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THE IMPACT OF BREXIT ON THE EUROPEAN ARMAMENT INDUSTRY

By

OLIVIER DE FRANCE / Research Director, IRIS

BASTIAN GIEGERICH / Director of Defence and Military Analysis, IISS

ALESSANDRO MARRONE / Senior Fellow, IAI

JEAN-PIERRE MAULNY / Deputy Director, IRIS

TREVOR TAYLOR / Professorial Research Fellow, RUSI

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Report

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EXECUTIVE SUMMARY

A year after the UK's vote to leave the bloc, there has been altogether little thinking dedicated to the potential consequences of Brexit on the British and continental armament industry. The most likely scenario will see the UK leave the European Union following the Brexit talks with Brussels, and negotiate a different status in relation to the single market as well as to access to a variety of EU funding. This status will have to be defined within the framework of overall Brexit negotiations, and the margin of manoeuvre for defining specific defence measures will depend on the overall settlement.

However, it remains difficult today to realistically identify what the UK government's desired outcome is, and how that translates into its bargaining positions on the whole spectrum of technical issues which are on the table. It is also challenging to predict what the country's general intent will be across the coming months of negotiations, and the political context remains volatile. In January 2017, the British Prime Minister stated that she would look to take the UK out of the Single European Market (SEM), and that the economic relationship between the EU and the UK should then be governed by a Free Trade Agreement (FTA)¹. She has argued that 'we are leaving the EU but we are not turning our backs on Europe'.

The defence sector is a crucial element in giving credibility to this point. British and continental analysts alike struggled to see any significant upside for defence from a Brexit choice even if the UK ceased to be a blocker for institutional progress of CSDP. A year after the referendum, that is still the case, but it is now clearer that the defence sector overall, and specifically the industrial part, will have a significant role in containing the potential damage from the Brexit decision. What will be the impact of negotiations on defence companies from Thales to Airbus, and from MBDA to Leonardo, on bilateral and multilateral European programmes, on the European Defence Agency, on the implementation of the EC directives on EDEM, on OCCAR and the LOI, or on the UK's access to EU research funding up to and after 2020?

The debate around money is probably the most politically sensitive, and covers two key separate issues. Firstly, it concerns the 2017-2020 period, which is unlikely to see much change because the UK is expected to remain an EU member until at least 2019. Simply put, until an agreement is reached or the negotiating timeframe expires, the UK remains a fully-fledged member of the Union, with the same rights and duties as any other. It is unlikely that any agreement between the EU and UK occurs before 2019, therefore Brexit will probably not formally affect current EU research funding in the realm of security, dual-use technology or defence. But legal stability *per se* does not quite

equate to business as usual. In itself, uncertainty over future British participation in EU-funded activities represents a disincentive to invest. What is more, defence research funding up to 2019 is linked to preparations for a bigger budget line within the next EU budget, which the UK will presumably not be part of.

The thornier issue indeed concerns British access to the next EU budget (2021-2027). On the one hand, UK participation in EU-funded research activities benefits all scientific and technological actors, both across the continent and across the Channel. On the other hand, there is a case to be made that EU policy should prioritise the needs of EU citizens and member states in terms of security and defence. The research and capability windows of the European Defence Fund are financial tools at the disposal of a certain polity to pursue its policies in the defence and security field. If “Brexit means Brexit”, the UK’s decision to leave the EU polity should be respected and implemented. Politically, this makes it difficult to envision British participation to future defence research funding. The EU’s starting position in Brexit negotiations is accordingly that UK defence companies will be excluded from applying for common European defence funding as soon as the UK will leave the EU if you take in account the proposal of regulation of the EC on the EDF.

