SoS becomes a legitimate reason for the Member States to discriminate between domestic and external bidders.

This reveals another major deficit: in contrast to other sectors where internal market regulations apply, the intra-European transfers of military goods are considered as exports, even if they are part of an intra-European production chain. As a consequence, the same procedures apply for intra-European transfers and for exports of such goods to third countries. Defence companies therefore have to calculate time-consuming and costly administrative procedures to acquire *ex ante* licences and certificates for the export, import, delivery and end-use – even if all of this takes place within the EU.

EU armaments policy – need for change

The current situation serves neither the economic nor the security interests of the European defence sector. With this 'lose-lose' situation becoming increasingly apparent since the end of the Cold War, the pressure on the Member States to adopt a more systematic approach towards armaments policy has been growing. The deepening gap between the policy objectives of the Union on the one hand and its capabilities and the political options available to it on the other has further increased the pressure on the Member States to address this problem. The more ambitious and active the EU has become within the last few years in the field of defence, the more the deficits have become obvious.

5. '"Security of Supply" means an actor's ability to guarantee and to be guaranteed a supply of Defence Articles and Defence Services sufficient to discharge its commitments in accordance with its foreign and security policy requirements (state actor) or its contract commitments (private actor) vis-à-vis another state or private actor.' NATO definition cited in William Denk, presentation, 'Security of Supply', US-Spain Defense Industry Cooperation Conference, Madrid, 16 July 2003. See: http://proceedings.ndia.org/3991/Denk.pdf.

The EU's 27 national regulations obviously do not reflect the industrial reality: TDCs have emerged over the last decade as a response to the economic necessities of the defence sector. But they are still hindered in their efforts to further consolidate and rationalise their production along managerial lines across EU borders. For SMEs it is difficult and costly to participate in European bidding processes and to earn their share as part of a supply chain or subcontractor for production, as the national regulations still differ considerably. This implies, especially for SMEs, comparatively high overhead costs to access other Member State markets. Moreover, non-national bidders have to fight against regulations designed to protect national strategic interests or uncompetitive national firms against market mechanisms.

With regard to national military spending, Member States have experienced a double constraint. On the one hand, defence budgets have been frozen or reduced over the last few years. On the other hand, prices per item for military systems have increased. Both processes undermine the acquisition of military goods both in terms of required quality and quantity.

As a consequence of predominantly nationally allocated spending as well as impasses in cooperation and procurement, the competitiveness of EU companies *vis-à-vis* non EU-suppliers is undermined. Due to comparatively small production lots, EU companies rely heavily on exports to keep prices at reasonable levels. Moreover, low spending affects the ability to keep up innovation and diversity of the industries, as a reasonable scale of investment in R&D is lacking. This weakens, and in the long run even endangers, the European Defence Industrial and Technological Base (EDITB). In turn, it negatively influences competitiveness in terms of the quality and variety of products.[6]

Consequently, European industries are increasingly failing to maintain expertise and to produce capabilities to underpin ESDP. However, ESDP's inner legitimacy as well as outer credibility and effectiveness remain questionable if the Member States are unable to generate the capabilities called for in the Helsinki Headline Goal and the Headline Goal 2010.

The result is markets that are too small to survive economically as they do not provide sufficient economy of scale. Consequently, they cannot produce the necessary profits to be reinvested in the industries or to allow for lower prices. This market tends increasingly to offer goods nobody either needs or can afford.

6. Rohde, op. cit. in note 3; European Defence Agency, 'National Breakdowns of European Defence Expenditure', Brussels, January 2007.

The inefficiency and blocked integration of the European defence market does not only have an impact at the European level but above all affects the Member States. Even in situations in which the Union is not involved, the Member States risk losing their capabilities to act and thus, by extension, their political options. In a long-term perspective, the EU may even become more dependent on external actors than on their own Member States. This may affect the acquisition of war material and thus the supply chain.

A European defence market as a solution?

As a viable way out of this impasse, the idea of a European defence equipment market (EDEM) has been developed. Many observers certainly agree on the general need for and objectives of further integration towards an EDEM. But the consensus fades when it comes to defining the concrete terms of regulations and the degree of integration.[7]

From an economic perspective the main idea is to create a (kind of) single market for the defence sector. This would improve the efficiency of defence spending via a bigger internal market for European companies where economy of scale can take place to a higher extent. It may also increase the growth and competitiveness of Europe's defence industrial and technological base.[8] Within this internal market, trading and competition among companies would be possible without restrictions and state intervention. For TDCs it would open up the option to restructure and rationalise production and hence become more competitive.

Regarding the security policy-related needs of the Member States, such a market should enable them to get more value for their money and thus to acquire the capabilities needed to pursue European military security tasks. Ultimately it would enable the implementation of a coherent and effective European security policy.

In order to create the necessary economic conditions for such a market certain changes would be required for a variety of regulations and practices in the areas of competition, industrial cooperation, procurement and shipment of goods. These may be based on Community instruments or on EU-wide intergovernmental agreements.[9] A fully integrated EDEM would consist of a single set of regulations and harmonised procedures in the following areas:[10]

7. See Rohde, op. cit. in note 3.

8. General arguments can be found in Schmitt, 'The European Union and armaments. Getting a bigger bang for the Euro', op. cit. in note 1; European Commission, 'Communication from the Commission to the Council and the European Parliament on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives', (COM(2005) 626 final), Brussels, December 2005.

9. Community instruments such as directives and regulations would be most effective where a fairly independent supervision and interpretation of regulations is needed, such as in the area of procurement. Intergovernmental elements may suit best in cases where sensitive political issues are concerned, e.g. concerning security of supply and state intervention respectively.

10. Schmitt, 'Defence Procurement in the European Union – The current debate', op. cit. in note 1, pp. 11-12.

- **Competition:** regulation of exemptions from common rules, merger & acquisitions and state aid.
- **Procurement:** harmonisation of rules and procedures, open markets for non-national suppliers, generating transparency of market structure, minimising use of Article 296.
- **Exports:** development and implementation of a common/coordinated export policy.
- **Community transfers:** simplified licensing and reduced state intervention in intra- European transfers of defence goods.

Community transfers: market and security perspectives

Transfer regulations in the EU – an outline

Today no general EU-wide transfer regime exists. As the defence equipment sector evolved, the whole area of export regulations evolved in parallel, with countries developing their own national particularities. Currently 27 different national legal systems govern the export of military goods within the EU. These vary in terms of items, kinds of licences, application procedures and with regard to the authorities in charge.[11]

So-called 'ammunition lists' define the *scope*, i.e. those items that are nationally recognised as military goods subject to export regulations. The most common lists within the EU are the one annexed to the Code of Conduct on Arms Exports (CoC Ex) and that of the Wassenaar Agreement.[12] While many Member States refer to these lists, they have made their own modifications to them reflecting their national legislations and cultures. Consequently, the national lists are similar but not identical.

Several licences and documents are needed for the shipment of military goods: e.g. import, export and end-use certificates. Today three basic types of licences exist for exports of military goods: 'individual', 'global' and 'general licences'. In some Member States additional licences may be required. The licences differ in terms of validity, scope/coverage, and the general availability of a licence type. The most common licence for military goods is the individual licence. It requires *ex-ante* evaluation. The licence is granted for a defined timeframe in which several consignments can be delivered to the defined destination. But the licence is always limited to one specific good.[13] Particular transfer licences only exist within the LoI framework.[14]

11. Unisys, 'Intra-Community circulation of defence-related products', Final Report of the Study 'Assessment of Community initiatives related to intra-Community transfers of defence products', carried out by Unisys for the European Commission, February 2005.

12. International agreement on export controls for conventional arms, dual-use goods and technologies.

13. 'An individual licence is typically valid for 12 months, and is usually granted for the most sensitive exports. The licence may cover several consignments of a specific good to the consignee/end-user specified on the licence. Thus, an individual licence must be applied for each transaction, meaning that a case-by-case evaluation will take place. The licence either expires by the defined period, i.e. it lapses, or it can be fulfilled by quantity. If a licence has expired due to time but has not yet been fulfilled, it is possible, in some countries, to apply for an extension. In other countries it is easier to submit a new application for the remaining quantity.' Unisys, op. cit. in note 11, p. 14.

14. LoI: 'Letter of Intent' agreement, signed in 1998. See Burkard Schmitt, 'European armaments cooperation. Core documents', *Chaillot Paper* no. 59, European Institute for Security Studies, Paris, April 2003, pp. 68-94.

Likewise, the certification process, which recognises the reliability of defence exporters, is based on different practices in each Member State. Therefore companies that are eligible to import/export military items in one country are not routinely allowed to do so in others.

Moreover, within the EU, eleven different national types of authorities are involved in the licensing process. At least two different authorities are involved in each Member State. They range from specific councils and commissions to branches of ministries. This reflects the different political perspectives on exports. This may also explain the diverging interpretations of the legislation and subsequent export decisions. Moreover the procedural steps and the time span from application to result differ considerably.[15]

For some areas transfer regulations exist. However, this concerns arrangements outside the EU framework. They are based on *ad hoc* agreements or are valid for a specific area only. These are:

- **state-private sector relations:** here governments undertake to not intervene in the transfer relation between a state party and a private supplier from another state. Hence, they rule out the potential use of Article 296. Such bilateral agreements exist, e.g. between Germany and France (the Schmidt Debré Agreement of 1972).[16]
- **State-backed multilateral programmes:** these programmes are initiated by states to cooperatively carry out larger procurement programmes. Here transfers are simplified by *ad hoc* agreements in terms of Memorandums of Understanding (MoUs) that flank a treaty. An example for such programmes is the procurement programme for the transport aircraft A-400 M.
- **The LoI/Framework Agreement (FA)**[17] allows participating states to differentiate between transfers and exports. It introduces simplified and harmonised procedures for both. It also includes procedures and provisions for security of supply, end-use assurances and protection of classified data.[18]

Hence, armaments cooperation has developed comparatively well at the inter-governmental level. Conditions have also improved for foreign companies that manufacture military goods for a national or multinational procurement programme. For industrial cooperation, which especially concerns private actor relations, virtually no transfer regulations exist.

15. Unisys, op. cit. in note 11.

16. Michael Brzoska and Hartmut Küchle, 'Folgen Auswirkungen und Gestaltungsmöglichkeiten internationaler Abkommen für eine restriktive deutsche Rüstungsexportpolitik', BICC paper no. 19, Bonn 2002, pp. 11-19.

17. Signed 1998/2000 by major arms producers (France, Germany, Italy, Spain, Sweden, the UK).

18. Schmitt, 'European armaments cooperation', op. cit. in note 14, pp. 68-94.

Background: diverse frictions and interests

Since the Western European Armament Group (WEAG) was founded in the 1960s, Member States have generally acknowledged the need for a more effective and integrated defence market. However, such statements have not yet led to any EU-wide framework. Instead, the fragmentation has been consolidated. This is mainly due to the numerous dividing lines between different (groups of) actors. The reasons range from divergent political traditions and resulting military, industrial and procurement policies which seriously obstruct agreement on the basic principles and scope of a common armament policy, to Member States' refusal of the EU Commission having any serious role in this area. Most important however is the lack of trust between the Member States and their ignorance regarding the policies of other Member States. These trends have resurfaced within the current debate.

A significant rift runs between the Member States and the Commission. Although Member States suffer from the nationally-based structuring of the market, they insist on the Commission's lack of jurisdiction over this policy field and deny the Commission's expertise in security policy issues.[19] The Commission perceives itself as the guardian of principles like the single market, fair competition or free trade. Backed by the European Court of Justice (ECJ) the Commission increasingly calls for the introduction of internal market elements into the EU defence sector.[20]

Producing and non-producing states have different if not opposite interests with regard to exports policies and a potential transfer regime.[21] Within the EU 27, six states, France, Italy, Germany, Spain, Sweden and the United Kingdom, produce and export the majority of military goods. They share a specific interest in simple and on-time flows of military goods, be it for multinational procurement programmes or supply of national forces. However, in parallel they want, to a different degree, to protect their national defence industries – especially if these are state-owned. The remaining Member States are more or less passive on the transfer issue. However, their interest in the issue may grow once suppliers want to build production sites in their countries and thus would need to transfer defence products to foreign system-integrators.

Even among the LoI-countries lines of division exist, *inter alia* over a control and monitoring system and the question of responsibility. Some favour a more governmental-based approach with a

19. Rohde, op. cit. in note 3; Martin Trybus, ,'The Limits of European Community Competence for Defence', *European Foreign Affairs Review*, no. 9, 2004, pp. 189-217.

20. European Commission, 'Consultation Paper on the Intra-Community Circulation of Products for the Defence of the Member States', Brussels, March 2006, p. 3.

21. For a more differentiated account see Schmitt, 'Defence Procurement in the European Union', op. cit. in note 1, p. 12.

high visibility of ongoing transfers. Other countries tend to delegate the obligation to comply with existing regulations first to their national companies.[22]

Also, the low degree of mutual trust among the Member States affects the options for achieving an intra-Community regime. Every Member State wants to retain a certain level of control over 'its' exports. Moreover, there seems to be particularly little confidence in the 'new' Member States. Their capability to implement the existing body of law and set up reliable procedures is questioned and a higher risk of re-exports from these countries is perceived. This is due to ignorance about the already existing and well-executed export control procedures in these countries as well as the lack of a history of shared cooperation.[23]

The economic-industrial perspective

This deficit exacerbates industrial cooperation in the area of R&D and production and impedes consolidation and rationalisation within the EU defence industrial landscape. Companies generally have to apply for export licences. They find it very difficult to establish effective cross-border cooperation. They are still having to contend with red tape and legal uncertainties. This applies to vertical relations (suppliers delivering system integrators) as well as to horizontal ones (cooperative R&D or production among companies).

As the majority of system integrators work mostly under governmentally-backed arrangements, the aforementioned problems affect them to a lesser degree. However suppliers have to carry an extra burden. If they do not supply governments directly but sell their products to the system integrators, special arrangements do not apply. Furthermore, it is comparatively difficult to enhance their visibility on the European market and sell their products and services.[24]

From a general economic perspective the free movement of goods represents an essential element of every market.[25] Moreover, transfers play a central role for the performance of a market as they are vital for effective procurement, competition and cooperation.

As in the civilian sector, the development and production of goods and the provision of services in the defence sector is characterised by transnationalisation of cooperation, production and security of supply. Nowadays, the competences and capacities for high-tech defence products subsystems and components are spread over Europe. In the context of these internationalised struc-

22. Contributions to the consultation on the intra-Community circulation of defence-related products. See: http://ec.europa.eu/enterprise/regulation/inst_sp/docs/consult_transfer/list_contrib1.pdf.

23. Unisys, op. cit. in note 11, p. 25; Unisys, 'Intra-Community Transfers of Defence Products Impact Assessment', Final Report of the study 'Analysis of the impact of a proposal for intra-Community transfers of Defence products', carried out by Unisys for the European Commission, Brussels, February 2007, p. 32.

24. Unisys, op. cit. in note 11, p. 117.

25. They are part of the four basic freedoms in the EU single market context: free movement of goods, services, capital and people.

tures for R&D and production, the EU defence sector depends crucially on the shipment of military goods across the EU.

Transnational industrial cooperation is also key to competitiveness. Today, this implies the ability to react rapidly to changing demands for military equipment. This ability is not only a competitive advantage, but corresponds also to the interest of the states. The states expect the industries to react quickly to new challenges and to come up with solutions. Hence, military systems are increasingly self-designed and produced 'off the shelf'. Unless a specific request is forthcoming from the state, companies develop prototypes and demonstrators and offer them on the market.

For such development as well as for subsequent production, ideally, a system integrator would buy the required quality of components at the cheapest prices across Europe and ship them to the production site. However, such supply becomes seriously complicated if the components are military items. To transfer them across Europe defence companies have to apply for export licences. This applies not only for every single item but also for every state crossed during the shipment. Thus, in private industrial relations companies have to contend with not only the financial risk but also the state-induced financial and administrative burdens.

Although the degree of variance between the national systems is sometimes rather small, it nonetheless has a negative impact. The multiple licences and accompanying procedures increase the red tape and administrative workload for exports, create extra costs and delay delivery. One of the main issues is the increased complexity and uncertainty about the procedures and the viability of successful applications. The different timeframes and constraints hamper the planning process for production.

This applies for transnational defence companies (TDCs) as well as for small and medium-sized enterprises (SMEs). TDCs, which often act as a system integrator, have to invest a huge amount of time and money to find subcontractors who can produce the required quantities, and right quality, of components. But additionally they have to ensure that military goods for the development phase and production are authorised by a licence to be transferred to the production site where the integration takes place – and delivered on time. Even if they ship parts from one of their own sites to another in Europe, they need export licences.

