

**TOWARDS THE DEFINITION OF A STRATEGIC
EUROPEAN DEFENCE COMPANY**

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The European Commission communication dated 24 July 2013 is a reminder of the economic importance of today's defence industry: 400,000 jobs and a turnover of €96 billion. These figures are complemented by the qualitative added value inherent in this industrial sector: the use of very high technology generates jobs which are not readily outsourced, and the use of dual technologies increasingly blurs the lines between civilian and military innovation. Many businesses are not solely defence companies: they are high-tech companies which happen to supply both the defence sector and the security and civil industry sectors. The defence industry has changed in the last 20 years and the 'arms dealer' image is now out of date. It remains a manufacturing industry, but one that manufactures high-tech products which are a showcase for innovation and an instrument of EU economic competitiveness. The arms sector also possesses a number of specific characteristics.

> The first characteristic is linked to the fact that these industries were always developed under political impetus. It is national demand, a consequence of governments' wish for strategic autonomy, which leads to the development of defence industries. Arms markets today remain dominated by political and diplomatic considerations: they are not like the open and competitive markets we see in the civil sector. If the European market is

today still in the process of being created, thanks to the initiatives of the European Commission, it is just as much a consequence of the Common Foreign and Security Policy (CFSP) as of the need to create an open market with enough room for European businesses, allowing for economies of scale.

> The second specific characteristic linked to the nature of this market arises from the fact that defence businesses have always preferred to have research and development in the arms sector financed by governments. They consider that in the absence of a naturally accessible export market they cannot take the risk of financing research themselves which can account for as much as 5% of a programme for research and technology (R&T) and not far short of 30% for research and development (R&D). Defence industries are understandably reluctant to take the risk of financing their own research as the vast majority of them are private businesses with shareholders who tend to be financial investors seeking a quick profit who would be unlikely to approve investment strategies without a management-guaranteed financial return. At best these development costs will be shared, as has been the case with the Rafale programme in France, although it should be remembered that the French market was already secured for Dassault, as was the profit margin on the sales of this aircraft.

The necessity of sharing the same vision of the perimeter of EDTIB

The specific nature of the defence industry thus calls for some form of industrial policy on the part of European authorities. We know that the word ‘industrial policy’ is not accepted by everyone at a European level. To take the example of Germany: although the country is adverse to the idea because it smacks of state interventionism, it has a *de facto* defence industry policy, as Christian Mölling¹ points out. So rather than use the expression let us talk in terms of objectives, as they are expressed by the European Commission. It is necessary to put in place a framework which encourages the development of European defence industries insofar as defence is a strategic interest; and all measures should make the link between the Common Security and Defence Policy (CSDP) and the need for a competitive European defence industry: political and economic objectives thus converge. The European Commission’s publication of 24 July 2013 and the road map it drew up a year later rely on several instruments to develop the European defence technological and industrial base².

Among them may be cited:

- The European defence equipment market, which is being put in place following two directives adopted in 2009 and in force since 2011, Directive 2009-43 on intra-community transfers and Directive 2009-81 on defence and security markets;
- The introduction of a road map to ensure security of supply throughout the European Union, following the decisions of the European Council in December 2013. It is within this framework that the green paper on the control of foreign investment in strategic defence industries should be launched;
- Preparatory action in the field of defence research linked to the CSDP.

All these measures have a common feature. Their successful implementation rests upon a shared vision of the definition of EDTIB which would allow for them to be applied in a harmonised way by the Member States. Today, this does not exist, which increases the risk of failure, or at least of disagreement between Member States on measures needed to make the EDTIB more competitive.

The Defence and Security Procurement Directive has led to the definition of three levels within the defence market.

At the top, there is equipment linked to essential security interests for which member states can apply Article 346 of the Treaty on the Functioning of the European Union and

¹ Hélène Masson (ed.), Christian Mölling, Keith Hartley, Martin Lundmark, Krzysztof Soloch, Defining the ‘European Defence Technological and Industrial Base’: Debates & Dilemmas (I)

² ‘Towards a more competitive and efficient defence and security sector’, COM(2013) 542 final, 24 July 2013, ‘A new deal for European defence. A road map for the application of Communication COM(2013) 542 ‘Towards a more competitive and efficient defence and security sector’, 24 June 2014

restrict the defence markets to their national industries.

At the bottom there is the equipment whose use is not specific to defence, such as military uniforms not intended for combat purposes. This area is covered by the interpretative communication of the European Commission on Article 296 of the EU Treaty³. In this case, Member States should proceed by a call for tender using public procurement rules which are laid down in European directive 2004-18.