In terms of procurement cooperation, much occurs in an intergovernmental setting, and the percentage of UK defence exports that goes to other EU member states is less than 10% of the total. However, a more granular examination shows that the broader institutional and regulatory impact both on the UK and the EU should not be ignored. For the UK in particular, there is a possibility that it will face an increasingly international market environment, with fewer opportunities for collaboration and less access to talent. Working with EU-based customers and suppliers would become more difficult. The above also shows that leveraging EU-level funding, which is only beginning to become available in defence, may not be possibly for British companies in a post-SEM environment. On the contrary, R&D efforts of continental competitors would benefit. The most challenging development would be one in which future regulatory steps initiated by the European Commission take on a “buy European” bend, structurally favouring EU companies over others. Such a blatant move is unlikely, but the objective to develop a level of EU strategic autonomy would support the competitiveness of EDTIB.

On the other hand, Brexit will have little or no consequence on current bilateral or multilateral cooperation between the UK and EU member states. This is likely to be different for future cooperation, however. Brexit takes place at a time when EU member states wish to structure themselves more strongly together in the realm of armament. Because the UK possesses significant industrial and technological capabilities in the field, Brexit is unwelcome news for EU member states. It is no doubt worse news however for the UK, which will end up excluded from this process.

For European defence multinationals, the Brexit choice introduces many elements of risk, which are unlikely to be clarified for two years and possibly more. In the short term, however, Brexit does not spell doom for UK operations; indeed much may continue as usual. Naturally, from the multinational corporate perspective, the easier people, goods and intellectual property can be moved across borders, the easier it is for a company to be efficient and competitive. Put succinctly, the defence industrial sector in the UK is therefore calling for a 'soft Brexit'. National restrictions on information movement still exist and transfers of intra-community defence assets will certainly progress further in the following years. However, over time, within continental Europe the restrictions will likely diminish further. If the UK stays outside such an evolution, it will be harder for defence firms operating in the UK to succeed.

If the UK chooses to try to use the weight of its security and defence contribution to Europe as a lever in economic negotiations, there is little chance that the separation of Brexit talks from defence cooperation will continue. There is the generic risk that disputes and high emotion associated with the negotiations poison the atmosphere in which defence and security cooperation must operate. In sum however, the Brexit decision has increased rather than decreased the salience of defence cooperation with Europeans for the UK: first, because it is likely to become a key mechanism for maintaining links with EU governments, and second, to reduce the possibility that the British decision could prompt other societies to follow the British example.

On 19 June 2017, Michel Barnier and David Davies sat down in a colourless meeting room in Brussels, to kick off an epoch-making negotiation. The EU's chief negotiator and the UK Brexit minister launched a process, which, in all likelihood, will result in Britain leaving the bloc. Over a year after the UK's landmark referendum however, the Brexit debate still carries more uncertainty than it does clarity.

The political context is volatile. In January 2017, the British Prime Minister stated that she would look to negotiate a Brexit agreement that would take the UK out of the Single European Market (SEM), and that the economic relationship between the EU and the UK should then be governed by a Free Trade Agreement (FTA)¹. In April, Theresa May called an early general election to discipline the Conservative party and unify the country behind her. On 9 June she emerged with neither outcome, and currently heads a fragile domestic coalition which appears unlikely to outlast the negotiation. As such, it remains difficult today to realistically identify what the UK government's desired outcome is, and how that translates into its bargaining positions on the whole spectrum of technical issues which are on the table. But it is also challenging to predict what the country's general intent will be across the coming months of negotiations.

Such political variables are sure to affect coming negotiations on both sides all the way up to 29 March 2019, earmarked as the formal end to talks. They are likely to have an impact on the EU's position too, particularly in the latter part of the discussion – on sensitive trade and migration issues when continent-wide consensus begins to fray, as well as in the run-up to the 2019 European elections. In view of this, the objective of the following analysis is not to indulge in any crystal-ball gazing.

The present paper maps out some of the tangible potential consequences of Brexit on the European armament industry. A year after the UK's vote to leave the bloc, there has been altogether little thinking dedicated to the issue. Will the UK have access to EU research funding up to and after 2020? What is the potential impact of Brexit on the European Defence Agency, the European Commission and its directives, on OCCAR and the LOI? What repercussions might it give rise to for bilateral or multilateral European programmes? What will be the impact of negotiations on UK-EU defence company agreements, from Thales to Airbus, and from MBDA to Leonardo? The aim of the following report is to provide a modicum of clarity on issues, which may seem uncharted in places, and inscrutable at times.