In such transnational production lines, SMEs are primarily subcontractors and suppliers of components and spare parts. It

becomes especially difficult for them to enter the market. Export-application fees add to the overall cost of the bid. Even if they can offer competitive prices they cannot guarantee that the export licences will be granted by the authorities, which in return makes them unattractive partners. Therefore, unimpeded transfers are also an issue for fair competition.

Finally, unimpeded transfers would facilitate the necessary restructuring of the EU's defence industrial landscape. National structuring and practices such as *juste retour*[26] have led to costly duplication and overcapacities for R&D and production. A transfer regime could make it possible to outsource labour-intensive tasks and maintenance services to countries with lower labour costs. This would decrease the costs and allow for a more efficient supply chain.[27] Overall, this may, in a long-term perspective, allow for reallocation of resources – from subsidies for national champions towards investment in innovation and up-to-date capabilities.[28]

Thus, from an economic perspective, a more integrated European defence market can only disclose its full potential if the issue of transfers is tackled. Lowering the price per system through cheaper components is a major strategy in the civilian production sector, but it cannot be used for defence products. Moreover, the potential benefits of recent initiatives to harmonise EU defence procurement, e.g. the CoC for Defence Procurement and the Defence Directive, will be limited or even neutralised if the transfer system is not opened up. Even if Member States were to harmonise procurement and increase its transparency, existing restrictions would not allow the free transfer of such items among Member States.

The security perspective

When formulating the cornerstones of a potential transfer regime, these purely economic considerations have to be balanced against the security interests of the Member States. From a security perspective, the defence market is a distinctive area in that it touches upon sensitive issues related to national foreign, security and defence policies.[29]

Generally, production and trade of defence goods are not only important instruments of a state's security and defence policy but are also considered an expression of its sovereignty. Hence, these questions need to be managed at the highest political level. More-

26. See Jean-Pierre Darnis, Giovanni Gasparini, Christoph Grams, Daniel Keohane, Fabio Liberti, Jean-Pierre Maulny, May-Britt Stumbaum, 'Lessons learned from European defence equipment programmes', *Occasional Paper* no. 69, EUISS, Paris, October 2007, p. 25.

27. Unisys, op. cit. in note 11, p. 87.

28. Ibid., p. 37; Rohde, op. cit. in note 3; Hartley, op. cit. in note 1.

29. Ian Davis, *The Regulation of Arms and Dual-Use Exports: Germany, Sweden and the UK* (Oxford: Oxford University Press, 2002).

over, the technology is extremely sensitive. Technological superiority is an integral part of military capabilities and strategy. However, the proliferation of technology may undermine security as it could allow potential adversaries to reveal weaknesses within the existing technologies.

Moreover, arms exports can be used as an instrument of foreign and security policy towards a country or a region. Export of defence materials, or the refusal to export them, can influence the evolution of a conflict or the human rights situation in such circumstances. Thus, from a perspective of moral responsibility the impact of an export of bombs, delivered to an area regardless of the political/security situation pertaining therein, cannot be compared with a similar situation applying to an export of bananas. However, exports are also used as a diplomatic instrument of foreign policy for non-security reasons.

Through their participation in various export control and non-proliferation regimes,[30] Member States are obliged to monitor certain goods and technologies. These liabilities have to be reflected in a transfer regime as well. The intention to support and preserve a national defence industrial base also characterises export policies. Often defence products only remain affordable if national industries manage to gain the necessary profits through foreign arms-trade.[31]

Furthermore, any handling of sensitive technologies has to reconcile the need for both secrecy and transparency of information related to exports and transfer. The confidentiality of technological details is a vital security interest of states. These details reflect the intellectual capital and competitiveness of companies *vis-à-vis* other suppliers. Thus information cannot be easily released. Meanwhile the parliament and the public, for example, have the right to know about the quantities and quality of military items that are imported and exported.

Based on these general concerns and related political interests the suggested transfer regime has triggered specific objections over re-exports and traditional ways of ensuring security of supply, particularly among the Member States. Some Member States are especially aware that lowering controls for sensitive goods under a transfer regime as well as the subsequent increase in the number of goods moving across Europe may result in a higher probability of re-exports taking place. Re-exports in this context denote the export of defence items out of the EU that have previ-

30. e.g. Wassenaar Agreement (WA), Missile Technology Control Regime (MTCR), Nuclear Supplier Group (NSG). See Christian Mölling and Achim Maas, 'Auf dem Weg zu einer einheitlichen europäischen Rüstungskontrollpolitik?', IFAR Working Paper no. 8, January 2006.

31. From an European perspective a coordinated specialisation of some military capabilities and industrial efforts may be needed to avoid on the one hand producing duplicative and non-interoperable capabilities or on the other hand the loss of vital European defence industrial assets. See Michèle A. Flournoy, Julianne Smith, Guy Ben-Ari, Kathleen McInnis, David R. Scruggs, 'European Defense Integration: Bridging the Gap Between Strategy and Capabilities', Center for Strategic and International Studies (CSIS), October 2005. Available at: http://www.csis.org/media/csis/pubs/0510_eurodefensereport.df: 13.

ously been exported within the EU. As exports reflect part of their national policies, Member States want to retain control over the exports and the end use of defence products or components manufactured in their country. They fear that their export controls may be circumvented by the re-export of defence items from another EU country whose exports controls are less rigid or are based on a different policy, even if such a re-export of items is not allowed by the country of origin. This can occur for example if complete systems are exported which consist of components made in other Member States.

Aware of inconsistent national export policies and different levels of export controls within the EU, Member States advocate the principal use of Article 296 TEU. Consequently they apply their export control procedures also to intra-Community transfers to avoid illegal shipment and end use.

However, these concerns are not based on empirical evidence. Furthermore, Member States have already taken measures against re-exports within the current system. Within the licensing, end-use as well as end-user have to be given proper assurances and guarantees. Furthermore, since 2002 the CoC Ex contains specific regulations prohibiting re-exports.[32] All these advances must be preserved in a new transfer regime.

Nonetheless, some Member States seek further guarantees against the risk of re-exports in case rules on intra-Community transfers are eased. Drawing upon existing measures the following instruments can be envisaged:

- end-use certificates for intra-European transfers
- a licensing process based on common criteria and their coherent interpretation
- traceability of the goods to ensure an unbroken chain of custody as well as controls
- trading and exporting only by certified companies.

Besides, Member States consider that the transnationalisation of production may undermine their SoS. To date, Member States have argued that they have to rely on domestic instead of transnational supply. This builds on Article 296 which allows the cutting off of transnational supplies, i.e. a domestic company's supplies to armed forces of another Member State.[33]

However, actual practice shows that Article 296 no longer binds Member States to domestic supply: systems procured from

32. Sibylle Bauer and Mark Bromley, 'The European Union Code of Conduct on Arms Exports: Improving the Annual Report', SIPRI Policy Paper no. 8, November 2004.

33. Two principal ways of restricting the invocation of Article 296 can be envisaged: domestic pressure to use safeguards against indirect support of a military operation conducted by another Member State that is publicly perceived as being an illegitimate act of aggression. Second is the illegal re-exportation of military goods.. However, there is no indication that such cases have taken place to date. See Schmitt, 'Defence Procurement in the European Union', op. cit. in note 1, p. 11.

domestic suppliers frequently incorporate components from other Member States. These transnational supply chains are secured by bilateral or multilateral agreements, which do not have to be replaced by a transfer regime. Such supplies may also be less prone to violation of export rules, given that the end-users are armed forces of another Member State.

Additionally, on a less critical level, such transnational supply chains are already common: in particular, Member States which do not possess a fully-fledged defence industry order entire systems from other Member States. They depend on the transnational delivery of spare parts and services.

Given that an increasing number of supplies have already became transnational and thus Article 296 principally applies, SoS has in fact become more 'critical' – but because its transnational reality does not correspond with the Member States' conceptions and regulations.

The resulting dilemma: the economic-security jungle

As transnationalisation of production is likely to continue, it would be not only desirable but even necessary to have a more solid base for transfers. These should ensure shipment of military items across EU-national borders without regular state interference or impediment. The basic rule should be that as long as the transfer partners comply with the regime, no state interference should be permitted.

However the Member States face a multi-faceted dilemma. Implementing their individual security interests through export controls is legal and legitimate. However, in particular the double-edged character of Article 296 creates a vicious circle: as Article 296 is seen as the safeguard option for stopping undesired re-exports, Member States are reluctant to allow key parts of this article to be changed. As a result, their insistence on preserving Article 296 in its present form legitimises reliance on national SoS. However Article 296 not only guarantees security, but also reduces it. When Member States insist on retaining Article 296 intact they are by the same token blocking regulative adaptation to the already existing transnational reality of SoS.

Instead, Member States have turned industrial cooperation, a central pillar of the modern defence industrial base, into the area with the most state-based obstructions for free trade and ship-

ment. Thus, the transnational 'security of supply', i.e. guaranteed and on-time supply of spare parts and components, is absent. To develop such systems within short timeframes and at low cost, system integrators need to act on the market without obstruction by those who demand these new modes of production – the states.

Quite apart from the fact that the Member States' attitude is unrealistic, it does not allow the financial gains from consolidation and restructuring of the defence sector to be realised. It hampers the rationalisation of production processes and the furthering of defence industrial cooperation which may eventually make it possible to purchase military equipment less expensively. Hence, missing transfers also lower the budgetary room for manoeuvre for defence procurement and consequently narrow the political options for the ESDP.

Finally it is not only the production but the technology itself that induces the need for new international controls and a new relationship between industries and states: the most sensitive technologies have become so-called 'intangibles', i.e. information and software. Their illegal shipment is beyond the capacities of any classical state-based regime.[34]

It seems that Member States are increasingly becoming aware of the predicament in which they find themselves: they have only two options open to them – and, whatever decision they take, it will entail major consequences:

- do nothing for the foreseeable future but accept comparatively higher prices for defence items in parallel with a constant loss of industrial capacities as these cannot survive international competition.
- transfer national regulations into an EU framework, followed by extensive changes in industrial production and cooperation.

Changing the situation implies that Member States accept that a transfer regime is not a problem but a solution to their problems, i.e. the growing reliance on transnational supply and the increase in price of defence items.

Moreover, governments would have to accept that transnational restructuring involves a gradual loss of domestic production capabilities and increasing mutual dependence on effective transnational supplies from foreign companies or TDCs. Moreover, in terms of security interests, Member States have to seek assurances against re-export, but also have to grant SoS.

34. Amitav Mallik, 'Technology and Security in the 21st Century: A Demand-Side Perspective', SIPRI Research Report no. 20, Oxford University Press, Oxford, 2004; Unisys, op. cit. in note 11, p. 9.

Hence a solution for a transfer regime also has to incorporate assurances related to the end use and the authorised final destinations. This will guarantee the Member States that defence items are free to circulate within Europe as long as regime obligations are adhered to without items under their political responsibility being dispatched to an undesired destination.

To break the vicious circle surrounding Article 296, Member States have to agree on some kind of reform of Article 296. Otherwise it will continue to create distrust in SoS but also to offer a 'backdoor' via which to escape Community-based approaches.

Also, proposed solutions have to be qualified: it is more than plausible that hurdles related to the non-existence of a transfer regime generate massive costs. However, although some attempts have been made to calculate the cost of non-Europe in transfers,[35] the results should be treated with caution. Moreover it would be too simplistic to imply that these costs equal the revenues once a transfer regime is finally put in place. Nor are costs and red tape always the most significant causes of the bottlenecks that hinder exports or transfers.

Finding a way through the jungle: the current initiative

Until recently a high priority has not been assigned to 'transfers' on the agenda of the Member States. In the past, some suggestions have been made regarding a change of the export system, including the alleviation of intra-Community transfers.[36] These endeavours had only limited success as up until today Member States have neither given away competencies to the Community within the first pillar nor organised their national policies within the second pillar. The inception of the European Defence Agency (EDA) gave hope to some observers that traditional divergences would be surmounted. However, the EDA has not yet received the mandate to get involved in the subject of intra-Community transfers.

To date, only the Commission has put some serious thought into the issue of intra-European transfers as part of its activities to promote a more integrated defence market and an EU defence equipment policy.[37] It has pushed for solutions through studies and conferences.[38] Additionally it has launched a series of communications.[39] Fundamental to all these is the plea to simplify intra-Community transfers by reducing administrative burdens.

35. Unisys, op. cit. in note 11, pp. 101-14.

36. In 1995 POLARM *inter alia* examined topics like security of supply, and transfers. Greece and Germany also introduced some suggestion.

37. EU Commission, 'Implementing European Union strategy on defence-related industries', Communication COM (1997)583, Brussels, January 1997, esp. Annex II.

38. Conferences: Defence Conference of 11 July 2005 in Brussels, European Commission's Conference 'European Defence Procurement in the 21st Century', 8 November 2000. Studies: 'Standardisation Systems in the Defence Industries of the European Union and the United States; Industrial and Strategic Cooperation Models for Armaments Companies in Europe'. See: http://ec.europa.eu/enterprise/defence/eu_defence_policy.htm.

39. European Commission, 'The challenges facing the European defence-related industry, a contribution for action at European level', Communication COM (1996)10, Brussels, January 1996; Communication COM (1997)583, op. cit. in note 37; European Commission, 'European Defence Industrial and Market Issues – Towards an EU Defence Equipment Policy', Communication COM (2003)113, Brussels, March 2003.

Only recently the Commission tendered a study on intra-Community transfers of defence products.[40] It provides a comprehensive evaluation and overview of the current system, including an analysis of national practices, resulting obstacles and recommendations for solutions. After having discussed the results of the study with the Member States, in March 2006 the Commission issued a consultation paper on the intra-Community circulation of defence-related products in order to launch a public debate.[41] The latest development has been an impact assessment study of a potential transfer regime.[42] Both of these initiatives have been necessary to prepare the ground for the now proposed Directive.

A transfer regime at a glance

An ideal transfer regime would integrate the security and economic perspectives. To be economically efficient, such a regime needs to facilitate unhindered cooperation and undistorted competition within the EU. Therefore it needs to entail a single set of binding regulations which apply to all Member States, and which would differentiate transfer and transit of military goods among Member States from those towards third states.[43] On the security side, a regime has not only to support the development of military goods and capabilities. It also has to reflect the particularities of the military sector as a politicised market, and especially those related to the distribution of military items like security of supply and the risk of re-exports. Its main objectives therefore are listed below.

Main objectives of a transfer regime[44]

- to establish the free movement of defence goods within the EU.
- to ensure that national security and political interests of the Member States are considered, especially re-exports and security of supply.
- to simplify and harmonise licensing procedures.
- to organise the control, traceability and transparency of transfers.
- to link the regime to the CoC Ex and other international treaties.
- to confirm safeguards options for Member States.

40. Unisys, op. cit. in note 11.

41. EU Commission, Consultation Paper on the Intra-Community circulation of defence-related products, Brussels, 21 March 2006. See: http://europa.eu.int/comm/enterprise/regulation/inst_sp/docs/consult_transfer/consult_en.pdf.

42. Unisys, op. cit. in note 11.

43. Third states means every country outside the EU.

44. Derived from the EU Commission, Consultation Paper on the Intra-Community circulation of defence-related products, op. cit. in note 41, p. 5.

Beyond the specific objectives, every regime has to provide the necessary elements that allow for managing the system as well as integrating the political dimension:[45]

Necessary elements of a regime

- **A definition of the scope of the regime**, i.e which items are subject to control. While the basic definition is to be made by a political body, the regime also requires specifications based on performance or technological parameters.
- **Conditions for a transfer allowances system.** This represents the implementation of the defined export policy by the relevant authority.
- **A policy-making mechanism** will have to integrate the responsible bodies of the Member States (and the Commission) to formulate the general policy guidelines for the issues discussed above.
- **An executive mechanism** that incorporates authorities and regulations. It includes those agencies who control and monitor the regime as well as those who deal with the authorisation process for transfers.
- **A control/compliance mechanism** monitors adherence to the regime obligations. It therefore comprises enforcement agencies like customs, penalties but also services to the exporters.
- **A legal basis**[46] clarifies responsibilities, rights and relationships of and among state and private actors. It also allows interference in their activities and defines the extent to which this is possible and the forms that it can take.

Useful components of existing regimes[47]

Although a comparable regime does not exist elsewhere, useful components can be identified from other regimes like the EU dual-use regime and the CoC Ex.

45. Adapted from http://www.sipri.org/contents/expcon/expcongen.html. They reflect Krasner`s slightly theoretical definition of regimes as 'sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations.' Stephen D. Krasner, 'Structural causes and regime consequences: regimes as intervening variables', in Stephen D. Krasner, (ed.) *International Regimes* (Ithaca and London: Cornell University Press, 1983), p. 2; See Davis, op. cit. in note 29.