In the middle is the scope of the Defence and Security Procurement Directive 2009-81, which is destined to facilitate the opening of the public European markets without compromising the Member States' concerns about the security of information or the security of supply.

While the demarcation between the bottom and middle levels does not really create a problem – an abusive use of the procedure covered in the 2009-81 Directive to the detriment of the 2004-18 Directive would in any case result in the opening of the market – the same is not true of the middle and top levels.

³ Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement, 7 December 2006 COM(2006) 779 final

The risks which could affect the implementation of 2009-81 Directive

Initiatives have been taken in the past, notably by the European Defence Agency, to define the scope of Article 346 of the Treaty of the Functioning of the European Union (TFEU). These initiatives have not produced conclusive results, for two reasons:

- It is unlikely that Member States would ever agree on a definition of essential security interests;

- Some Member States are wary of defining exactly what essential security interests might mean, for two reasons:

- > Firstly, anything to do with essential security interests in the field of armaments is relative and contingent. They cannot be simply reduced to sectors linked to deterrence and cryptology, as has sometimes been suggested. Technologies change as do the arms manufactured. New technologies, or indeed the use to which they are put, may be sufficiently critical to involve national security interests, as is the case with cyber technology and its utilization today.

- > Secondly, it would be an oversimplification to limit the notion of security of supply (which appears as a criterion which may be taken into account in the 2009-81 Directive) to the immediate future and to the medium-term supply of military equipment over several years. To guarantee security of supply, it must be ensured that the company which supplies a certain type of equipment will continue to

invest in this sector in future years. But only the Member States can give this guarantee, since it is they who finance defence research and technology (R&T). Thus it is the absence of financing of European manufacturing in basic electronic defence components which has led to a loss of expertise in this type of product in Europe and thus to dependence and not the action of predatory foreign investment.

As such, it would be an oversimplification to think certain member states resort to the unfounded use of Article 346 simply to protect their defence industries. It is also because they have a clearer view of the technological skills which their industry has developed, thanks to the R&T credits which they provide for this industry, and of the future technologies which they intend to finance, that Member States adopt conservative positions on the delimitation between the scope of Article 346 and that of the 2009-81 Directive. To avoid this phenomenon it would be necessary for European consolidation to be more advanced and for there to be a genuine interdependence and joint management of long term R&T funding in defence companies by Member States. This only currently exists in embryonic form with the MBDA missile manufacturer. It would also be necessary to launch more European cooperative arms programmes, which are currently at a state of low ebb.

To avoid this risk of ‘leaking upwards’ in the application of the Defence and Security Procurement Directive, the scope of the Directive must be better defined and Member States must be provided, in the application of this directive, with better guarantees for the preservation of technological defence capacity which lies at the very heart of the notion of security of supply. For this to happen there must be a material definition of the European Defence Technological and Industrial Base (EDTIB), in addition to the organic definition which today lays down the frontier between the 2009-81 Directive and Article 346 of the Treaty of the Functioning of the European Union (TFEU).

Today the scope of the 2009-81 Directive is capped at the top by the essential security interests of the Member States as defined in Article 346 of the TFEU, and limited at the bottom with equipment which is not specific to defence and which is governed by the 2004-18 Directive. The Defence and Security Procurement Directive today thus covers a mixed bag of products and equipment. There consequently exists an area of low-level technology defence equipment which requires limited R&T investment or R&D investment. This area has to be governed by the rules of the open market, particularly because there is a significant export market for this type of equipment, which emerging countries are in the process of occupying and which European companies tend to ignore. There is really no

question of security of supply being threatened for this market.

But there also exist high-level defence equipment or technologies which cannot really be covered by essential security considerations at the strictly national level, and which present a strategic interest in the long term in terms of strategic autonomy and security of supply at the European level. We will use for this sector the term of **high strategic value defence equipment and technology**. Sometimes both types of equipment - low-level technology with no strategic value and high-level technology - may even be present in the same arms system. In this case, the principle of precaution will lead Member States to set the regulations of acquisition of this complex equipment according to the highest technology used in this equipment (this may be the case with entire defence platforms where the proportion of high-value strategic components and sub-systems varies according to the type of platform).

The necessity of defining a high value strategic EDTIB

Member States, the European Defence Agency and the European Commission must work together in the sector of high strategic value defence equipment, from both the technological and operational points of view.

They must accurately define its scope, and apply a suitable regulatory and financial framework. This would guarantee the preservation and the development of the European DTIB in the years to come, and avoid excessive recourse by states to Article 346 of the Treaty on the Functioning of the European Union, as is the case today.