MONEY

To the extent that the Brexit debate has a defence dimension, it is usually focused on future British participation in EU missions, the capability gap that the UK would leave in the EU's Common Security and Defence Policy (CSDP), or the chances of a push for closer defence cooperation among the remaining EU member states. Defence procurement is rarely covered. Yet as an EU member state, the UK is involved in all the defence institutions and regulations that the European Union has developed since the turn of the century, such as the European Defence Agency, EU regulations on armament, and a common EU position dating back to 2008 on arms exports. The UK is also part of OCCAR and of the LOI agreement, which are not EU bodies, despite all of their members being EU member states.

As a contributor to the European budget, the UK will also pay into the EU's forthcoming efforts to fund more defence research, which Britain may benefit from itself. Money – and more specifically UK access to EU funding for research in security and defence – is a thorny issue, which recent months have shown to be sensitive politically. In these matters as in others however, the UK will have to negotiate its future status with contradictory objectives in mind, and the overarching political agreement between London and Brussels – or lack thereof – looming in the background.

The debate around money covers three separate issues. Firstly, it concerns the 2017-2020 period, which is unlikely to see much change because the UK is expected to remain an EU member until at least 2019. Secondly, it has to do with common defence research funding over the same period, which paves the way for a bigger budget line within the next EU budget. Thirdly, it questions British access to the next EU budget (2021-2027) in two ways: security and defence research on the one hand, and funding for emerging armament programmes on the other.

Up to 2020: What UK Access to EU Funding?

Simply put, until an agreement is reached or the negotiating timeframe expires, the UK remains a fully-fledged member of the Union, with the same rights and duties as any other. It is unlikely that any agreement between the EU and UK occurs before 2019, therefore Brexit will probably not formally affect current EU research funding.

In the event the EU-UK agreement includes provisions for an orderly transition, activities planned in the current EU budget for security or dual-use technologies (funded within the Horizon 2020 budget line) will continue and be completed. A hypothetical extension of

the negotiation timeline beyond March 2019 would ensure that the legal and institutional framework remain stable until 2020.

But legal stability *per se* does not quite equate to business as usual. In itself, uncertainty over future British participation to joint EU-funded activities represents a disincentive to invest. Although solid data is not yet available, anecdotal evidence suggests that private companies, think tanks and universities based in the UK are re-organising and reducing their applications for EU funding. This will particularly be the case for larger grants, and for key roles such as project coordinator or work package leader. It is mechanically riskier to invest in projects whose mid-term horizon and return on investment look uncertain.

In itself, uncertainty over future British participation in EU-funded activities represents a disincentive to invest.

Uncertainty also affects the possibility of building upon current and upcoming research activities after 2020, through follow-on projects, demonstrators and pre-procurement. The rules for the UK's relation with the single market will indeed have to be defined from scratch. One of the major indirect advantages of partaking in EU-funded research is the capacity to influence the future research agenda – as well as methodologies, requirements and standards, and ultimately the Union's single market for dual-use technologies and security products. If the terms of the UK's access to the single market are questioned, this advantage will be questioned too. This reduces the value of EU-funded research programmes for British actors.

Uncertainty over future cooperation will also mean that actors in the EU27 are likely to be less keen to partner with British private companies, think tanks and universities in upcoming bids for EU funds. If negotiations between London and Brussels descend into acrimony², non-British applicants for EU funding may consider it counterproductive to include UK partners in a consortium to avoid harming their chances. Brexit negotiations are not supposed to affect the evaluation process or EU funding allocation – but perception of the risk may suffice as a precautionary principle. The concerns raised by the participation of UK companies to the EU-funded Galileo satellite navigation system³ epitomise the doubts affecting the decisions faced by aerospace, security and defence companies in Europe.