46. Additional tasks are: to explain the relationship to other legal frameworks and international regimes like European Community law or international non-proliferation treaties. In addition to this principal body of law, the implementation and execution of the system needs concrete regulations and instructions.

47. Although the LoI explicitly deals with transfers, its regulations cannot be applied analogously because it leaves out exactly the private-to-private relationship.

Dual-use regime

The dual-use (DU) regime contains some instructive elements concerning the framing of responsibilities and the implementation of a transfer regime, as the monitoring of dual-use goods and defence goods shows certain similarities regarding the issue area and constellation of actors and resulting problems.[48] The regulative design results from a dilemma of responsibility between the Member States and the Commission. The Community had to establish regulations for a common market that would fall under Commission competence according to Article 133 TEU. On the other hand, Member States had to fulfil their obligations resulting from their membership of international non-proliferation regimes.

The dual-use regime is a specific inter-pillar construction.[49] It is implemented as well as overseen by the Commission but enforced by the Member States.[50] They grant export and transfer authorisations and have the right to carry out additional controls of dual-use items other than those listed.[51]

The result of the regime is that, although for this group of items specific controls are in place, an EU single market largely exists. Concerning intra-Community transfers, most items move freely within the European Union after initial authorisation by one of the Member States.[52] This is due to a common and uniform legal base for dual-use transfers within the EU. The system is based on the mutual recognition of national export decisions and information sharing among the Member States regarding decisions to grant export licences. Consequently, the EU has an inherent interest in ensuring effective export controls of all Member States, in particular of those at the Union's external border.

CoC Ex on conventional weapons

A central problem for the transfer regime is the assurance against re-exports. Within the dual-use regime this has been solved via information exchange within a system that builds on mutual trust. This might not work for the area of military items, as the Member States trust neither each other nor the Commission.

Consequently, a rule-based system would be appropriate. Here the CoC Ex offers useful insights. It can be seen as the attempt by the Member States to regulate the political and ethical dimensions of arms trade. It sets out eight criteria as minimum stan-

48. Dual-use goods are technologies of civilian origin but with potential military applications.

49. The original solution was a hybrid first and second pillar legal framework: Council Regulation (EC) no. 1334/2000 setting up a Community Regime for the control of exports of dual-use goods, Brussels, June 2000. This Regulation became part of Community law and thus legally binding to all Member States.

50. Even after further integration of the regime in 2000, with the Commission granted the sole right to update the ammunition list, the Member States retained their central position.

51. Under circumstances described under Arts. 4 & 5 of Council Regulation (EC) no. 1334/2000 annex I (see footnote 49).

52. Council Regulation (EC) no. 1334/2000, article 21, op. cit. in note 49.

dards for export decisions. The procedural elements contain mechanisms for information exchange and consultation. These should allow for greater transparency and convergence of national policies.

Options for a transfer regime

The debate following the Commission's initiative on intra-Community transfers generated several suggestions on how to deal with the various elements of a potential regime. This section explains the main ideas and evaluates their feasibility and efficiency in order to assess their potential to solve the acknowledged problems.

Scope of a transfer regime

The scope concerns only items to be transferred within the EU. Exporting will still be subject to national licensing. Defining the scope means singling out from the wider sphere of military technology – which is *per se* sensitive – those items that do not touch on the essential security interests of a state. Such a group of items can be defined via several options. Generally, to ensure the effectiveness of the regime, any of these options has to be transparent and feasible for Member States and companies as well. Additionally, the more items are included, the more economically efficient the regime will be.

Discrimination according to the sensitivity of goods[53] is unlikely to achieve more than a rough categorisation but very likely to cause major difficulties. The sensitivity of components is technology-inherent as well as context-dependent: modern weapon systems consist of numerous components. The quality of the system is highly determined by the integrational design. It is thus unlikely that Member States will opt out of a case-by-case transfer decision if the cases concern high-technology components or subsystems. Additionally, an elaborate set of specifications would create greater complexity and thus raise the level of uncertainty for the Member States or the companies as well, thus complicating the management of the regime.

Several factors point towards the existing Common Military List of the European Union (CML) as a basis. Most of it is familiar to the Member States. The list could also facilitate the link with

53. Within a consultation paper the Commission also suggested differentiating according to sensitivity if a transfer is to be controlled ex-ante or ex-post. EU Commission 2006, op. cit. in note 41.

the CoC Ex and potentially support further harmonisation of the Member States' export policies via the similar interpretation of definitions. It is also comparable to the list of the Wassenaar Agreement[54] – the main non-proliferation agreement on conventional weapons, which EU Member States are obliged to implement. If a transfer regime covers this obligation sufficiently, Member States will have a strong interest in the effective functioning of the list's implementation. Moreover, any new list may lead to convoluted debates about definitions and interpretations.

However, some common exceptions from simplified transfers are necessary: e.g. war materials like tanks or components of weapons of mass destruction or 'highly sensitive goods' (i.e. comprising the cutting-edge technology of a country or enterprise) will be excluded *a priori*. They will remain subject to individual procedures. A further *a priori* limitation could be made by only permitting components to be transferred between companies. This would automatically exclude all finished and war materials and thus accommodate Member States' concerns about the illegal re-exportation of such items.

Moreover, Member States may want specific national considerations to be reflected in the regime, thus items manufactured by their indigenous companies cannot be subject to simplified transfers. To implement this, Member States could be allowed to have a 'particularities list' and implement it under Article 296 (safeguards). To create trust, this 'particularities list' and decisions regarding it have to be made transparent to states and industries. Overall, the economic impact of exclusions may be marginal unless the exceptions represent more than 5% of the goods.[55]

A list comparable to the 'dual-use' list[56] may be the best solution if distrust among the actors leads to a stalemate in the definition or common interpretation of the scope, thus raising fears about undesired re-exports. Such a rather extensive list defines precisely each item that comes under the regime.

Drawing up such a list raises several challenges. It may become a long and difficult process for the Member States to agree on the numerous definitions needed. But the positive record of the dual-use list shows that, once established, the handling of such an exhaustive and complex document does not pose an excessive challenge.

A further suggestion is a 'positive list'. It would identify those military items that could be generally transferred within the

54. See : www.wassenaar.org.

55. Unisys, op. cit. in note 11, p. 53.

56. Council Regulation (EC) no. 394/2006 amending and updating Regulation (EC) no. 1334/2000 setting up a Community regime for the control of exports of dual-use items and technology, Brussels, February 2006.

Union without individual licences or controls. This would make it possible to reduce the number of items under control and increase the certainty about items which can be moved without any verifying procedure. But a positive list, comparable to the LoI 'white list', would also create problems for transparency of information, due to the fact that it would necessarily be classified. This may reduce democratic control, undermine the legal framework and result in a counterproductive outcome regarding the export policy.[57] It may also induce uncertainty for the companies as they could not access such a list.

Conditions for transfer allowances: certification and licences

To offer an added value to the current situation, an allowance has (a) to be valid in all Member States and (b) to permit the transfer of military items without case-by-case applications or quantitative limits. However, the allowance must especially protect against re-exports.

The transfer allowance defines who is authorised to transfer which items to whom (destinations/actors) under which circumstances. Allowances can be issued through certifications and licences. A certification reveals the trustworthiness of a company concerning the quality of its management with regard to export-related security issues.[58] A licence defines which specific item may be transferred to whom or where. The transfer allowance will always depend on both: the item and the exporter/receiver. Thus certification and licence are complementary and interacting elements within the control system.

The first level of allowance is likely to be a certification of companies, displaying their eligibility to trade in military items. Such certification would be based on a regular audit and EU-wide common criteria and procedures for it. Companies who apply for the licence the first time may have to be examined more frequently or more intensively. As a further option, certificates or licences could be limited to single items or groups thereof: those the company produces or needs to import for its production.

Different stages of certification are also imaginable. The basic one is for those who seldom export or only export one type of product and this on a case-by-case basis. Here, even a General Licence may neither be necessary nor even preferable as the administrative workload and procedures involved may be comparatively cumbersome.

57. Matthias Dembinski, Barbara Schumacher, 'Wie Europa dem Rüstungsexport Schranken setzt. Von der Zusammenarbeit europäischer Regierungen zum europäischen Regieren', HSFK-Report no. 9/2005, Frankfurt/M, pp. 16-17.

58. i.e. implementing and respecting reliable processes for circulating goods and intangible information inside an enterprise and in its communications with the exterior. This should not be confused with ISO 9000 certifications which concern mainly qualitative criteria of the production process. See EU Commission: 'Brief analysis of the results of the consultation', p. 3. Available at: http://ec.europa.eu/enterprise/regulation/inst_sp/docs/consult_transfer/analyse_cons_en.pdf.

The second step is to acquire a licence for a specific item. The licence requirements have to be balanced against the certification requirements. If the latter are rather high the licence criteria may be lower, because a certain stage of transfer security is already achieved by the certification. In a licence-based regime, after a basic certification (comparable to a registration) every company would be allowed to transfer. However, the criteria for obtaining the licences would be higher. Depending on that security level, transfer licences for some items may even become obsolete.

However, in principle *ex-ante* licensing is likely to remain in place. Otherwise the preventive approach of the export system would be abolished. The 'EU Global Licence' is regarded as a vital element which would ensure extensive simplification and streamlining of procedures. It would allow for a certain timeframe to transfer an unlimited number of an item to a defined choice of destinations. Moreover it may state if re-export is allowed, as well as the end use and under which circumstances safeguards can be applied. Goods that received a global licence from one national authority would then be free to be circulated across the EU according to the prior specifications.

For some goods, a global licence may be unacceptable under all circumstances. For those, individual licences should remain available. This however implies retaining a lot of cumbersome and time-consuming bureaucracy.

A core task of the regime is to ensure against prohibited re-exports of transferred goods. Within the licensing, measures have to be taken to guarantee the correct recipients and end-use. With regard to re-exports the licence should display clearly whether re-exports are allowed, not allowed or depend on individual circumstances. The regime has to ensure that the responsible transfer authority has the power to decide for all options. To reduce the influence of other Member States, it should be ensured that if a Member State once allowed re-exporting under a general licence, it has to accept that all EU authorities stick to this decision. The Member State of origin may only get involved if the final destination is not stated. Then the exporting authority will have to contact the Member State of origin to gain confirmation on an individual basis. Nonetheless the authorities will inform the Member State of origin on a regular basis about re-export requests as well as those products containing components from that country that have received licences.

Moreover, finished products can be *a priori* excluded from simplified transfer licensing. They do not need to be transferred between companies as part of a production process and therefore are beyond the scope of the regime. This would also embody a second barrier against re-exports in the event that Member States – against the rules – exercise different exporting practices. Instead, only individual licences should be available. Here, it has to be kept in mind that the export of a finished product can also constitute a re-export. Therefore the exporter has to mention all components of the finished product that are EU-transferred and display the permission to re-export.

The chosen balance between certification and licence impacts on the responsibility and implementation of security measures, the costs related to this and the issue of trust. A licence is by definition granted by a state authority. Thus the state is responsible and bears the major share of the administrative burden. Nonetheless the companies have to deliver the requested documentation. A certification-based approach implies financial burdens for the companies as they have to invest in security management to meet the certification criteria. This will especially strain SME and those who have little experience related to these activities. TDCs have the resources to invest in such measures and can, within a homogenous EU system, transfer a management scheme, once it has been designed, to their different locations. In contrast, smaller exporters would have to take on an extra burden. That may either reduce their competitiveness due to higher prices or they may refrain from exporting. Consequently this approach could achieve improvement for TDCs but also unequal conditions *vis-à-vis* smaller suppliers. A state-/licence-based approach may offer the opportunity to reduce such private investments. Furthermore, using staged pricing for the licensing, e.g. based on the companies' annual turnover, the licensing authorities could further balance the burdens. This may also open the door for new suppliers.

Whether the responsibility lies with the state or private companies impacts upon users' confidence in the regime. Thus, if the political responsibility for the regime's effectiveness rests primarily with the states they may want to ensure its effectiveness and users' trust in it by managing the regime themselves Alternatively, the management principles of the dual-use regime may be adopted, i.e. while keeping the responsibility at the state level but leaving the technical management to the EU Commission.

To assure EU-wide validity of certification and licences, both instruments have to be based on a common set of requirements reflecting EU-wide accepted minimal conditions. Otherwise conditions for fair competition are blurred. In fact today defence companies are already certified nationally. Through common EU criteria the national allowance can be converted into a licence that is valid EU-wide. However, taking into account current diverse practices among the Member States, this may imply allowing them to add specific conditions to the common criteria that reflect their national legislations etc. Criteria and procedures would necessarily be subject to a legal enactment, be it Community-based or EU-multilateral. The withdrawal of an allowance should only be legal if the states or firms involved violate the regime.

Besides, such a coherent certificate would create a 'club of legitimate exporters', imposing not only normative but also material burdens on a company if it loses this status. Thus certification clearly combines economic competitiveness and the security perspectives.

Monitoring and ensuring compliance

Generally, monitoring is indispensable for several reasons: it makes it possible to examine if a component has been licensed for re-exports or if a finished product that is to be exported contains components that do not originate from the exporting country and thus needs a re-export licence. It thus ensures that regime compliance can be enforced. Moreover, with regard to re-exports, it provides knowledge of product quantities which a third state aims to acquire. This is important in order to estimate the influence an export might have on the region's military balance. Additionally, several Member States are obliged to report the exported quantities of military goods to their publics.

Monitoring may ensure that such cases are detected swiftly. However a cast-iron guarantee against re-exports cannot be provided – not even through the current system in place. For the potential regime, several options have been mentioned:

- **Traceability through a computerised system:** while this would make it possible to localise the good, it does not provide information about the end-use. This however is the main concern of the Member States. While they prefer a strong control option, they reject the idea of a new complex database. The industry is aware of the costs and administrative burden such a

system would involve. Thus expected costs are high while the utility is questionable.

- **Traceability only for sensitive systems:** in essence, this embodies the first option limited to a smaller number of 'sensitive items'. However, this option is rather unlikely to be implemented as it is hard to imagine that a sensitive good would receive a general licence or at least that such a licence does not entail an obligation to request a re-export allowance from the Member State of origin.
- **Certification, reporting and *ex post* enquiries:** The combination of these stages with sanctions (e.g. withdrawal of certification, blacklist for offenders) is considered to guarantee a maximum of security. This solution is very similar to the current system. In order to gain the certification, a company has to demonstrate that relevant security mechanisms are in place. Furthermore the allowance requires serious transfer reporting. Moreover, Member States of origin are allowed to inquire about the whereabouts of transferred components.

Although the least spectacular among the three, the last option appears as the most solid and secure solution. It offers precautionary measures, a high responsibility for the transferring company, investigating rights for the state authorities and sanction mechanisms.[59]

The problem for all solutions is that they first have to demonstrate their viability against the current system, which is by nature less prone to failure. However, it should be kept in mind that one of the initial reasons for the initiative was the apparent 'over-securitisation' of intra-Community transfers. Moreover, for an EU-wide system there has to be mutual confidence in the effectiveness of controls and traceability of transfers by Member State authorities. Ultimately, even if monitoring certainly cannot prevent all illegal re-exports, it demonstrates efficiency in that it ensures that spoilers can be punished and excluded.

Again, the regime will only address those goods for which a general licence was applicable, thus representing less sensitive items. *Ex-ante* controls will remain in place for all those items for which a general licence is not obtainable, by definition of the scope or because the company has no certification for the transfer of the good and thus has to apply for an individual licence.

59. Unisys, op. cit. in note 11, pp. 71-2.

Executive and policy-making mechanisms

Depending on prior decisions, appropriate institutional bodies or mechanisms are needed to carry out the duties related to the set-up and management of a regime. However, instead of setting up new institutions, priority could be given to existing bodies. This will not only ease apprehensions regarding increased bureaucratisation but also build on established expertise, functioning and trusted working relationships. This could include Council working groups such as COARM, the Commission or EDA, depending on whether the tasks are of a political or rather technical nature. Such a division of labour comes close to that exercised within the DU-regime. This again may be an advantage given that this regime is working successfully.
These bodies and mechanisms have to carry out some major tasks:

- Examining, defining and updating the list of items or the common and national exceptions.
- Defining, improving and updating of criteria for certification and licences.

While the tasks aim at technical issues, they nonetheless involve political considerations of the Member States. The list is the gateway through which (national) arms policies can be introduced. Hence it has to be ensured that the list balances the different interests instead of privileging some particular ones. Therefore the body entrusted with mentioned tasks needs political legitimacy and decision-making powers. Here COARM as a Council Working Group may be the appropriate body. It has been responsible for the CoC Ex since its inception, thus it is familiar with the subject.