What is the current situation?

At the European Commission level there have been some attempts to limit the scope of Article 346 to avoid countries unduly closing their markets, and thereby slowing the process of EU consolidation. But the Commission has acted on the structuring of supply without being able to influence the demand, the capacity to initiate common requirements, or the financing of R&T upon which the survival of EDTIB depends.

More problematically, the regulatory framework put in place for the strategic defence industry (which do not relate to essential security interests covered by article 346 of the TFEU) is not suitable for high strategic value equipment. The 2009-81 Directive places this industry in competition with foreign industries without guaranteeing its competitiveness with regard to the financing of strategic technologies. The latter depends not on the market but on the involvement of the public authorities whether they be the Member States or the European

institutions, the European Defence Agency or the European Commission. It is not a matter of accepting or not accepting the rules of the market and competition but of making European defence companies sufficiently competitive to face up to the competition, particularly those who manufacture equipment and develop technologies necessary for strategic autonomy. This is in line with the spirit of the European Commission Communication of 24 July 2013.

As has already been noted in a previous publication⁴, the priority should be to determine what belongs to the high strategic value defence equipment and technology sector, and to apply to the European companies working in the sector specific regulations, both legal and financial, which would allow them to develop their competitiveness and guarantee the EU's strategic autonomy.

From the high value strategic EDTIB to the European defence strategic company

It is necessary to provide a definition of a strategic European company, based on the notion of high strategic value defence equipment and technology, before deciding

on the appropriate legal framework and the related financial regulations.

Today some states have already produced a definition of high strategic value equipment which is not necessarily linked to the essential security interests mentioned in Article 346 of the TFEU. The European states with the largest defence industries have tried to define a perimeter for this industry. Sometimes the lists of materials or technologies are not made public, as is the case in France. Sometimes the scope is defined implicitly, as is the case in Britain with the document *National security through technology* published in February 2012 by the UK Ministry of Defence⁵. Italy on the other hand has drawn up a public list⁶.

Overseas, similar measures have been taken. In Brazil, for instance, Law No. 12-598 of 12 March 2012 set up a special tax regime for the defence industry. For this purpose, strategic defence industries (EED) have to be certified, according to five criteria:

- Be active in the defence sector from research to maintenance;
- Have headquarters, establishment and administration of the business in the country;
- Have available within the country proven scientific or technical knowledge in the

⁵ National security through technology, technology equipment and support for UK and defence security, MoD UK, February 2012

⁶ Decree of 15 August 2014 modifying the decree of 30 November 2012 in application of the decree-law Regolamento recante individuazione delle attività di rilevanza strategica per il sistema di difesa e sicurezza nazionale of 15 March 2012

⁴ Jean-Pierre Maulny, 'European Commission Communication on the Defence and Security Sector: Towards a Definition of a Strategic EDTIB?' Notes de l'IRIS, September 2013

company's own right or in partnership with other institutions;

- Ensure that major foreign shareholders do not have more than 2/3 of the voting rights;
- Ensure continuity of production within the country.

Some think tanks have also made proposals regarding this idea of strategic activity. In their report for the European Parliament, Christian Mölling, Alessandro Marrone, Valerio Briani and Tomas Valasek called on Europeans to define *key strategic activities*⁷. More recently, Christina Balis and Henrik Heidenkamp asked what exactly a coherent defence technological and industrial base is⁸.

Today it is no longer enough to ask what constitutes the core of the strategic defence technological and industrial base but also to give it a precise scope which is acceptable to all. The solution is in three stages.

The order to proceed

The first step would be to give a material definition to what should be the core of the defence technological and industrial base: the high strategic value defence equipment and technologies, in other words the sectors which

should be preserved in Europe to guarantee the strategic autonomy of the European Union. It will be objected that the Member States do not today share the same definition of the scope of Article 346. But this is to overlook the fact that the European Union has already established common lists dealing with defence or dual-use equipment at the European level and that the task is therefore not insurmountable.

At the time the Treaty of Rome was drafted, the Council drew up a list of equipments (Decision 255/58 of the Council), never published, which would become part of what at the time was Article 223 of the Treaty of Rome which has become today Article 346 of the TFEU⁹. This would be no doubt more difficult to accomplish today but the definition of a highly strategic defence technological and industrial base would help to better define the scope of Article 346.

Another example: the European Union agreed on a common list of defence materials which serves both for the application of Directive 2009/43 on intra-community transfers as well as for the application of the common policy 2008/944 CFSP as far as arms exports to third countries are concerned¹⁰.