UK actors have traditionally been very successful in applying for H2020 funds, including in security and dual-use technologies. They have obtained more from the EU than HM's government contribution to the Union's research programme – 12,5% of total security funding from 2011 to 2013⁴, for instance. The absence of contributions or access to the successor of H2020 would therefore constitute a net loss for the British economy. London is already making efforts to mitigate the potential damage. HM's government has committed to guarantee post-Brexit funding for UK organisations taking part in EU

research programmes⁵. It is also working to enhance bilateral cooperation with single EU member states⁶ on defence research, and with important military spenders such as the US, Turkey or India⁷.

The Transition Period and EU Funding for Defence Research

Over the 2017-2019 period, the EU is aiming to direct funding towards defence research for the first time, through the so-called Preparatory Action for Defence Research (PADR) – for which the first call for proposals was launched in April 2017. As with security and dual-use funding, nothing much in the realm of defence funding should change in principle until 2019. The UK should remain a fully-fledged EU member state for the entire duration of PADR. Secondly, a possible extension of the negotiation timeline would extend British membership, and thus its access to PADR. Thirdly, a future EU-UK agreement is likely to include provisions for a transition period during which PADR activities will be concluded. However, uncertainties over the participation of UK-based actors to follow on activities post-2020 will affect PADR too, and Brexit negotiations will influence the likelihood of seeing British partners in consortiums applying for PADR.

One of the major indirect advantages of participating in EU-funded research is the possibility of influencing the future research agenda

Nonetheless, PADR differs slightly from H2020 because it is a newly established mechanism to fund research activities in the defence field. Compared to H2020, stakeholders have less familiarity with selection criteria, project management and outcome exploitation. In addition, the preparatory action in itself is linked to the future European Defence Research Programme (EDRP), which constitutes the bulk of the European Defence Fund's (EDF) "research window". The fact that the preparatory action ties in with future EU funding for defence research increases the uncertainty attached to British participation to PADR.

Thirdly, defence research is more politically sensitive than security research, and it is closely linked to both national sovereignty and EU integration. With the UK turning its back on EU integration and emphasizing the importance of national sovereignty in the face of European defence efforts, British involvement in the PADR will likely be more limited than in H2020. The combination of these factors means there is less value in building consortiums involving UK-based actors. In all likelihood, there will therefore be fewer than in current EU-funded security programmes.

After 2020: The Next EU Budget

The most likely scenario will see the UK leave the Union following the Brexit negotiations. Accordingly, London will have a different status in relation to the single market, as well as to access to a variety of EU funding. This status will have to be defined within the framework of overall Brexit negotiations, and the security and defence arrangements will plug into this framework. The margin of manoeuvre for defining specific measures for defence will therefore depend on the overall settlement. The same applies future security research and dual use technologies, namely the successor of the H2020 programme.

UK participation in EU-funded research activities benefits all scientific and technological actors, both across the continent and across the Channel.

Having said that, the EU's experience with Associate Countries helps consider the options available, in particular those partaking in H2020 such as Israel, Norway and Switzerland. In the case of Israel for example, a non-EU government co-finances research activities funded by the Union. Its companies or universities therefore benefit from partnering with Europeans, without it being a substantial burden on the EU budget. This experience might usefully apply to UK participation in EU defence and security research programmes, bearing in mind that no single previous model will be straightforwardly replicated in these new circumstances.

The margin of manoeuvre for defining specific defence arrangements will depend upon the overall political settlement.

Another way for British stakeholders to access EU funding would be to open subsidiaries in EU member states which are eligible to apply for research grants. Establishing branches in continental Europe is an option already being considered by academia and by the British private sector to avoid losing access to the Union's single market in the advent of a "hard Brexit" scenario⁸. It is worth noting, for example, that the European subsidiary of the US-based Rand corporation has already applied for and obtained research funding from the European Defence Agency (EDA).

The political decision regarding British access to EU funds will have to consider the deep integration of UK defence in the European context at industrial and technological levels, the size and quality of British defence spending, as well as of its Defence Technological Industrial base (DTIB). When it comes to security and defence research, British stakeholders are extremely active. They master cutting edge technologies (i.e. electronics, avionics, engine manufacturing) and scientific knowledge, are deeply interconnected with the US, and have partnered in a variety of research, development and procurement programmes with EU-based counterparts.