Other tasks are related to the processes induced by a regime and the intention to manage them effectively:

- **Advisory services:** the refusal of a licence, invocation of safeguards or allegation of re-exports may lead to serious disputes among the Member States. It is difficult to imagine that the Member States would allow the establishment of an independent body that has the power to impose a legal decision. However a consulting body may advise Member States or companies on risks of infringement, develop suggestions on how to solve conflicts or advise on appropriate procedures or sanctions against companies or states. An additional consultation board reflecting public and expert opinion as well as the perspective of the European Parliament would be helpful.

- **Information exchange and evaluation:** Especially in the beginning the exchange of information, the evaluation of the regime and recommendations for improvements are highly relevant to build confidence and enhance efficiency. If the regime is a system based on various national lists and interpretations these have to be communicated to states and companies. Moreover a platform that displays certified and licensed actors is necessary. If traceability is based on an IT system, this has to be set up and maintained.

These tasks could be carried out by integrated technical working groups consisting of personnel from the EDA, the EU Commission and possibly external experts. In particular, the IT system for traceability could come under the jurisdiction of the EU Commission as it has wide-ranging experience with the execution of such systems in the area of taxes, and the DU-regime.[60]

What is open to discussion is the relationship between the political and the technical bodies. If the technical group is subordinated to the political body, the Commission has to be given a seat in the political group. Otherwise, the monitoring of the adherence of market-related elements to the regime might be inadequate.

Safeguards

A safeguard clause would allow Member States to limit or interrupt the circulation of items if actors violate the regime. This may be the case if companies infringe the conditions of the certification of the licence so that goods have been transferred or re-exported illegally. Here safeguards represent the legal option to raise essential security interests. In serious cases, a Member State may be allowed to withdraw its licence or certification because of non-compliance with the regime in a way that endangers the security objectives of the state or the EU.

Such an instrument has to be defined cautiously as its unnecessary or excessive invocation may not only damage trust in the regime but also trigger the second concern of the Member States: that is, the loss of SoS. However, such options have to be qualified *vis-à-vis* the regulations of the regime: cases in which safeguards are probable are rare. They can only concern components. Therefore, issues concerning an undeclared end-use of the component do not concern the companies and the transfer regime but the Member States. More-

60. Unisys, op. cit. in note 11, pp.138-40.

over correct end-use has always been a matter of trust towards the importing state – even within the current system.

The basic rule for the safeguards should be: as long as nobody violates the commonly agreed rules, no state should interfere. To improve confidence Member States should explain when safeguards could be imposed, through which procedures as well as when safeguards are not applicable. This would minimise complaints after the licensing.

The direct consequences of safeguards regarding end use and re-exporting are subject to further specifications: can a Member State of origin in principle block the export of systems, which contain non re-exportable components produced on its territory, by other Member States? It may be also become politically delicate to engage a Member State to withdraw war material with such components from a current military operation.

Article 296 TEU can act as a safeguards clause. For this purpose it has to be redefined either with regard to its scope or its application[61] (see below).

Legal aspects

Concerning the legal establishment and implementation of a regime two options are conceivable: a Directive or a Regulation (both under Art. 95 TEU). Although having the same legal impact, they have important differences: A Regulation would be directly applicable and does not have to be enshrined in national law. It would allow for less flexibility of implementation for the Member States.

However the Commission has decided on a Directive for several reasons. While a Regulation addresses issues of common commercial policy – an area of exclusive Community competence – a Directive is often more suited to the functioning and establishment of the internal market. Implementing the internal market usually requires far-reaching and very detailed measures that are better enacted at the national level. Thus the Commission has clearly indicated the primacy of Member States in the area.

However, a Directive involves a complex transposition process into national law. This may cause resistance at the national level as it may imply changes to national laws as well as non-subject related domestic bargaining. Moreover, it has to be confirmed that the instrument does not violate other obligations of the Member States introduced by international law or treaties.

61. A revision of Art. 296 is also indicated by the Decision of the European Community Court of Justice.

Besides this, a new regime implies legal solutions and potential changes for the following aspects:

- scope of Art. 296 and its relationship to SoS and safeguards
- the regime's relation towards the CoC Ex and national export policies.

Article 296 influences both matters, safeguards and SoS. Thus the revision either of its scope or its invocation practice is necessary. Changing the scope would especially seek to reduce the so-called '1958 list' that is mentioned in the Article.[62] Here, only those elements have to stay on the list that are still required to be under national oversight. These are NBC-technologies, goods that Member States *a priori* do not want to be traded under the intra-Community regime, and those elements defined by treaties the Member States have to fulfil, e.g. the MTCR.[63]

However, this option is unlikely to be accepted by the Member States. Besides generating long debates on the content, shortening the list in this way would prevent the Member States continuing to use Art. 296 as an effective impediment to undesired non-EU exports as well as other policy areas.

Another option would be to leave Art. 296 unchanged and restore it to its original scope by changing the practice of invocation, as intended by the Commission's 'Interpretative Communication'[64] on Art. 296. Additionally, a clarification by the Commission in the form of a Directive to provide more clear-cut guidelines for the interpretation of Art. 296 may become feasible. Without legal framing any changes to Art. 296 would lead to a certain amount of uncertainty, at least for an intermediate period in which a new practice has to be established and gain the trust of the Member States.

Therefore, in the – rather probable – event that Art. 296 is left untouched, it seems to be appropriate to have mutual reassurance regarding security of supply and non-interference for transnational supplies arranged among the Member States by Memorandum of Understanding (MoU). Such arrangements would become essential to establish trust. Here the LoI already offers guidelines.

These arrangements would have to consist of a double layer of accords as the problem has a state-state as well as a state-private dimension. States will have to guarantee non-interference in a private (company)-to-state transfer relationship. This is primarily the case for finished products, spare parts and services. Private actor relations have, secondly, to be secured. Otherwise a company

62. The '1958 list' is reproduced at: www.sipri.org/contents/expcon/art223.html. Reducing the scope will serve also to achieve transnational SoS. This would be perfectly in line with the interpretation of the European Community Court of Justice (ECCJ). The Court says that such a national derogation can only be justified if it is necessary for safeguarding essential national security interests. See Elena Bratanova, 'Legal limits of the national defence privilege in the European Union', BICC Paper no. 34, April 2004.

63. Missile Technology Control Regime.

64. EU Commission, 'Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement', COM(2006) 779 final, Brussels, December 2006.

cannot guarantee to fulfil its contract commitments *vis-à-vis* another company. The arrangements may include safeguard clauses for cases in which the essential security interests of the Member State of origin are affected.

CoC Ex and national export policies

To minimise the options for undesired re-exports, the regime can be made part of a common export policy of the Member States. This would have to include equal standards on re-export decisions. Moreover interpretations of the CoC Ex and the transfer regime have to be harmonised. Therefore, one suggested way is to make the CoC Ex legally binding, including a well-defined re-exporting clause. A further argument for utilising the CoC Ex is that its policy outcomes within the last few years revealed a high degree of convergence of Member State policies. Although there is no official EU-wide export policy, an informal one seems to exist to some degree.[65]

This, however, appears to represent a step too far for some Member States. Today the CoC Ex only acts as a minimal criteria catalogue, mainly against undercutting. It allows scope for very diverse policies on arms exports that the Member States and their industries are reluctant to lose.

The alternative is to effectively integrate the re-exporting clause into 27 Member State export control procedures. A first step would be to concentrate the expertise and responsibilities in the same authorities. While this would ensure equal treatment at the domestic level and also serves the principle of subsidiarity, it would not automatically lead to harmonisation among the Member States. Here, the dual-use regime offers the best practice for information exchange in an equivalent setting.

Conclusion: out of the jungle?

Europe's ambition is twofold: it wants to act as a military actor and to be able to produce the military means it requires on its own. Consequently, Europe needs a competitive EDEM and a solid industrial base. Here, an effective transfer regime can make an important difference.

As has been shown in this chapter, European security is increasingly an interpillar issue. This does not make things easier. In

65. See Dembinski and Schuhmacher, op. cit. in note 57; see also Bauer and Bromley, op. cit. in note 32.

order to attain an efficient result, not only the divergent Member State perspectives but also the Commission's and the industries' point of view have to be considered. Nonetheless, an integration of economic and security positions into one single regime is possible.

The breakthrough in this regard will not depend on the Commission but on the Member States. They have to realise that the circumstances for defence industrial issues have changed and they have to adapt to transnationalisation. This does not prescribe the instrument, i.e. a specific regime or agreement. However, with the Commission's proposal for the Regulation on a regime for intra-European transfers of defence items on the table, it is now the Member States' turn to come up with constructive solutions.

Ultimately, a decision on whether the proposed regime is an appropriate instrument should be based on its effectiveness, namely on an evaluation of two prospective questions: will the proposed regime (a) ensure at least the same security level regarding SoS and re-exports compared to the current system?; (b) deliver its economic added value?

Here it is helpful to recapitulate some important points that should be taken into consideration when evaluating the proposal or suggesting alternatives. Now going on for two years, the debate has revealed that the following aspects have to be an essential part of a successful Regulation:

- **Scope:** the transfer regime will only allow a very specific family of goods to be transferred without *ex-ante* individual licences: components that are of a military nature but less sensitive regarding national security interests.
- **Certifications & licences:** certification and licensing will remain tasks of the Member States. However this has to be done under a commonly agreed set of rules and criteria. Moreover, for those items for which a general licence is not granted, individual licence procedures will stay in place. Two cumulative types of certification are conceivable: (a) companies certified as suppliers are allowed to transfer (specified) components and subsystems towards EU system-integrators and Member States. (b) Companies certified as system-integrators can transfer (specified) items and whole systems to other EU system-integrators and Member States.
- **Monitoring and compliance:** the core of a compliance system has to be the ability to effectively sanction spoilers, i.e. prohibit.

such companies from trading. Besides a standard reporting system, *ad hoc* inquiries on end use and end user must be answered. Beyond this, it is especially in the area of re-exports that the regime could generate added value if it is assured that Member States of origin are regularly contacted by the monitoring authorities.

- **Executive and policy-making mechanism:** even if the Member States accepted the Commission's role as a competent facilitator, it is ultimately somewhat unconceivable that they would grant the Commission a serious role with regard to the security dimension. Therefore an appropriate division of labour should grant responsibilities to the Member States. The added value of the regime is not its top-down approach but the EU-wide common set of regulations and criteria. Thus the primary question is not *who implements* but *what is implemented*. As Member States are the 'owners' of the system, effective implementation is in their security interest. The Commission could concentrate on establishing an information-sharing system as well as preparing an evaluation of the implementation phase. Furthermore, a task force should be recommended that facilitates the implementation and technical management of the regime by offering advice. Moreover the Commission should be given a formal possibility to intervene below the highest political level if the regime is not run effectively.
- **Safeguards:** the invocation of safeguards under Article 296 is a highly political act. It has to be based on proportionality and case-by-case evidence. An *a priori* non-legally binding explanation of principal cases should be laid down. Especially, if Member States consider a regime as a test case for re-establishing mutual trust on the use of the Article, dealing with the first cases will establish the new baseline for the legitimate use of Article 296.
- **Legal aspects:** under given circumstances a change of Article 296 seems to be unconceivable. Therefore the only way is to change its invocation practice. The future will not only depend on a measure as outlined above but on the use of Article 296 in other areas, e.g. procurement as well as the reaction of the Member States towards the Commission's clarification regarding the Article's scope.

Steps and challenges ahead

If Member States and the European Parliament decide on a regime, the challenge to the establishment of such a regime is considerable. Here the psychological barriers are as important as the technical implementation. Much will then depend on the follow-up process.

Right institutions: the Council working group in charge is decisive. It may well be that for formal reasons the issue is directed to an industries-related working group (WG). This bears the risk that the economic issues are overrated and security issues are overlooked. A presence of experts on security issues has to be assured. This could be done by having cooperative sessions that include COARM or the Political Military Group (PMG).

Establish trust: the issue is as much about mutual trust as it is about technical details. Member States have to mutually guarantee that defence goods are treated under the export regulations of the country of origin. Therefore domestic authorities either have to be aware of the regulations in other EU countries or contact the authorities of the other countries. Therefore, informal meetings, workshops and cooperative multinational products and processes such as best practices studies, with multinational information teams built from experienced national desk officers serving in the advisory services on a rotational basis, may make it possible to develop trust even at the micro levels.

Use existing expertise, experience and institutions: central elements of trust are common practice and persuasive expertise. Moreover the problem cannot be solved by one actor alone. Therefore the follow-up process should actively make use of the existing expertise of the Commission in internal market issues as well as national expertise when it comes to security-related issues. This chapter has also highlighted existing, efficiently-functioning institutions like the dual-use regime and the CoC Ex, with their concomitant lessons identified.

Keep it simple: the more change is introduced, the more complexity is induced in the transition phase towards a new regime. Therefore keeping things simple means retaining as much of the established system as possible. New regulations and definitions, especially regarding the definition of the scope, should provide a more effective alternative to attempting to identify every single case that can be imagined.

Implement step-by-step: due to different levels of administrative readiness and political hurdles, the implementation should be conducted reasonably swiftly in the individual Member States. Moreover it might be possible to first test a 'pilot system' in some Member States that is then evaluated. The lessons learned could then be integrated in a revision prior to further implementation. Conversely, a 'big bang solution' is unrealistic, even if agreed.
Industries and states as partners: states have to actively build partnerships with reliable industries. The classical control approach is not compatible with the character of technology and the options to illegally transfer tangible and intangible technologies. It has to be in the interest of the industries to apply the controls and to fully comply with them. This constitutes the best way of protecting their own rights regarding material and intellectual properties. Therefore the state has to deliver.
Do not expect immediate impact: calculations on money wasted by the non-existing regime are misleading in so far as they imply that this money can be saved directly. As a progressive growth of trust is necessary this time-consuming process may on the other hand consume the financial benefits of the process through the trickledown effect. The important point is the long-term efficiency and the structural adaptation. This is not a matter of simple numbers but of strategic long-term thinking.
Integrate into the existing architecture: the regime should be linked to other EU initiatives such as the defence directive but also activities outside the EU framework, like the LoI, the CoC Ex or the dual-use regime and updated in the light of potential changes. The kinds of complications that arise from parallel activities have to be avoided.

Plan B – if the proposal is rejected

Although this chapter has tried to identify potential solutions for a transfer regime, the challenges are considerable. Consensus among the Member States has not yet been achieved: even a majority in favour of a precise compromise may be fragile, if existing at all.

To save the impetus of the initiative, alternative viable suggestions should be at hand that could quickly be brought into play. These would potentially call for a more extensive involvement of the Member States. Two options have already been discussed that may build a basis for solutions. One way forward could be a 'LoI

plus'. This would mean progressively enlarging the LoI regime towards other Member States who would like to join. Additionally the LoI would have to be expanded into the area of 'private to private' relations as well. A second alternative could be to build in an analogy to the CoC on defence procurement which provides the backbone of a voluntary intergovernmental regime. This option was initially greeted with great scepticism. However this has declined as the CoC has to date been more successful than expected.

Regardless of the ultimate outcome of the Commission's proposal, it has already had an impact. First, it has raised awareness. Second, it has asked the Member States to clarify their perspective on the issue. Third, as the benefits of a regime imply serious structural changes, the proposal should be seen as an important step towards this long-term aim. Finally, it should at least signal to the actors involved that it may be time for them to lower unrealistic economic expectations as well as to rethink their well-rehearsed security objections.

The changing transatlantic defence market

Sophie de Vaucorbeil

Introduction

When we talk about the defence market, as Ron Sugar (chairman of the board and Chief Executive Officer of Northrop Grumman Corporation) bluntly puts it, 'we are not just making toothpaste; we're in the business of national security. National borders do matter.'[1] As a consequence, the US relies very little on defence equipment imports: the Pentagon's foreign military purchases represented 2.4 percent of all its military purchases in 2000;[2] this plummeted to 1.2 percent in 2001 but has been growing steadily since. In 2004 foreign imports represented 1.7 percent of its military purchases. There is a massive imbalance between the amount of contracts that the US awards to US suppliers (65 billion dollars worth in 2005) and to European suppliers (only 1.016 billion dollars). About 770 million euro of direct European defence sales to the US in 2005 represented 1 percent of the total US defence market. Pierre Chao[3] points out, however, that this was a 100 percent increase on the direct sales of 10 years ago. If successive administrations understood that globalisation was inevitable at the subsystems and components level, they relied far less on foreign firms at the prime level. But the advent of globalisation is changing all of this.