⁷ The development of a European defence and technological industrial base (EDTIB), Directorate General of external policies in the EU, European Parliament 2013

⁸ Christina Balis, Henrik Heidenkamp, *Prospects for the European defence industrial base*, Rusi occasional paper September 2014

⁹ On this, see Olivier Lhoest, *La production et le commerce des armes et l'article 223 du Traité instituant la communauté européenne (Arms manufacturing and trading and Article 223 of the Treaty establishing the European Community)*, *Revue belge de droit international*, 1993/1

¹⁰ Transposed into French national law by the **Arrêté du 27 juin 2012 relatif à la liste des matériels de guerre et matériels assimilés soumis à une autorisation préalable d'exportation et des produits liés à la défense soumis à une autorisation**

Finally, a European regulation on the control of international transfers of dual-use equipment has been in existence for nearly 15 years. It was last revised in 2009. This regulation also includes a list of dual-use equipment as an annex¹¹.

The second stage should be to determine the nature of a strategic European defence company. Here it should be stressed that it is not the company as such which will be strategic but the sectors in which operates.

Companies could conceivably be certified as being high strategic value European companies if they fulfil certain conditions:

- The location where the high strategic value equipment and technologies are developed (i.e. the research departments) should be located within the European Union;
- The companies should have control of the intellectual property rights and usage rights of the equipment and technologies developed, with the only exception to those property rights which exist through agreements with Member States of the European Union or European institutions like EDA and European commission who have financed this equipment and technology;
- The criterion of shareholder nationality could also be used, but care must be taken.

préalable de transfert (Decree of 27 June 2012 concerning the list of war materials and related items subject to prior export authorisation and of defence-related products subject to prior transfer authorisation)

¹¹ European Council Regulation n°428/2009 dated 5 May 2009.

The aim should not be to forbid foreign investment but to protect the technologies which have been financed by the Member States of the European Union and European institutions. Here we may certainly take inspiration from the American legislation applied by the Committee on Foreign Investment in the United States (CFIUS) to enforce American legislation on the control of foreign investments: Section 721 of the Defense Production Act of 1950, amended by the Foreign Investment and National Security Act of 2007 (FISNSA). The aim should be to be able to verify the effective control of the company over the most important decisions on its business and on the control of technologies.

Stage 3 would consist in drawing conclusions from the specification of the high strategic value European Defence Technological and Industrial Base as well as the certification of high strategic value European companies. There would appear to be three consequences to the definition of high strategic value EDTIB and a European defence strategic company.

Beneficial consequences of the definition of European defence strategic companies

The first priority would be to direct European defence and security funding towards the high value strategic EDTIB. **Only companies**

certified as such should be able to benefit from appropriations for preparatory action for research in the defence and security sector, and also be able to apply for finance within the framework of the Horizon 2020 programme in the *secure society* sector. The most important role which Europe can play in the future to support the competitiveness of the EDTIB would be to finance innovative projects, which will help to guarantee strategic autonomy.

Secondly, **possible future European legislation on the control of foreign investments could be applied to the field of high strategic value equipment and technology.** This would lead to limiting the scope of this control to what is strictly necessary – that is, high strategic value equipment and technology as far as security of supply, ownership rights and free use of equipment for use and export are concerned.

The last consequence would be to enable the creation of **a subdivision in the scope of the 2009-81 Directive** by distinguishing high strategic value equipment and technologies from other defence equipment. In the case of high strategic value equipment and technologies, only certified European companies could put forward tenders in application of the 2009-81 Directive. Factoring in operational needs, **this measure should enable the application of Article 346 of the TFEU to be restricted.**

In conclusion, this paper attempts to define the scope of high strategic value defence technological and industrial base, to meet the requirements set down as follows in the EC Communication dated 24 July 2013: ‘This necessitates a certain degree of strategic autonomy: to be a credible and reliable partner, Europe must be able to decide and to act without depending on the capabilities of third parties. Security of supply, access to critical technologies and operational sovereignty are therefore crucial.’