All this points to allowing UK participation in EU funding for defence and security research, to make the most of cross-fertilisation, spill-over, and circulation of knowledge, technologies, and human resources generally speaking. In addition, there may be some willingness in Brussels to ring-fence security and defence cooperation from political Brexit disputes, given the importance of cooperation in this field for European democracies. This would entail Brussels setting this specific strand of work aside, and pragmatically recognising that good working relations constitute a win-win solution for both sides of the Channel.

On the other hand, there is a philosophical issue at stake with allowing UK access to EU funding for security and defence research. These funds are meant to contribute to the security of EU citizens, to support the needs of armed forces and law enforcement agencies of EU member states and Union's agencies (i.e. European Border and Coast Guard), and to sustain a competitive EU defence technological industrial base. Research funding is thus a financial tool at the disposal of a certain polity to pursue its policies in the defence and security field. If "Brexit means Brexit", the UK's decision to leave the EU polity should be respected and implemented. Politically, this therefore makes it difficult to envision British participation in future defence research funding, and specifically in the European Defence Research Programme (EDRP) which is to be funded by the next EU budget (the 2021-2027 financial framework).

To enter into specifics, an EDRP Coordination Board has been established, bringing together the European Commission, member states, the High Representative and the EDA, to ensure consistency between two so-called "research" and the "capability" windows⁹ in light of the broader priorities set in the defence field¹⁰. The EU Commission aims to link the two windows by working across the scale of Technology Readiness Levels (TRL), in order to pull technologies from R&T to R&D phases to procurement¹¹. Ultimately, both windows aim to support filling capability gaps within the EU.

The "capability" window sees the Commission offering an umbrella structure for specific capability development projects, as well as, theoretically, a number of economic incentives. In this case, the EU polity aspect is still stronger than in the "research" window, because the fiscal incentives would be deeply embedded in the EU legal and institutional framework. Moreover, should Permanent Structured Cooperation be properly implemented, the funds would be linked to this treaty-based deepening of EU integration¹². In this context, although not impossible, UK participation in the "capability window" would be more complicated than its participation in the "research window".

Research funding is a financial tool at the disposal of a certain polity to pursue its policies in the defence and security field. The UK's decision to leave the EU polity should be respected, which politically questions British participation in the EDRP.

This is further confirmed by a more recent development, which suggests that UK defence companies will not have access to EU funding on defence after Brexit. The European Commission has stated that the European Defence Industrial Development Plan (EDIDP), which serves as a bridge in funding between the research and procurement phases, will be reserved for EU member states. It specifically proposes that “beneficiaries shall be undertakings established in the Union, in which member states and/or nationals of member states own more than 50% of the undertaking”¹³. The EU’s starting position in Brexit negotiations is therefore that UK defence companies will be excluded from applying for common European defence research funding as soon as the UK will leave the EU.

Generally speaking, looking at the post-2020 environment for defence and security research, a balance will have to be found between two competing rationales. On the one hand, UK participation in EU-funded research activities benefits all scientific and technological actors, both across the continent and across the Channel. On the other hand, EU policy should primarily cater to the needs of EU citizens and member states in terms of security and defence. Much work will therefore be required to understand, define and agree such a balance, in light of the overarching political agreement to be reached between London and Brussels.

INSTITUTIONS

Institutional and regulatory aspects seldom feature in the defence dimension of the Brexit debate, and not merely because of the technical nature of the subject. After all, much procurement cooperation, when it occurs, does so in an intergovernmental setting. The percentage of UK defence exports that goes to other EU member states is less than 10% of the total¹⁴. Defence equipment market institutions are thus unlikely to take centre stage.

In addition, if a far-reaching FTA were to be agreed between the UK and the EU (see *supra*), there are strong reasons to believe that the effects of Brexit on defence procurement would be limited, because a comprehensive FTA is likely to require “full compliance with the EU public procurement *acquis*”¹⁵. It is too early to speculate, but a key issue is whether such an FTA might include a defence “pillar” which would include operational, capability and industrial aspects.