Up until now, the Department of Defense (DOD) had few reasons to favour foreign firms rather than an array of American suppliers. Today, the US has no choice but to develop an intricate supply chain to produce and sell more competitive products. Boeing, who used to design and engineer all its aircraft models itself 'has scoured the world to find the best possible suppliers.'[4] Boeing's global partners number around 100 for the Dreamliner and around 500 to 700 for its 777 aircraft. 'In the 1960s, only two percent of the content of Boeing's 727 was non-American. By the mid-1990s, this had increased to 30 percent in the 777 model. Going forward, at least 70 percent of the 787 Dreamliner will be built out-

1. Christopher Bowe, 'US unlikely to back mergers', *The Financial Times*, 6 October 2003, p.18.

2. In Philippe Esper, '2007-2012: Les enjeux de la défense', *Défense et stratégie*, p. 2. Available at: http://www.defense.gouv.fr/ced/content/download/84379/762599/file/D%C3%A9fense&Strat%C3%A9gie.pdf.

3. 'Allies in disguise', *CNBC European business*, May 2007.

4. Terrence R. Guay, 'Globalization and its implications for the defense industrial base', Strategic Studies Institute of the US Army War College, February 2007. Available at: http://www.strategicstudiesinstitute.army.mil/pdffiles/PUB756.pdf.

side the United States, mostly in Japan'.[5] A Pentagon study identified 73 foreign suppliers who provided parts to twelve of the most important weapon systems used by American troops. Laser-guided bombs use German aluminium tubes, Tomahawk missiles have Italian guidance systems and Predator drones have Swiss data terminals.[6]

Similarly, some European governments had already started looking at other growing markets, such as China and Latin America. The Spanish and French governments, for example, infuriated Washington in 2005 when they argued for a relaxation of the international arms embargo against China and negotiated a sale of military patrol boats to Venezuela. France and Spain stepped back when Washington threatened to take punitive action against European companies operating in the US. The EU understood very clearly that it had no choice but to be on good terms with the US if it wanted its share of the defence market. On the other hand, it is difficult to rule out cooperation with new players. In 2005, Malaysia and South-Africa joined the ranks of those participating in the multinational A400M programme.[7] This example is interesting for two reasons. First, it illustrates how new players squeeze themselves into the global market. Partaking in the A400M programme links them into the global supply chain through Airbus.

Secondly, it highlights the fact that Europe needs newcomers' money to make up for its budgetary shortfall. In fact, Europe is increasingly dependent on outsiders' technology. As Stephanie Neuman[8] notes: 'the technological and resource demands of new, sophisticated weapon systems have escalated beyond the production capabilities of most countries, and most have grown increasingly dependent upon defence exports and imports for their survival. With the exception of the US, none of the arms-producing nations – including France, Germany, Italy and the UK – have been able to reduce their reliance on foreign imports, especially in the area of weapons design, engineering and development assistance, critical components and subsystems, machine tools and production know-how'.

New challengers are overtaking the US and the EU slowly but surely. 'Russia, after all, could produce supersonic cruise missiles that flew at 2,000 miles per hour only 100 feet above ground level, and the year ended with the Kremlin even expanding its joint manufacturing program to share technology with India. The US-built Tomahawk by contrast could still only fly at subsonic speeds, less

5. 'Going Japanese: how Japan learned to fly', *The Economist*, 25 June 2005.

6. Leslie Wayne, 'Pentagon defends its growing reliance on foreign contractors', *The International Herald Tribune*, 23 September 2005.

7. See: http://www.airbusmilitary.com/safocus.html.

8. Stephanie Neuman, 'Defense industries and dependency: current and future trends in the global defense sector', International Relations & Security (ISN) network, ETH Zurich, 2006. Available at: http://www.columbia.edu/cu/siwps/publication_files/neuman/Defense%20Industries%20and%20Dependency%20ISN%20Case%20Study%20-%20Neuman.pdf.

than 750 miles per hour at ground level, with increasing concerns that the latest Russian air defence systems like the S-40 deployed around Moscow during last summer or the Tor-M1 sold to Iran could have a significant rate of interceptions against it.'[9]

The arrival of newcomers seems to have overwhelmed both the EU and the US. To reduce their dependence on imports, both the EU and the US could work more closely. They should also do so because they face other common challenges at the moment. Those challenges are all of a different nature: budgetary, industrial and also strategic.

Budgets

Economically, there are many reasons why a transatlantic defence market matters. Perhaps the most important one is budgets. At the governmental level, EU Member States face hard budget trade-offs. They are currently multiplying commitments to resolve crises in the world, and this requires soldiers, equipment and money. The more you intervene, the more equipment and money you need. To illustrate, at the moment EU Member States are involved in 33 operations around the globe. According to a CSIS report on European defence released in late April 2008, the total number of European forces deployed abroad in combat, counter-terrorism, peacekeeping, humanitarian and other operations has gone up, from slightly over 65,000 in 2001 to 80,000 in 2006, not including the number of troops stationed overseas on a long-term basis. The problem today is that financial resources do not match deployments. The UK House of Commons reported in March 2008 that the combined cost of military operations in Afghanistan and Iraq had almost doubled to 3 billion pounds a year. The costs of operations are rising partly because the cost of equipment is steadily increasing. For example, the price of tactical combat aircraft has been growing by 10% a year. However, defence budgets in Europe are static (at best). Across the Atlantic, the picture is not very encouraging either. The cost of the Global War on Terror has put the Department of Defense under tremendous pressure. The Iraq war alone could cost 1,010 billion dollars between 2008 and 2010 if the US does not withdraw massively. As a result, some armaments programmes have been cut or delayed and budgets are being revised downwards. In the UK, 'the black hole in the defence budget is so large – close to £2 billion this year

9. Martin Sieff, *Defence Focus: Year in review – Part 2*, United Press International, 7 January 2008.

and as much as £5 billion over the next three years – that the budget increase will not prevent cuts.'[10] The new series of armoured vehicles for the UK army are currently delayed. In the US, for the fiscal year 2008, 200 million dollars was cut from the Army's modernisation programme, the controversial Future Combat System (FCS).[11]

Industries and exports

A transatlantic defence market already matters for defence industries. As they are suppliers to the defence ministries, they depend on defence budgets. In order to compensate for defence spending cuts, defence industries multiply cross-border partnerships. For example, the American champion Lockheed Martin has established eight joint ventures with European firms and participates in twenty collaborative programmes around the world, from the Joint Strike Fighter (JSF) to MEADS and the Future Aircraft Carrier.[12] Unfortunately, transatlantic partnerships do not yet yield interesting returns on investment or economies of scale because of the complicated legal environment. Export control policies are increasingly seen as a counter-productive administrative burden. According to the US Coalition for Security and Competitiveness, 'the current system regulating the export of defence and "dual-use" items (those with both civil and military application) is administered by the US departments of State and Commerce, respectively, but often involves other federal agencies. The Commerce Department processes more than 18,000 authorizations per year. The State Department processes more than 65,000 licenses each year, a figure that has been increasing about 8 percent annually. Some cases take months to process, causing a detrimental impact on allies.'[13] This administrative burden has motivated American defence companies to push harder and harder to rationalise defence spending and soften export controls.

The strategic challenge

As the question of export controls highlights, there is more to the transatlantic defence market than industrial politics. Take the word 'fortress' applied alternatively to the US or the EU: on the one hand, it depicts the difficulty of economically penetrating those markets. On the other hand it symbolises the power of the two

10. Michael Smith, 'MoD forced to cut budget by £1.5 billion', *The Sunday Times*, 13 January 2008.

11. FCS comprises about 14 vehicles, including unmanned aerial planes and tanks and other ground vehicles. The technology that links them all allows the soldier on the ground to be linked through a transmitter to the senior commander during an operation. Source: Gordon Lubold, 'Congress eyes defense cuts', *The Christian Science Monitor*, 11 February 2008.

12. See: http://defence-data.com/ripley/pagerip2.htm.

13. The US Coalition for Security and Competitiveness includes: Aerospace Industries Association, Association for Manufacturing Technology, Coalition for Employment through Exports, Electronic Industries Alliance, Information Technology Industry Council, National Association of Manufacturers, National Foreign Trade Council, US Chamber of Commerce.

main defence stakeholders. Today, neither the US nor the EU can afford the luxury of being a fortress. They still represent 75% of the global defence market business but governments cannot guarantee many contracts anymore. Meanwhile China and India's industrial bases benefit from steadily increasing defence spending (India joined the ranks of nations possessing intermediate-range missile capacity in May 2008). As Pierre Chao says: 'when you try to prevent technologies going out, I think we have got to be very careful that you do not prevent the raw technologies from coming in.'[14] Export controls were designed for an environment that no longer exists, since they are all grounded in the military, diplomatic and political realities of the Cold War. They fail to address the many new military, economic and political challenges that currently confront both Europe and America. 'The export control system as a whole is under increasing strain due to the nature of the changing environment. The high tempo of operations is increasing the volume of licences.'[15]

A more open transatlantic defence market would be efficient and more coherent both politically and economically. Reconciling economics and politics would help reconcile strategy and reality. Some would argue that the US and the EU do not have the same interests. However, if we look at the bigger picture, this is clearly not true. The US and the EU face the same threats, from terrorism to global warming and the spread of WMD. Some would argue that they have different approaches to tackle them. Even so, they are willing to work more closely. For example, George W. Bush[16] backed Victoria Nuland's repeated calls for a stronger Europe able to take a more robust approach to defence and security. In Europe, there is an increasing recognition that soft power alone cannot do much to restore stability and security (as demonstrated by the case of Afghanistan). The US needs an ally willing and able to intervene in the world's troublespots because it reckons hard power alone is not sufficient either to guarantee security and development. The EU could be Washington's special partner if it develops its capabilities. The US has been asking European leaders to spend more on defence for ten years now. Today, the discourse is changing along with the global economic context: European governments should spend 'better.' In the US, the Global War on Terrorism has increased defence spending dramatically. However, that budgetary situation may not be sustainable anymore, especially in the light of the current financial crisis.

14. Pierre Chao, 'Toward a 21st century export and technology control regime', Center for Strategic and International Studies (CSIS), 15 May 2008.

15. Ibid.

16. Vincent Jauvert, 'Exclusif: le plaidoyer de Bush pour l'Europe de la Défense', *Le Nouvel Observateur*, 23 April 2008 ; 'US Ambassador to NATO Victoria Nuland's Speech in Paris: Ambassador discusses strengthening global security for Europe', 22 February 2008. Available at : http://www.america.gov/st/texttrans-english/2008/February/20080222183349eaifas0.5647394.html.

Defence spending

How can the EU and the US spend better in the realm of defence? One answer is that they could reduce their procurement costs through cross-border competition, including across the Atlantic. This is a realistic 'win-win' situation. The EU would beef up its capabilities and the US would save money. Savings could possibly be spent on more civilian capabilities or defence R&T.

The American defence burden

The US spent 491 billion euro on defence in 2006, almost two and a half times the 201 billion euro spent in Europe.[17] Recent levels of spending are similar in constant dollars to those during other wartime periods such as Vietnam and Korea, and only slightly higher than the levels pertaining at the end of the Cold War. The US economy was much smaller during those times thus the current defence burden is much more manageable than one might think by only looking at absolute values in current dollars. On the other hand, as Anthony H. Cordesman[18] also points out, 'when one talks about the defence burden on the federal budget, it is also important to realize there are other factors, like mandatory federal spending and domestic expenditures', whose rapid growth (due to demographic reasons etc) will have a much larger impact on the budget than national defence spending.

The next US administration will have to deal with a twofold budgetary constraint: federal budget pressures together with the procurement calendar. Procurement funding is scheduled to increase more as early as 2009 because key procurement expenditures have been deferred to the next presidency. The actual level of spending combined with other burdens on the federal budget is unsustainable in the medium term. Medicare, Medicaid and Social Security already account for 9 percent of GDP, and for over 75 percent of federal spending according to the Centre for Strategic and International Studies.[19] They could rise to 15 percent of GDP, and to over 75 percent of federal spending by 2030. Additionally, defence procurement itself will be increasingly difficult to ensure because of the rising cost of the global war on terror (GWOT). For the 2008-2011 period the cost of this war is estimated by the Congressional Budget Office to reach between 481 and 603 billion dollars, assuming a more rapid withdrawal of

17. EDA figures published in December 2007.

18. Anthony H. Cordesman and Ionut C. Popescu, 'The changing challenges of US defense spending: an update', CSIS, September 2007.

19. Ibid.

American forces. It could reach 1,010 billion dollars in a scenario in which troops would withdraw more gradually from Iraq. The war is already responsible for the reliance on large 'war supplementals.' Funds appropriated through this mechanism represented more than the third of the Pentagon baseline spending in the financial year 2007 budget request (163.4 billion dollars for the GWOT supplementals and bridge funding, compared to the 442.8 billion dollars for baseline spending). A quarter of all the money appropriated for defence in 2007 has been classified as emergency funding. Combined with other burdens on the federal budget, this trend weakens budgetary credibility in that it is clear the US cannot afford to budget how much they need to match their strategy with corresponding capabilities.

European defence budgets

In 2005, 25 EU Member States spent roughly 30 billion euro a year on some 89 equipment programmes, before Rumania and Bulgaria joined with their own programmes.[20] The trend in the EU is not towards increasing public spending in general and defence spending in particular. The majority of European countries are experiencing difficulties in respecting the criteria of the European Stability and Growth Pact. As a consequence, few countries spend as much as 2% of GDP on defence: only France, Greece and the UK come close to this level (dedicating respectively 2.68, 2.43 and 2.5 percent of their GDP to defence), followed by Poland and Italy (both 1.81 percent).[21] In its December 2007 Defence Package, the European Commission noted that national defence budgets within the Union have halved over the last 20 years from 3.5 percent of GDP to a current average of 1.75 percent. The problem does not lie in the overall level of spending, but in the lack of harmonised procurement policies.

Furthermore, current levels of European defence spending may not be sustainable. First, if globalisation follows the same pattern, Europe will lose market shares. China will be the second global economy and India might take the third place, currently occupied by Japan. This relative loss of competitiveness could increase the number of the unemployed and the welfare bill for providing assistance to them, with defence budgets the most likely losers in public spending plans.

What is more, by 2025, according to the European Defence

20. Commission of the European Communities, Impact Assessment, 'Proposal for a directive on simplifying terms and conditions of transfers of defence-related products within the community', COM(2007)765, December 2007.

21. According to NATO figures which include pensions.

Agency (EDA),[22] the sustainability of defence budgets will be challenged by demographic trends. By 2025, Europeans will represent a mere 6 percent of the world population, of which 48 percent will be over 65 years old. Health care and pensions costs will skyrocket proportionally. Future public spending on the elderly could run to 33 percent of national GDPs, compared to an average of 16 percent today. An ageing population also implies that the taxpaying population will decrease.

Pooling resources and innovation would be the most productive strategies for European governments to maintain their position on the market. The challenge ahead will require much more coordinated efforts on the part of European governments. Today, the US is outspending Europe at a rate of six to one in defence R&D.[23] In 2006, the US dedicated 11.8 percent of the defence budget to R&D whereas the EU 26 spending in that field levelled off at 5 percent. If one looks at the wider R&T figures they present a sharp contrast: the US spent 2.78 percent of its defence spending on R&T, while the EU 26 spent 1.32 percent of its defence expenditure on R&T.The EDA made it clear that the EU risks losing a substantial share of market and expertise in many areas such as IT, biotechnology and nanotechnology.

How will European governments provide equipment to their armed forces in the future knowing that outfitting a soldier for battle costs a hundred times more now than it did in World War II?[24] The situation is the same in the aerospace sector: the average price of a fighter plane worldwide increased 10,000 percent in constant US dollars from 1945 to 1985. More recently, the real price of tactical combat aircraft has been growing by 10 percent a year.

A changing European defence industry

The European defence industry market turnover is 70 billion euro compared with 150 billion euro for its American counterpart. The EU has four or five prime contractors. The top 100 defence companies established every year by *Defense News*[25] ranked BAE Systems number three, EADS number seven, Finmeccanica number nine, Thales number eleven, and Rolls-Royce number sixteen. Compared to their American competitors, European firms still have room for improvement when it comes to consolidation, especially across borders. The naval sector is still organised on a

22. 'An Initial Long-Term Vision for European Capability and Capacity Needs', EDA document, 3 October 2006.

23. Ibid.

24. Brig. Gen. Mark Brown, head of the US Army agency for developing and fielding soldier equipment, 2 October 2007. See: http://www.msnbc.msn.com/id/21105586.