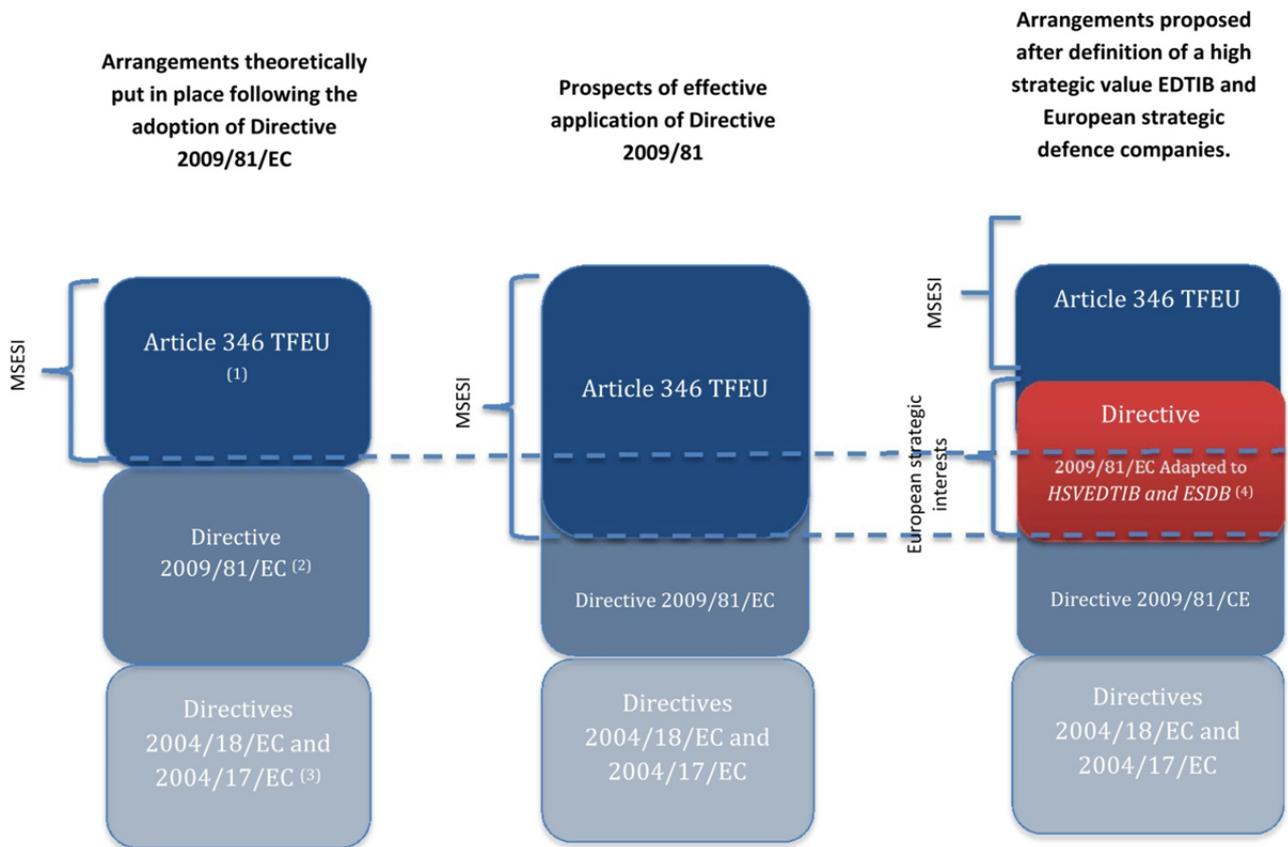
To fulfill this objective, a clear definition of the high strategic value defence technological and industrial base would have several advantages:

- Restricting the scope of Article 396 of the TFEU by creating a carefully defined entry for the European high strategic value DTIB within the limits of the Defence and Security Procurement Directive;
- Clearly defining the future scope of legislation on control of strategic defence assets;
- Defining the parameters of European strategic defence companies, which are the core of the competitiveness of Europe’s DTIB and the instrument of its strategic autonomy, in order to maintain control of the strategic technologies they have developed and foster their future competitiveness;
- Defining the parameters of the DTIB to enable it to access community funds to meet

the objectives on strategic autonomy set out by the EC Communication of 24 July 2013 and the road map of 24 June 2014;

- Promoting the consolidation of the European Defence Technological and Industrial Base by developing a shared vision of the industry. ■

High strategic value European Defence Technological and Industrial Base (EDTIB), European strategic defence companies, and regime for the acquisition of war materials within the European Union



⁽¹⁾ Scope of Article 346 TFEU, paragraph 1b): equipment intended for specifically military purposes linked to Member States' essential security interests (MSESI)

⁽²⁾ Scope of Directive 2009/81/EC: equipment intended for specifically military purposes not linked to MSEM and sensitive equipment intended for security purposes requiring/including classified information

⁽³⁾ Scope of Directives 2004/18/EC and 2004/17/EC: equipment intended for specifically non-military and non-sensitive purposes

⁽⁴⁾ Scope of Directive 2009/81/EC version 2 divided into two sections one of which is applicable to the high strategic value EDTIB (HSVEDTIB) and to the European strategic defence companies (ESDB)

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