For members of the European Economic Area (EEA), compliance with this *acquis* is monitored, and the same is therefore likely to apply to current and future defence directives. For civil goods and services, the EU already has a single market. While defence remains an exception, the ambition of the European Commission has also been to push for liberalisation in this area by means of regulation. Nonetheless, a more granular examination of current arrangements shows that it would be unwise to ignore the institutional and regulatory impact of Brexit.

The key issue is whether a future FTA might include a defence “pillar”, which would include operational, capability and industrial aspects.

The European Defence Agency, OCCAR and LOI

Observers have suggested the EDA is unlikely to be affected negatively even by a hard Brexit. European cooperation has not delivered great progress in the EDA’s area of responsibility, and the UK has kept such initiatives at arm’s length: since “the UK has not excelled in EU capability cooperation, existing frameworks, such as EDA, will not suffer”¹⁶.

Norway is often mentioned as a possible model for the UK to emulate with regard to the EDA. The logic for this suggestion was aptly explained by the EDA’s Chief Executive Jorge Domecq in a recent interview: “The UK will leave the [EDA] at the latest when it leaves the EU. My understanding is that the UK authorities would like to maintain a strong relationship with EDA after they have left the EU, and therefore I will work with member states to allow that to happen with minimum disruption for everybody”¹⁷.

Norway’s experience tends to show that in a policy area where there is still disagreement amongst EU member states, non-members are confined to a tightly defined space.

The reference point here is a cooperation agreement signed between the government of Norway and EDA on 7 March 2006. Similar agreements exist also with other non-EU members such as Switzerland and Serbia. The essential purpose of these administrative arrangements is to provide a predictable avenue for non-EU states to participate in and contribute to EDA projects. They enable information exchange on cooperation opportunities and other areas of mutual interest, but the relationship does not go beyond that.

Yet Norwegian scholars remain deeply sceptical of the desirability of their country’s arrangements vis-à-vis security and defence cooperation with the EU: “Norway’s influence over these processes has decreased in parallel with the acceleration of the integration process in this particular policy area. In the beginning, Norway emphasised

some important conditions that had to be met if Norway was to continue its participation. There was no surprise that such conditions, set by a non-member, were not accepted by the EU¹⁸.

Norway's experience tends to show that in a policy area where there is still disagreement amongst EU member states, non-members are confined to a tightly defined space. While just about workable for Norway, such a situation is likely to rub against the current self-perception of the UK as the major European defence power.

Without an FTA, the UK would find itself at a structural disadvantage, which the British government and industry will not be able to accept.

The picture looks somewhat more promising if OCCAR and LOI are added to the mix. Given the purely intergovernmental nature of these arrangements, there would naturally be no reason for the UK to leave them. The only circumstance in which they could possibly cease to function would be a Brexit so disastrous that cooperation would become politically unpalatable. Implementation of EDA projects can already occur in OCCAR and, as Nick Witney has suggested, the LOI could further strengthen the legal setting in which the UK could participate in joint programmes, while being outside the EDA¹⁹.

However, giving an adequate voice to the UK would remain a challenge. There may be a temptation amongst EDA members to move to OCCAR or LOI settings only after those within EDA have already satisfied their interests. These kinds of *ad hoc* and, to a degree, improvised arrangements would need to rely on a strong industrial logic propelling cooperation forward. That this is possible in principle has been demonstrated in the guided weapons and missile areas.

The European Commission and EU Directives

In general terms, the European defence equipment market has remained largely unaffected by EU single market principles. Instead, it has fed off and perpetuated some of the economic distortions and inefficiencies of the European defence industrial base. Historically, this was enabled by EU member state governments' use of Article 346 of the Treaty of Lisbon (previously Article 296 of the Maastricht Treaty) which was intended to provide member states with the ability to circumvent the rules of the single market and European procurement law in cases where national security considerations take precedence. Instead, recourse to Article 346 became standard practice for defence procurement, with member states invoking essential national security interests as a matter of course.