25. See: http://www.defensenews.com/index.php?S=07top100.

national basis. Indeed, consolidation is easier to realise on a national basis. In 2007, Thales acquired Alcatel Lucent's space activities and 25 percent of the shipyard group DCN in March 2007. Across the Channel, Babcock International acquired Devonport Royal dockyard in June 2007. In addition, BAE Systems and VT Group are to combine their shipbuilding activities. However, in the sectors in which transnational consolidation has been undertaken, results are promising. For example, the engine sector is a peer competitor to its US counterpart. Perhaps, because it is a less strategic sector, the US relies a lot on European engine manufacturers. Safran is now number 22 of the top 100 defence industries but the world's fourth and Europe's second major player after Rolls Royce in the engine manufacturers branch. Transnational consolidation is more difficult because EU governments do not 'think European' yet. If they did, based on what Keith Hartley of York University[26] estimates, a single defence market could save EU governments 20% of their procurement money (some 6 billion euro a year on current spending). More generally, a single defence market would put European defence firms in a stronger position to face competition from their American counterparts.

Consolidation strategies

When it comes to American defence firms, the Pentagon put a stop to the consolidation it originally launched as early as April 1999, when it opposed the merger between General Dynamics and Newport News Shipyard. Today, the industrial landscape is dominated by four or five system integrators: Lockheed Martin, Boeing, Northrop Grumman, Raytheon and General Dynamics.

The aerospace defence sector offers a good example of what consolidation entails. The nature of consolidation in the aerospace defence industry is demonstrated by the increase in the number of subsidiaries for the top five aerospace defence contractors. 'Four of the five top contractors more than doubled their number of subsidiaries. The top aerospace prime contractors now have over 25 subsidiaries compared to only four in 1986. Consequently, the number of prime contractors of DOD fixed-wing aircraft contractors declined from eight in 1990 to three in 2000.'[27]

Today, companies face a second wave of demand reduction due to governments' budgetary constraints. In addition, globalisation has obliged them to reconsider their strategy. Interestingly, some-

26. Keith Hartley, 'The future of European defence policy: an economic perspective', *Defence and Peace Economics*, vol.14, no. 2, January 2003, pp.107-15.

27. Michael Brewer, 'An aerospace business case for transatlantic cooperation', Eisenhower symposium, Industrial College for Armed Forces, June 2005.

times, they choose to put an emphasis on transatlantic cooperation to face those challenges. Between 2001 and 2005, 40 percent of US defence exports went to established markets in Europe. From 2001 to 2003, there were well over twenty major acquisitions and mergers between Western European and US aerospace defence manufactures.[28] The consolidation of European shipbuilding is taking shape on a transatlantic industrial basis. The Spanish Navantia has formed an alliance with General Dynamics/Bath Iron Works and Lockheed Martin to create a strategic alliance: AFCON.[29] AFCON will be their common interface to design and build frigates.

Industries also multiply cross-border relationships at the prime contractor level. This kind of arrangement is commonplace for BAE Systems, Raytheon, Thales, Lockheed Martin, Finmeccanica, EADS and General Dynamics. For the Joint Strike Fighter programme, ten partners' nations met around three companies (BAE Systems, Lockheed Martin, and Northrop Grumman). Defence companies' privilege partnerships with their transatlantic counterparts for two reasons. 'From an industrial health perspective, the development of mutually beneficial industrial linkages enhanced the US industry's access to global markets while simultaneously exposing US industry to international competition, which helps ensure that US firms remain innovative and efficient. From the manufacturer's perspective, the risks associated with development of new systems are too great for any one company to undertake.'

Industries rapidly understood the advantages of both globalisation and new manufacturing processes. For the last decade, industrialists have taken the lead to boost transatlantic cooperation. Industrialists have seized the opportunity offered by the revolution in military affairs, and more precisely Network Centric Warfare. The accent put on Network Centric Warfare (NCW or NEC in Europe) has completely changed defence companies' supply chains. Industrialists have developed less antagonistic relationships between prime and sub-contractors. The new emphasis on systems integration rather than weapons platforms enlarges massively the room for cooperation. As for the JSF programme (see toolbox no. 1 at the end of this chapter), today's defence equipment manufacturing obliges us to stop being obsessed by prime platform systems and also to take a look at the third and fourth levels of the US/EU weapons systems industry. As Pierre Chao[30]

28. Ibid.

29. Stefan Markowski and Robert Wylie, 'The emergence of European and Defence Industry Policies', *Security Challenges*, vol. 3, no. 2, June 2007.

30. Pierre Chao, intervention in New Defence Agenda conference, 'Is the transatlantic defence marketplace becoming a reality?', 17 July 2005, Brussels.

noted, we will then discover that mid-tier companies like Zodiac and the British GKN already play an important role in setting up a transatlantic defence market through daily cooperation, at sub-system levels, both in the EU and the US. Defence companies also consolidate on a transatlantic basis.

Over here

Between 2001 and 2005, European companies acquired 67 US defence firms, collectively worth 7 billion euro, making Europe an increasingly important player in the US defence marketplace.

The American dream attracts Europe. A company like 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 sells more to the Department of Defense than to the British Ministry of Defence.[31] Its US subsidiary also employs 45,000 of BAE's 100,000 workers.[32] That is partly thanks to mergers and acquisitions over the past ten years – and in particular due to the fact that the London-based company has targeted the land systems sector early, acquiring United Defence. Thus, it benefited from Iraq and Afghanistan war spending. To further strengthen its position on the US market, in 2007, it declared its intention to acquire the US military vehicle maker Armor Holding. In July 2007, the acquisition was cleared by the Department of Justice. This decision was made even though one of BAE Systems' most important contracts, with Saudi Arabia, was under scrutiny. On the other hand, this clearance also highlights the compromises BAE Systems made in order to enter the US market. One of them is the Special Security Arrangement (SSA) it got. It means the board of the company can only be composed of both American citizens and nationals from the parent company's country. However it also means that only American managers can participate when issues related to national security are raised. In addition, a Special Security Arrangement requires the company to be run under American law and by American citizens.[33]

In May 2006, the Chief Executive Officer (CEO) of BAE Systems aired his views on its US subsidiary status: 'the British members of the corporate leadership, me included, get to see the financial results; but many areas of technology, product and programme are not visible to us. The SSA effectively allows us to operate in the US as an American company, providing the highest levels of assurance

31. David Robertson, 'Milestone for BAE as its trade with America outstrips MoD business', *The Times*, 10 August 2007.

32. James Boxell, 'BAE Systems pursues its Atlantic devotion', *The Financial Times*, 22 August 2006.

33. Leslie Wayne, 'British Arms Merchant with Passport to the Pentagon', *The New York Times*, 16 August 2006.

and integrity in some of the most sensitive fields of national security provision.'[34] Indeed, what happens to BAE Systems in London, in terms of developments concerning the company's strategic orientation or anything else, is of little relevance to its US subsidiary BAE Systems Inc. Apart from BAE Systems, EADS and Thales have also developed what the Pentagon calls an American 'footprint.' EADS has manufacturing sites in Texas, Alabama and Mississippi, where it makes helicopters for American law enforcement agencies. 'Even so, the government keeps a watchful eye out. Top executives are required by the government to be American citizens. At EADS, all telephones are tapped, and computers are equipped with software to prevent any security leaks. Many technical discussions between the American executives and their overseas counterparts must first be reviewed by special advisory boards of former Pentagon officials and retired military executives.'[35] Even if they cannot obtain full return on their investment, European defence companies have not found another way to make money in the US other than to open subsidiaries in the US. In January 2008, the *Telegraph* published an article on EADS' new strategy.[36] Ambrose Evan-Pritchard describes it as an 'expansion blitz in the US.' EADS wants to raise its share of US operations from 2 billion dollars to 10 billion in annual sales and increase its workforce outside Europe from 3% to 10% by 2020.

Over there

Since 2001, American investments in European companies have created discontent in European defence companies for two reasons. First of all Europeans were not happy to see American companies, especially General Dynamics, re-shaping the European defence industrial landscape through acquisitions. Between 2001 and 2003, General Dynamics acquired three European companies: the Spanish Santa Barbara, the German EKW, and the Austrian Steyr. Today, its division based in Austria, European Land Combat Systems, employs 10,650 people and symbolises its involvement in the European land sector. Indeed, with its European arm, General Dynamics has won many contracts with European governments such as a 64 million dollar contract to supply Air Land Spike Missile Systems for HAD Tiger helicopters to the Spanish Army in January 2008. With the (Steyr) Pandur Wheeled Armoured Vehicle, General Dynamics provides war materials to the Austrian, Belgian and Slovenian Armies.

34. Mike Turner, Speech to the Washington Economic Club, Washington, D.C, 2006.

35. Leslie Wayne, 'Pentagon defends its growing reliance on foreign contractors', *The International Herald Tribune*, 23 September 2005.

36. Ambrose Evans-Pritchard, 'EADS moves into US defence market', *Daily Telegraph*, 12 January 2008.

Secondly, Europeans view the so-called 'Americanisation' of European defence companies' shareholdings with a jaundiced eye. In 2002, the US bank, 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 European producers of aircraft engines, respectively FiatAvio and MTU Aero Engines. As a result, 'important sections of European policy opinion remains concerned that transatlantic cooperation represents a "Trojan Horse" for the US takeover of the European defence industrial base.'[37] European governments expressed their concerns that the share of foreign ownership in European defence was becoming largely dominated by the US.

This is mainly because, up to now, US defence companies have been protected by law from substantive levels of foreign investment. As a result, Northrop Grumman has the largest share of foreign ownership, with about 7.5 percent of its stock held by foreigners. Lockheed Martin follows with 7.2 percent, Raytheon at 4.6 percent, and Boeing at 7.8 percent. On the contrary, European companies often 'have large blocs of foreign ownership'[38] (BAE Systems' share of foreign ownership fluctuated at around 45% in 2006, but was as high as 59% in 2003). European governments interpreted US influence in their shareholding as a symbol of a one-way street. They perceived it as an American interference to prevent European attempts to streamline and reorganise their defence industries on a European basis. Last but not least, they are concerned that the US will use its influence in European defence companies to achieve American foreign policy objectives. For example, when OEP invested in one of the world's leading manufacturers of conventional submarines, the takeover allowed the US to keep its promise to Taiwan to sell diesel-powered underwater crafts to that country. That decision particularly annoyed Germany whose position had always been to recognise the government of the People's Republic of China as the only legitimate representative of China's people, and prohibit German arms sales to Taiwan.

The business of a military alliance

The transatlantic defence market cannot be reduced to a mere 'mergers & acquisitions race' simply because of politics. The main

37. Joachim Rohde and Andrew D. James, 'The future of transatlantic armaments cooperation', German Institute for International and Security Affairs, June 2004.

38. Figures and quotes from Terrence Guay, op. cit. in note 4.

reason is because apart from Austria, Cyprus, Finland, Ireland, Malta, and Sweden, all EU Member States are part of NATO. As such, they are supposed to coordinate their defence apparatus (budgets, capabilities etc.) and engage in cooperative programmes. It is worth taking a glance at the reality of the Alliance as a cooperation enabler to gain an understanding of the reality of the transatlantic defence market.

Transatlantic cooperation within the Alliance has offered good opportunities for industries. The NATO air defence programme is a good example of cooperation between defence contractors. The first such programme, NATO Air Defence Ground Environment (NADGE) was launched in 1966. Five European contractors, including Thomson-CSF (now Thales) and the American company Hughes (now part of Raytheon group) joined forces to bid for the contract. As they won it, they set up a joint entity to act as a prime contractor. Today, the development of NATO's Air Command&Control System (ACCS) has fostered partnerships between different companies under the leadership of ThalesRaytheonSystems. It is a joint venture equally owned by the European-based Thales and the American Raytheon. To overcome political concerns about technology transfers, the joint-venture split its operation into two subsidiaries: one in the US that is 51 percent owned by Raytheon and one in the EU, 51 percent owned by Thales. Such an arrangement should generate free-flow of information technology within the company. However, there is no guarantee that this arrangement will deliver much.

Strictly in the framework of the military alliance, countries can share capabilities through NATO (military telecommunications, AWACS early warning observation, strategic airlift capability, and missile defence). For example, 13 countries agreed to buy three or four C-17 aircraft.

Cooperation through the Alliance, especially when it comes to pooling through acquisition, is difficult to manage on a daily basis. For instance, the fact that multinational crews fly the C-17 can be a problem when there is a political division in the Alliance. 'In 2003, the US wanted to use AWACS for the invasion of Iraq but several countries were hesitant to give authorisation. The German government, which had initially refused to allow its crew to fly the AWACS, finally relented, explaining that the operation was in order because it was taking place on the Turkish border and would therefore serve to protect the Alliance.'[39] As Richard A. Bitzinger

39. Jean Pierre Maulny & Fabio Liberti, 'Pooling of EU Member States assets in the implementation of ESDP', European Parliament, February 2008.

puts it, 'in fact, one has to go back to the mid 80s and the so-called Nunn Amendment programs to find any golden age in NATO armaments cooperation, as a result of which the US and its European allies launched more than 25 collaborative arms projects. Even then, most of them failed within a few years, as seed funding ran out and the US DoD chose to pursue US only programs.'[40] Back in the 1980s, the US had a tendency to participate in collaborative programmes to get the technologies it needed to grant an optimal security of supply. Once it obtained these, it turned its back on the cooperative framework. Today, the US is still dictating its conditions depending on its strategic vision. For example, after some European countries denounced the Iraq war back in 2003, the US refused to provide Europeans with the engine they needed to power their new ASTER missile. As a result, Europeans had to spend much more money and time than expected to produce this missile. Europeans realised that not only do the security of supply and the strategic vision determine the degree of American cooperation, but also power politics. Power politics determine the level of technology transfers at the operational level.

However disappointed Europeans may be when they cooperate with the US, most collaborative large-scale transatlantic programmes are likely to be launched within NATO. For example, governments have no choice but to cooperate when it comes to 'population protection systems' because they cannot afford it on a purely national basis. When it comes to missile defence, NATO-reluctant members have little room for manoeuvre: 'bear in mind the cost of exo-atmospheric interceptor[41] is ten times more expensive than those engendered with a Theatre Missile Defence', underlines Jean-Pierre Maulny.[42]

A transatlantic defence industrial potential

Yesterday...

The development of the atomic bomb was spearheaded by a group of German Jewish scientists who fled Nazi Germany.

An Irish immigrant invented the modern submarine.

Space launch and intercontinental missiles were also developed thanks to a group of German scientists.

The jet engine and the tank were British inventions.

Stealth technology was the result of a Lockheed Skunk Works engineer coming across a soviet algorithm.

40. Richard A. Bitzinger, 'Overcoming impediments to transatlantic armaments collaboration', *The International Spectator*, vol. XXXIX, no. 1, January-March 2004, pp.83-94.

41. = exo-atmospheric anti-missile defence system.

42. Interview conducted in Paris in March 2008. Jean-Pierre Maulny is the deputy director of the Institut de relations internationales et stratégiques (IRIS).

... and even more today, there is a strong interdependence in the supply chain

The Army's MiA2 Abrams tank uses a German 120 mm cannon and British Armour technology.
The Stryker armoured vehicle is a Swiss design.
The Marines howitzer is a British design.
The President's next helicopter will be an Anglo-Italian design.
The next generation Atlas space launcher uses a Russian rocket engine, while the next generation F-35 JSF uses British engine technology.

(Source: Derived from Michael Brewer, *An Aerospace Business Case for Transatlantic Cooperation*, Industrial College for Armed Forces, June 2005)

What has prevented more cooperation up to now is the difficulty experienced by European and American governments in striking the right balance between security and competitiveness. The International Traffic in Arms Regulations (ITAR) in the US, and the absence of any common binding EU policy on export controls, strangle EU-US defence trade even if they satisfy state security interests.

Reforming transatlantic rules

Governments tend to reform the legal framework in favour of defence industrial cooperation when state security interests and industrial strategies coincide. In Europe, back in the late 1990s France pushed hard for the reorganisation of the aerospace sector. Following the first move to implement this decision, companies lacked a legal framework to match the new industrial landscape. In response, six EU countries[43] signed the Letter of Intent in 1998.

Across the Atlantic, the Albright Declaration of Principles and the Defence Trade Security Initiative (DTSI)[44] also aimed at fostering and facilitating defence industrial cooperation. As a result, two transatlantic programmes were launched. The Joint Strike Fighter and the Medium Extended Air Defence System (MEADS) programmes benefit from looser export controls. However, the main dilemma confronting a cooperative programme remains technology transfers. MEADS, a government-to-government transatlantic cooperative programme, represents perfectly how

43. In 1998, France, Germany, Italy, Spain, Sweden and the UK signed a Letter of Intent (LoI) that paved the way for a July 2000 Framework Agreement aimed at better co-ordination within the defence industries of these countries and to ensure that further restructuring would run smoothly without affecting any major collaborative defence projects. It also encouraged cooperation in the areas of supply and research as well as common equipment procurement.