For some time, the European Commission has tried to build an economic case for making the defence equipment market more efficient by opening it up to competition, based on

the savings EU governments could expect from lower prices for equipment. In its attempt to increase efficiency by deepening internal EU defence cooperation, the Commission has tried to remove market distortions (state aid to industry, offsets, etc.), introduce greater commonality and standardisation of certification and licensing systems, and exploit dual-use innovation. EU states including the UK have watched these attempts with a degree of wariness, because they might lead to a growing role for the Commission in an area governments perceive to be at the core of national sovereignty.

Despite such national suspicions, the Commission was able to launch two significant directives, which entered into force in 2009. The Defence Procurement Directive (Directive 2009/81/EC) deals specifically with goods and services related to security and defence. Covering contracts above a certain value, the Directive establishes a principle of non-discriminatory competition, and an obligation to award contracts on the basis of price and performance. It *de facto* forbids the use of offsets, which were required by some EU member states when they procure defence services and goods from a foreign supplier. Crucially, the directive does not apply to cooperative or collaborative procurement programmes. By the spring of 2013, EU states had transposed this directive into national law.

The Directive on Transfers of Defence Related Products (Directive 2009/43/EC) provided a new licensing system for intra-EU exports, distinguishing between general licences, global licences and individual licences. Under this framework, pre-approved licences become the norm for transfers within the European Union and individual licences are only foreseen in particular instances. These include one-time transfers and the protection, in individual cases, of member states' essential security interests. It was hoped such transfer regulations would improve security of supply within the Union and reduce the bureaucratic burden related to transfers among EU member states.

National governments of countries with a defence industrial base have traditionally sought to maintain a degree of autonomy and in this effort protected their respective defence industrial players. On the contrary, EU level regulation in essence tries to limit or reduce national control and replace it with competition and a common approach. The fact that under these circumstances legislation emerged at all, irrespective of its effectiveness, is an interesting case study in European policymaking²⁰.

It is likely that both EU directives would continue to apply in the UK at the point of Brexit, because they have been transposed into national law, and replacing them is likely to be time consuming. If Brexit takes the UK out of the SEM but puts a comprehensive FTA in place, this would be sustainable. Without an FTA however, the UK would find itself at a structural disadvantage, which the British government and industry will not be able to accept. Indeed the likely effect of EU defence equipment market regulation on the UK

would restrict access to markets and raise security of supply concerns. At that point, the pressure on the UK to draft new legislation would be high.

A strong fear is that the UK would not have access to customers and supplies in the European defence equipment market²¹. The EU Commission stresses that it is not trying to prescribe government choices when it comes to equipment. But access for non-EU defence producers could be further restricted in the future. It would probably be enough to interpret current legislation as allowing the prioritisation of internal EU supplies, perhaps through security of supply arguments or scoring mechanisms. Recently, there have been few new major European defence programmes. Should they be launched in the future, the UK might not be able to join such initiatives.

The UK has been a strong voice for defence equipment market liberalisation in the EU, while also acknowledging that there remain some areas in which governments will seek to protect national sovereignty and control.

The UK has been a strong and reliable voice for defence equipment market liberalisation in the EU, while also acknowledging that there remain some areas in which governments will seek to protect national sovereignty and control. This position was compatible with the way in which EU-level institutions and defence regulation developed, even though the inherent tension in this position was becoming increasingly obvious.

Following the UK's exit from the EU, those pushing for defence equipment market liberalisation will find it harder to get through. This introduces the possibility that attempts to establish a European defence industrial and technological base take on a moderately protectionist flavour. EU investments in SMEs and security of supply arguments could produce a Europeanised supply chain over time, but one that is not necessarily driven forward by regulatory liberalisation²². This likely represents an undesirable and inefficient outcome from both the UK's and the European Commission's point of view, but it is a possible result of an unfriendly Brexit, ignorant of regulatory and institutional implications of the UK's exit for defence.