44. In May 2000, US Secretary of State Madeleine Albright launched an initiative to soften US exports controls.

tricky these negotiations can be. The US insisted on having the right to conduct on-site security inspections of German and Italian facilities, and proposed the use of 'black boxes' to protect US technology. The Germans refused the proposals because they considered it as a test case for US willingness to share technology with its allies.[45] After eight months of tense negotiations, Italy got an assembly chain on its soil (see toolboxes no. 2 and 3 at the end of the chapter). This hard trade-off between security and competitiveness hampers cooperative programmes because it prevents the free-flow of technology and knowledge. Technology transfers are an incentive for both sides to enter cooperative ventures. The current US licensing system prevents cooperation because the US export licence system allows only nationals of one country to access the technology.

The reform of the American export control policy started in 2000, with the Declaration of Principles (DOP) and the Defence Trade Security Initiative (DTSI), only benefiting the 'happy few.' The DOP consists in proposing an extension of the ITAR to NATO allies, Australia and Japan. It would permit the permanent and temporary export and import, without any licence, of certain unclassified defence goods and data. It is restricted to pre-selected companies. When it comes to the DTSI, it only applies to the UK and Australia. In addition, its scope is very narrow, as it concerns only unclassified technologies and equipments. It will certainly not contribute to bridging the technology gap between the US and the EU. What is more it does not prevent the Congress from interfering: its implementation takes place within the Arms Export Control Act (see toolbox no.1 on page 112). Last but not least, it is still very much in tune with the US bilateral approach to trade and cooperation because it only considers countries on an individual basis from the negotiation of the deal to its implementation. It does not target multinational joint-ventures. Up until now, DoPs have been signed with the UK, Australia, Norway, Spain and the Netherlands. So far, the UK is the only EU Member State with whom the US has begun negotiating a binding export control agreement (reflecting the 'special relationship'). ITAR-talks with additional partners are envisaged only after negotiations with the UK have been completed.

However, the Americans have started making overtures towards European allies. For instance, in recent years, the US seems more inclined to offer contracts to European companies. Finmeccanica won a contract to provide the US Marine One pres-

45. Andrew D. James, 'The prospects for the future', in Burkard Schmitt, 'Between cooperation and competition: the transatlantic relationship', *Chaillot Paper* no. 44, EUISS, Paris, January 2001.

idential transport fleet with a US (US 101) version of AgustaWestland EH101 Medium-Lift Helicopter. Offsets principles grant European companies a participation in the US C-130J transport aircraft. The US coastguard ordered five more CASA HC 235A (eight in total) from EADS. More recently, in March 2008, the US air force announced the decision to award a 35 billion dollar contract to supply aircraft-refuelling tankers to Europe's EADS and its US partner Northrop Grumman Airbus.

The Bush administration has also instigated the UK-US treaty which has still to be ratified by the US Senate.[46] This treaty is highly symbolic of the way politics can economically influence the transatlantic defence market. This bilateral treaty offers privileges to British entities only; such a restriction could lead to a two-tier European defence market with non-British firms lagging behind. In its current form, this treaty may not boost transatlantic cooperation. As the House of Commons Defence Committee said in December 2007,[47] the UK-US treaty does not apply to multinational programmes like the JSF in order to comply with the US habit of favouring 'one-to-one' agreements, no matter how many countries may be involved in a programme. In a word, the treaty still enshrines the American way of cooperation. Besides, the treaty also highlights that current export controls policies are not coherent anymore in that it is not clear what they really aim at controlling: exports? technologies? industries? end users? For example, the UK-US Treaty simultaneously tackles industries, technologies and end user/end destination of exports with the concept of a 'Security Community.' The companies who will receive this label will be obliged to ask for a specific licence if they want to re-export a product. In imposing such a rule, the US enhances the strength of its export control policy.

In fact, defence exports controls reform is thus driven by two different trends of equal strength. On the one hand, the American administration orientates according to its broader security strategy. In January 2008, President Bush published an Export Control Directive to clarify his vision of the export control policy revision. His main concern was to 'ensure that US defence trade policies and practices better support the National Security Strategy. The package of reforms required under this directive will improve the manner in which the US Department of State licenses the export of defence equipment, services and technical data, enabling the US government to respond more expeditiously to the military equip-

46. 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).

47. 'UK/US Defence trade cooperation treaty', House of Commons Defence Committee, December 2007.

ment needs of our friends, allies, and particularly our coalition partners.'[48]

On the other hand, defence companies are seeking more business opportunities. Industrial associations' main concern is having the right balance between security and business opportunities. For example, in September 2003 the US House of Representatives drafted a controversial bill barring the Pentagon from using overseas suppliers in purchasing parts for essential weapons systems. Industrial associations, like SBAC and AIA, intervened vehemently and succeeded in preventing its application. They worked hard on the Bush administration to modernise export controls. After their March 2007 petition, the UK and the US signed a treaty in June 2007 to soften defence procurement rules within their 'security community' (this mainly consists in streamlining the licence approval process and in providing licensing exemptions for unclassified items for certain pre-approved firms). If ratified by the Congress, such a treaty would be a great step forward. It might help European prime contractors working in the UK to penetrate the US market the way British ones do. European industries will wholeheartedly welcome any measure likely to ease business with the US. Up to now, sales and investments on the US market have been minimal. In 2005, Thales was unable to improve much on its 9 percent of overall sales to North America. Finmeccanica's sales to North America also remained low. 'They slightly edged up from 8 percent of total sales in 1999 to 9 percent in 2005.'[49]

In a word, both European and American companies work for a transatlantic defence market. What has prevented more open free-trade on the defence market up to now is European and American governments' difficulty in striking the right balance between security and competitiveness. The International Traffic in Arms Regulations (ITAR) in the US, and the absence of any common binding EU policy on export controls, strangle EU-US defence trade even if they satisfy state security interests.

Security and competitiveness: the right balance

In an ideal world, the new Barack Obama US administration would enlarge the UK-US Treaty on defence equipment to the EU and grant its defence and security companies a 'licence-free label.' The incoming administration would do so to boost cooperation within the Alliance. The main argument from an American point

48. See: http://www.state.gov/r/pa/prs/ps/2008/jan/99562.htm.

49. Seth G. Jones, *The Rise of European Security Collaboration* (Cambridge: Cambridge University Press, 2007), p. 276.

of view would be to revitalise NATO at a time when the US chronically complains of European unwillingness to share its part of the burden. In an article entittled 'Allies and armaments', Ethan B. Kapstein[50] gives a convincing overview of the economics of defence alliances. The idea is that armaments cooperation is a way of entangling allies into an alliance. Countries weigh up the costs and benefits associated with defence cooperation. They would cooperate as soon as the benefits outweigh the costs. Free trade would foster more collaborative programmes, 'signalling a renewed commitment to strengthening the continent's military capability.' As Stephen Walt[51] argued in 1985, free trade in the field of arms cooperation would be an important signal from the US to its allies that would revitalise NATO. The UK-US treaty can be taken as a starting framework because it contains important innovations. For instance, there is a potential to include facilities within universities carrying out defence work in the approved community. Such a move would greatly improve research simply because it would avoid duplication. What is more, from a Washington point of view, transatlantic partnership could be an efficient way to influence European procurement. From a European point of view, it would be a good opportunity to start spending defence budgets more efficiently through pooling and cooperative programmes, especially R&T projects. In fact, a transatlantic market will allow both sides of the Atlantic to take the lead in defence technologies' innovation because they could allocate benefits stemming from economies of scale to R&D. In effect, while the DOD has doubled its planned investment in new systems from 750 billion dollars to almost 1 trillion dollars for the 2007-2011 period,[52] it has largely sacrificed research and development. Again, the level of Research Development Test and Evaluation (RDT&E) funding (70 million dollars)[53] represents no more than half the amount the US devoted to that portfolio in the late 1980s.

If the EU were to negotiate such an agreement with the US, it would simultaneously accelerate the consolidation of demand. An EU-US agreement would facilitate the launch and realisation of cooperative programmes. More transatlantic cooperation should encourage Europeans to move together as well. In that sense an EU-US agreement would help. The European Security and Defence Policy and growing need for armaments cooperative programmes is one of the main arguments in favour of common EU legislation. Also, a European defence industrial community

50. Ethan B. Kapstein, 'Allies and Armaments', *Survival*, vol. 44, no. 2, summer 2002.

51. Stephen Walt, 'Alliance formation and the balance of power', *International Security*, spring 1985, p. 232.

52. Anthony H. Cordesman, 'A poisoned chalice: the flaws in FY 2008 Defence programme', Centre for Strategic and International Studies (CSIS), July 2007. See: http://www.csis.org/media/csis/pubs/070703def_chall_fy2008.pdf.

53. Defence R&D figures: FY 2007 $79,009 million; FY 2008 $77,782 million; FY 2009 $80,688 million. See: http://www.defenselink.mil/comptroller/defbudget/fy2008/fy2008_p1.pdf

can only be achieved through concrete common experiences where different stakeholders build something together, overcoming strictly national points of view. A European security community already exists to some degree in consolidated areas such as aerospace, for example EADS. A few initiatives are already on track. For example, the defence ministers of Germany, France and the UK decided on 22 February 2008 to pool the maintenance of the A400M transport plane. 'Britain and France will take the idea further, developing a common stock of spare parts for the fleet of 130 carriers (out of 180 ordered), allowing the aircraft purchased by each government to be pooled for use across the partnership. For now, Germany will continue to go it alone on that element.'[54] Such initiatives should become the norm rather than the exception. If ratified, the Lisbon Treaty might offer good opportunities for cooperation with the Permanent Structured Cooperation mechanism. This is because 'those Member States which meet a set of capability-based entry criteria can choose to co-operate more closely after securing a majority vote.'[55]

European coherence

To convince the US that they are reliable allies, Europeans should also work hard on the consolidation of demand. Cooperation is key for strengthening the European defence industry through the consolidation of demand. A European security community, complying with American standards, would require that the EU reinforce its internal regulations to strike the right balance between security and competitiveness. When it comes to defence products, and more specifically to export controls, Member States do not have to abide by any EU regulations. For example, the EU code of conduct on arms exports has more or less as many interpretations as there are Member States.

In the medium term, greater coherence is required within the EU. While the economic side of export control is discussed and ruled by the Commission, its security side depends on Member States' intergovernmental decision-making. Nevertheless, since the Commission issued a Communication with recommendations for improving the export control environment in Europe in December 2006,[56] the balance is shifting towards more effective EU legislation at least when it comes to dual-use goods and technology. In December 2007, the balance shifted a little further

54. Brdo Pri Kranju, 'Pan-European defence too often lost in translation: ministers', 22 February 2008. See: www.spacewar.com.

55. Keith Hartley, op. cit. in note 26, pp. 107-15.

56. European Commission, 'Communication from the Commission on the review of the EC regime of controls of exports of dual-use goods and technology', COM (2006)828final, Brussels, 18 December 2006.

towards the Commission with its defence package and more precisely with its draft Directive on 'simplifying terms and conditions of transfers of defence-related products within the Community.' The main way in which progress could be achieved via the Directive would be to induce governments to replace their existing individual licences with a general one for those intra-Community transfers where the risks of undesired reexportation to third countries are under control.[57] This system of licence is very much in tune with the UK-US Treaty and if it is pushed far enough it could even transform the European landscape; with licence-free and non licence-free companies already labelled, the US would be more likely to consider enlarging the UK-US Treaty to Europe. The draft directive offers enough security guarantees to comply with US standards. Article 3 starts by defining a 'defence-related product' as any product which is specifically designed for military use and which is listed in the Common Military List of the EU (adopted by the Council in March 2007). The Commission clearly wants to regulate more than dual-use goods and technology.

What is more, this draft Directive has the potential to Europeanise defence procurement and transfers within the Union in two ways. First, the draft Directive entails that Member States would establish a common system of general licences for transfers of defence equipment and supplies to certified Member States or other recipients (within the EU). Second, it proposes a three-year-long 'global' licence (Article 6) to an individual supplier authorising one or several transfers of one or several recipients in another Member State. At the end of this implementation process, European defence stakeholders would be certified as a trustworthy partner (or not). Such a process could be a trigger for the US to enlarge the 'certified community' they have already proposed to the UK to all EU governments. Last but not least, it could greatly encourage more cooperative programmes. Article 5 allows Member States which participate in an 'intergovernmental cooperation programme' to publish a general licence for transfers to other participating Member States. The new Directive should help European defence industries to be more competitive since it would streamline licensing rules they have had to comply with even when they wanted to exchange components with one of their subsidiaries within the EU.

The Directive would also have a more general consequence on rules defining exports to third countries within the EU. The eight

57. 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 Member States.

criteria of the Code of Conduct have already moulded the 'European mindset' in that respect but it is very likely that Member States would soon have to turn the Code of Conduct into a binding tool. Such a change is the minimum guarantee required by free trade of defence products within the Union to reassure non-EU partners like the US of EU seriousness in the field of arms trade.

Conclusion

Time and money is already running out: governments cannot make ends meet anymore. In the US, 'the Navy is apt to [have] a net loss in its carrier fleet capacity because it has been delayed in developing a new carrier beyond the point where it will have to start retiring current carriers. The Marines will have to wait five years to get half the quantity of expeditionary vehicles that it has planned.'[58] The Commission Communication, 'A Strategy for a stronger and more competitive defence industry', considers that 'national defence budgets in isolation can no longer finance the development of a full range of top quality products and new national defence programmes have become less frequent' (e.g. French aircraft carrier cancelled in mid-April 2008 after any collaboration with the UK failed to be agreed).

The defence technological and industrial bases of both sides of the Atlantic suffer from a lack of investment in R&D. Contrary to what many think, Europe has a lot to offer to the US. As Daniel Keohane has underlined, 'European governments are the world leader in some technologies with potentially military application. The French, for example, have conducted potentially important experiments with transparency energy from satellite to satellite using laser beams. This could be used to keep military satellites longer in orbit or to make them more manoeuvrable.'[59]

Plus defence companies cannot reap the full benefit of the mergers, acquisitions and joint-ventures they build with their counterparts. As Professor Keith Hayward[60] has pointed out: 'Interest in reforming the US system has come with the growing realisation of defence industrial globalisation and that the US does not have a monopoly on all the key emerging military-relevant technologies. In short, there is a strategic and operational value to the US in increasing defence industrial collaboration between close allies.' The EU is also in the process of improving its defence indus-

58. 'DoD Weapons Procurement Broken, Auditor Warns', Agence France-Presse, 3 June 2008, http://www.defensenews.com/story.php?i=3560506&c=AME&s=TOP.

59. Daniel Keohane and Tomas Valasek, 'Willing and able? EU defence in 2020', Centre for European Reform (CER), London, June 2008.

60. Keith Hayward, 'Friends and Rivals: Transatlantic Relations in Aerospace and Defence in the 21st Century', a specialist paper by the Royal Aeronautical Society, June 2005.

trial landscape, but Europe-only reforms might not be enough in the face of budgetary constraints. The other reason why governments should move towards softening their export controls is more political. Transatlantic partnership would grant both sides of the Atlantic greater capability and consistency in their strategic partnership.

To monitor the reform of exports controls and consolidation, European and American governments should set up an assembly. This assembly does not need to be permanent. It would already be a major step forward if both governments and executives could meet formally three times a year to guarantee a coordinated follow-up of the defence policy with the defence market. However, this assembly should not be seen as a meeting between the European Defence Agency and the US Defence Procurement Agency. Participants should form a representative panel of the defence community from politicians to industrial executives. What is more, if the reform of exports controls is conducted in coordination with all the stakeholders engaged in defence procurement, it will guarantee a quick and homogeneous implementation of the reform.

Toolbox no. 1: US control in the field of defence

Direct Foreign Investment in the defence field: US obstacles

In 1975, the Committee on Foreign Investment in the US (CFIUS) was created and empowered to review and make recommendations on foreign takeovers. It is chaired by the Secretary of the Treasury and 'includes more agencies that might be concerned with foreign takeovers.' Defence, State, Commerce and Justice Departments, as well as several officials from the Executive Office of the President, take part in the decision-making process.

After getting the green light from the CFIUS, a firm willing to acquire an American entity has to create a corporate entity in the US. What is more, the Pentagon requires the creation of a separate subsidiary for US operations along with the delivery of a Special Security Arrangement (SSA). If no SSA is agreed, the Pentagon insists that the parent firm's equity is placed in a separate, non-voting trust. In that case, the board of directors of the subsidiary must not include overseas members of the parent firm. By the same token, it is quite likely that overseas members will not be allowed to be involved in the operation of the firm or be given information regarding its financial situation. In other

words, the parent firm is no more than a fiscal entity; it has no role in the management.

Export controls and technology transfers regulations

The Cold War transatlantic Coordinating Committee for Multilateral Export Controls (COCOM) has disappeared. Instead, the Wassenaar Arrangement (1995) covers conventional arms and dual-use goods and technologies. As the Arrangement did not establish any common binding rules, each country remains free to invent its own set of measures. The US decided to build their export control law on a system of licences. Today, the common rule is that whenever a firm wants to export to a foreign entity, it has to get a licence. This rule has a broad scope: from discussions between US subsidiaries of foreign business and the parent company, to discussions over potential cooperation, joint-ventures, mergers or acquisitions across boundaries.
Transfers of any kind are protected in a very similar bureaucratic and time-consuming way.

The Department of State

The Secretary of State implements the Arms Export Control Act (AECA).The International Traffic in Arms Regulations (ITAR) and the Munitions List that he/she elaborates are monitored by the Office of Defence and Trade Controls (ODTC).

The Department of Commerce

The Bureau of Export Administration at Commerce oversees the Export Administration Regulations.

Economic sanctions and embargos

The Directorate of Defence State Control publishes and updates on a very regular basis the list of embargoed countries. The last update was made public on 2 January 2008. Today, it comprises 22 countries: Afghanistan, Burma/Myanmar, Belarus, China, Côte d'Ivoire, Cuba, Cyprus, Democratic Republic of the Congo, Eritrea, Haiti, Iran, Iraq, Lebanon, Liberia, Libya, Rwanda, Somalia, Sudan, Syria, Venezuela, Vietnam and Zimbabwe.

The Congress

Because it is responsible for amending the Arms Export Control Act, the Congress has substantial power to complicate the US arms export policy.

Toolbox no. 2: The Joint-Strike Fighter

Type of aircraft
Multi-role fighter, joint service aircraft.

Participating countries
The US, the UK, Italy, the Netherlands, Canada, Denmark, Norway, Turkey, Australia, Singapore, Israel.

1. Background

The JSF programme stems from the US Administration's Bottom-Up Review (BUR) of US defence policy and programmes in 1993 which advised that a fifth-generation fighter programme be launched.
The JSF is currently in the System Development and Demonstration Phase.
In October 2001, a team from Lockheed Martin and BAE Systems won the contract over Boeing.

Why is the JSF so revolutionary in theory? A new approach to international procurement.

- A joint service aircraft.

The programme focus on the development and production of three variants with common components: a land-based conventional take-off and landing (CTOL) version for the Air Force, a carrier-based version (CBV) version for the Navy, a short take-off vertical landing (STOVL) version for the Marines and the UK. 'JSF programme officials anticipate major savings because of a high degree of commonality in components and systems among the three versions (from 70 to 90%), which are to be built on a common production line.'[61]

- 'Historically, subcontractors provided parts; in JSF, partners provide systems and sub-systems.'[62]

The two JSF developmental phases where international participation has been offered are:
- Systems Development and Demonstration
- Production, Sustainment and Follow-On Development.

61. Anthony Murch and Christopher Bolkcom, 'CRS Report for Congress, F-35 Lightning II Joint Strike Fighter Program: Background, Status, and Issues'. Updated October 2007. See: http://www.european-defence.co.uk/jsf.html.

62. Robbin F. Laird. 'Transformation and the defense industrial base: a new model', Center for Technology & National Security Policy, National Defence University, May 2003. Available at: http://www.ndu.edu/inss/DefHor/DH26/DH26.pdf.

2. In reality

The production line
Participants build subsections for the global programme before they are assembled in the US or in Italy for European fighters.

Partnership
It is broken down into three levels, according to the amount of the monetary contributions to the programmes.
'The higher the investment level, the greater the nation's voice with respect to aircraft requirements, design, and access to technologies gained during development.'[63]

The US is the main financial contributor to the programme with US$5.3 billion (€3.6 billion) allocated in 2007. Some US$6.2 billion (€4.2 billion) has been allocated in 2008, which will include the procurement of 12 aircraft for testing purposes. The other nations involved in the project are designated partners at three levels (I, II, III). Each level provides different industrial participation and how many staff is assigned to the F-35's programme office in the US. Level I and II partners have some influence in the F-35's design and development to meet their own specific national requirements.

The UK is a Level I partner and is contributing some US$2.0 billion (€1.4 billion). As Level I partner, the UK has the biggest industrial participation after the US and should also financially gain more from sales.

Italy and the Netherlands are Level II partners and are contributing US$1.8 billion (€1.2 billion), while Australia, Canada, Denmark, Norway and Turkey are Level III partners and are together contributing some US$725 million (€494 million) to the overall programme.

Israel and Singapore are reportedly each paying less than US$50 million (€34 million) through their Security Co-operative Participation (SCP) agreements, with their aircraft likely to be purchased through the US's Foreign Military Sales (FMS) scheme.

Technology transfers
▌Technology sharing and government-to-government agreements: opportunities for interactive military transformation

63. Anthony Murch and Christopher Bolkcom, op. cit. in note 61.

- Unique export licence developed by the US
- A single point of contact to review licences related to the programme in the US.

Financing

Importance of private-public partnerships to create systems architecture, manage system-of-system approaches and work with sub-systems providers;

3. A test-case for US allies and for cooperative armaments programmes.

- Dominant position of the USA over technology transfers (TT): the US points out technology transfers and the risk of cost overruns to justify their domination in this area.[64] The UK claims TT 'like source coding' are crucial to guarantee enough autonomy for maintenance, support, upgrade, and weapon-integration
- Costs: according to CSBA, the overall cost has increased about 35% from its 1997 projections. A defence Aerospace analysis[65] of the costs of fourth and fifth generation fighter aircraft compares the cost of the F-35 with the Eurofighter (a 4+generation fighter)
- Support should be provided by a globalised logistics system managed by the US
- Aircrafts are being designed to operate in a 'system of systems': foreign users would depend on the US
- 'The success of the JSF will largely determine the future health of the UK defence aerospace sector; the links with the US are also affecting British willingness to embrace European programmes in UAV and UCAV development.' More broadly, the JSF, if it proves to be a successful cooperative aircraft could discredit both the Rafale and the Typhoon, leaving the EU in a dead end ... especially if it has not developed any UAV-UCAV alternative in which to specialise.

Toolbox no. 3 : MEADS

Medium-range surface-to-air missiles.
MEADS will be designed to kill enemy aircraft, cruise missiles and UAVs within its reach, while providing next-generation point defence capabilities against ballistic missiles.

64. Hélène Masson, 'The JSF/F-35 in Europe: the price of pragmatism', Fondation pour la recherche stratégique (FRS), 2004.

65. 'Sticker Shock: Estimating the real cost of modern fighter aircraft', *Defence-Aerospace.com*, July 2006.

Trinational transatlantic programme launched under the first term of the Clinton administration.
As for the JSF, it is a government-to-government programme to replace Hawk and Patriot systems.
The US and Italy agreed the Design & Development phase in July 2004 while Germany joined them in April 2005. They signed up for an initial 9 year contract for Design & Development for $3.4 billion.
In-service date scheduled for 2014.
The development work share will be equivalent to the national cost/funding share.
Percentage of cost share: US 58%; Germany 25%; Italy 17%.

1. MEADS, 'on paper'

To avoid the trouble experienced with certain cooperation ventures, a number of principles have been adopted:
- MEADS is conducted by an independent company, MEADS International Inc, in which Lockheed and EuroMeads have equal stakes. Where important decisions are involved, each partner will have a single vote
- MEADS Intl is official supplier to NATO's Medium Extended Air Defence Management Agency (NAMEADSMA) and therefore has at its disposal equity capital for systems engineering and integration as well as for managing the programme
- All contract segments will be fulfilled by MEADS Intl, to which the parent companies will make personnel available, being themselves awarded subcontractor contracts for implementation of the subsystems
- All work related to the systems and subsystems will be entrusted to the multinational production teams
- MEADS Intl runs an equal representation management structure
- Participating governments control the information sharing protocol.

As a consequence, a multinational joint venture, headquartered in Orlando, has been set up.
MEADS International's participating companies are MBDA in Italy, LFK in Germany and Lockheed Martin in the United States. Together, these companies have founded an international engineering team in Orlando to develop systems and technologies for the MEADS programme, which is closely watched as a model for collaborative transatlantic development.

2. The test of time

MEADS dates back to the late 1980s when the US Marine and US Army needed to replace the Hawk air defence system.
In February 1995, France, Germany, Italy and the US expressed their will to cooperate. In 1996, France had to drop out of the project for budgetary reasons. Estimating it was not a priority for US ballistic missile defence, the Congress refused to finance the MEADS programme as early as 1998. In 1999, the Joint-Venture, selected as the US contractor, was threatened. The Germans and Italians were forced to accept the use of the PAC-3 Patriot missile, the only condition under which the Pentagon would agree funding.
Europeans quickly started complaining about technology transfers. The US wanted to conduct on-site security inspections of European facilities and install black boxes to protect their technologies.

About the authors

Erkki Aalto is advisor at the Resource Policy Department of the Ministry of Defence of Finland. He is also a Ph.D candidate at the University of Turku, Finland, where his dissertation project deals with national security exemptions in EC law. He was a Visiting Fellow at the EU Institute for Security Studies from June to August 2007.

Daniel Keohane is Research Fellow at the EUISS where he specialises in ESDP, counter-terrorism and defence industry issues. He was previously Senior Research Fellow for security and defence policy at the Centre for European Reform in London and a Research Associate at the Institute for National Strategic Studies, National Defence University, Washington D.C. He is the EUISS representative on the academic board of the European Security and Defence College (ESDC) and has participated in consortia to carry out studies commissioned by the European Defence Agency (EDA) and the European Space Agency (ESA).

Christian Mölling graduated in political science, history and economics from the University of Duisburg and the University of Warwick (UK). He is currently a Senior Research Fellow at the Center for Security Studies (CSS) at the ETH Zurich, were he deals with strategy development, crisis management, arms control and arms politics. His Ph.D, obtained at the Ludwig-Maximilian-University, Munich, analyses the strategic coherence of ESDP in the fields of military crisis management, arms control and armaments cooperation.

Sophie de Vaucorbeil is a graduate of Sciences Po (Bordeaux) and has since specialised in ESDP issues and armaments industries at the Institut de relations internationales et stratégiques (IRIS). During 2007-8 she worked as Research Assistant to Daniel Keohane at the EUISS, where she helped manage a research project for the European Defence Agency on 'Enhancing mutual understanding and competences of stakeholders engaged in cooperative programmes.' She has also carried out research on ESDP issues, terrorism, defence industries and the international defence market.

Abbreviations

AWACS	Airborne Warning and Control System
CFIUS	Committee on Foreign Investment in the US
COARM	Common Military List of the European Union
CoC	Code of Conduct (on Defence Procurement)
CoC Ex	Code of Conduct on Arms Exports
COCOM	Coordinating Committee for Multilateral Export Controls
DoD	Department of Defense
DOP	Declaration of Principles
DTIB	Defence Technological and Industrial Base
DTSI	Defence Trade Security Initiative
DU	Dual Use
EADS	European Aeronautic Defence and Space Company
EC	European Community
ECJ	European Court of Justice
EDA	European Defence Agency
EDC	European Defence Community
EDEM	European Defence Equipment Market
EDTIB	European Defence Technological and Industrial Base
ESDP	European Security and Defence Policy
FA	Framework Agreement
GDP	Gross Domestic Product
GWOT	Global War on Terror
IT	Information Technology
ITAR	International Traffic in Arms Regulations
JSF	Joint Strike Fighter
LoI	Letter of Intent
MEADS	Medium Extended Air Defence System
MoU	Memorandum of Understanding
MS	Member States
MTCR	Missile Technology Control Regime
NATO	North Atlantic Treaty Organisation
NBC	Nuclear Biological and Chemical
R&D	Research and Development
R&T	Research and Technology
RDT&E	Research Development Test and Evaluation
SME	Small and Medium-Sized Enterprises
sMS	Subscribing Member State
SOS	Security of Supply
SSA	Special Security Arrangement

TDC	Transnational Defence Companies
TEU	Treaty on European Union
TT	Technology Transfers
WEAG	Western European Armament Group
WEU	Western European Union
WMD	Weapons of Mass Destruction

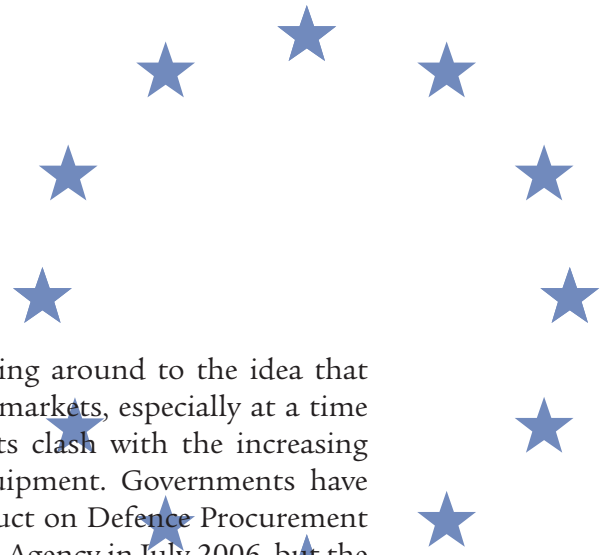
Chaillot Papers

All *Institute publications*
can be accessed via the Institute's website:
www.iss.europa.eu

n°112	EU security and defence. Core documents 2007 *Volume VIII, compiled by Catherine Glière (also published in French)*	October 2008
n°111	Bush's legacy and America's next foreign policy *Marcin Zaborowski*	September 2008
n°110	Rethinking Iran: From confrontation to cooperation *Christoph Bertram*	August 2008
n°109	Partnerships for effective multilateralism: EU relations with Brazil, China, India and Russia *Ummu Salma Bava, Feng Zhongping, Sabine Fischer, Marco Aurélio Garcia, François Godement, Giovanni Grevi, Dimtri Trenin, Alfredo Valladão, Álvaro de Vasconcelos and Christian Wagner; edited by Giovanni Grevi and Álvaro de Vasconcelos*	May 2008
n°108	Ukraine: Quo Vadis? *Sabine Fischer, Rosaria Puglisi, Kataryna Wolczuk and Pawel Wolowski; edited by Sabine Fischer*	February 2008
n°107	Is there an Albanian question? *Judy Batt, Misha Glenny, Denisa Kostovicova, Nicola Mai, Nadège Ragaru, Fabian Schmidt and Miranda Vickers; edited by Judy Batt*	January 2008
n°106	Pioneering foreign policy: The EU Special Representatives *Giovanni Grevi*	October 2007
n°105	Seeing blue: American visions of the European Union *Esther Brimmer*	September 2007
n°104	Regional cooperation in the Western Balkans *Milica Delevic*	July 2007

Books

The New Global Puzzle. What World for the EU in 2025? *directed by Nicole Gnesotto and Giovanni Grevi*	2006
Friends again? EU-US relations after the crisis *Nicole Gnesotto, James Dobbins, Federico Romero, David Frum, William Wallace, Ronald D. Asmus, István Gyarmati, Walter B. Slocombe, Gilles Andréani, Philip H. Gordon, Werner Weidenfeld, Felix Neugart, Geoffrey Kemp, Dov Lynch, Fiona Hill, Baudoin Bollaert, Joseph Quinlan, Marcin Zaborowski; edited by Marcin Zaborowski*	2006
Defence procurement in the European Union – The current debate Report of an EUISS Task Force *Chairman and Rapporteur: Burkard Schmitt*	2005



EU governments are gradually coming around to the idea that they need to open up their defence markets, especially at a time when growing budgetary constraints clash with the increasing need for sophisticated military equipment. Governments have already agreed to the Code of Conduct on Defence Procurement introduced by the European Defence Agency in July 2006, but the EDA cannot force governments to comply with the code. Also, the protectionist attitude of Member States derives from the fact that they regard defence procurement as an area that overlaps with national sovereignty.

The European Commission is currently proposing new procurement and trade directives aimed at streamlining defence market legislation, and it is to be hoped that Member States will respond positively to this initiative. The proposed directives would open up the defence market, improve European cooperation on armaments and lead to a more competitive European defence industry.

Plus, in the ongoing debate about the European defence market, the transatlantic defence market should not be forgotten, especially given the increasingly important role that American and European companies play in this arena on both sides of the pond.

published by
the European Union
Institute for Security Studies
43 avenue du
Président Wilson
F-75775 Paris cedex 16
phone: +33 (0)1 56 89 19 30
fax: +33 (0)1 56 89 19 31
e-mail: info@iss.europa.eu
www.iss.europa.eu
€ 10

ISSN 1017-7566
ISBN 978-92-9198-131-1
QN-AA-08-113-EN-C