Regulatory Issues

The EU's role in defence has been on a growth trajectory for almost a decade now, and an acrimonious Brexit would prove a real risk to defence supply chains in the UK, and also in other EU states. Some argue that in regulatory terms, the immediate impact of the EU and the UK failing to reach an agreement would likely be fairly

An acrimonious Brexit will prove a risk to defence supply chains in the UK, and also in other EU states.

contained, given that “the defence sector is not the financial sector”²³. The procurement system in place in the UK is bound by a degree of inertia. Given the complex legislation and consultation processes involved in drafting changes, this is likely to take some time, as mentioned above – even if the British government decided to tackle the task right away. Current EU level defence directives have been transposed into British law in 2011²⁴, and would therefore remain the default regulations for some time to come. In addition, the British government could also decide that even if new legislation was put in place, the principles would remain largely the same, which would again be liable to limit the general impact of Brexit²⁵.

The procurement approach currently embodied in EU legislation is broadly aligned with British preferences. It is aimed at procurement liberalisation, while giving room to sovereignty concerns. Any adjustment is therefore likely to focus on reviewing which of the specific provisions of the EU directives should continue to apply, and which ones the UK would want to drop. For example, the UK could opt to not tender contracts EU-wide. Or, if a more fundamental change were deemed desirable, the British government might choose to link defence procurement to national economic and employment considerations – a course of action which is not open under the current EU regime²⁶.

The procurement approach currently embodied in EU legislation is broadly aligned with British preferences.

This would imply a deeper shift of the current liberal procurement practice of the United Kingdom, but is conceivable if economic pressures in post-Brexit Britain were perceived to be significant enough. Of course, such a potential shift in procurement philosophy would then likely apply to other sectors of economic activity as well. Rolling it out as a cross-sectoral policy would indeed maximize its impact and likely return for British industry and the national economy²⁷.

This might actually sound like an attractive option from the UK’s point of view, but there are several drawbacks. As British industry voices have suggested, “the UK and Europe’s defence relationship is intertwined, whether related to international strategic interests, security co-operation or commercial and industrial relationships. Brexit must not be allowed to adversely affect those common interests”²⁸. Similarly to several other business sectors, a sizeable majority of the British defence industry feels that UK companies are better off in the EU, as part of an emerging European defence industrial and technology base, than outside.

This is akin to remaining in an increasingly international market environment, with fewer opportunities for collaboration and less access to talent. Working with EU-based customers and suppliers would become more difficult. Leveraging EU-level funding (see *supra*), which is only beginning to become available in defence, might not be possible for British companies in post-SEM environment – whereas R&D efforts of continental competitors would benefit. The most challenging development would be one in which future regulatory steps initiated by the European Commission take on a “buy European” bend, structurally favouring EU companies over others. While this would imply a policy shift that the Commission would likely judge undesirable, such a step is not entirely implausible.

The British government might choose to link defence procurement to national economic and employment considerations – a course of action which is not open under the current EU regime.

CAPABILITIES

Bilateral armament cooperation between European Union member countries is based on rules defined by states themselves. Broadly speaking, cooperating countries should therefore remain unaffected by Brexit. Nevertheless, such capability cooperation at times benefits from rules which have been established at the European level to facilitate armament cooperation and to guarantee security of supply. This is the case with the directive on transfers defence related products (see *supra*), which came into force in 2011, and which the United Kingdom would no longer have to apply.

In principle however, there is little reason for the UK to do away with such legislation post-Brexit. General licences – the heart of directive 2009/43 – facilitate transfers between countries that otherwise have no reason to deny one another armament transfers. In addition, the directive was largely inspired by British legislation on armament exports controls, based on a mechanism pairing general licences with *ex post* export controls. Amongst the EU27, the general trend has been to attempt to extend the general licences and global licences mechanism to other allies. It is therefore unlikely they would refuse such facilitating measures to a post-Brexit Britain.

Bilateral Cooperation

It is with France that the UK enjoys the most structured bilateral partnership, within the framework of the 2010 Lancaster House treaties. The scope of these treaties should not be overrated, because in themselves they only include non-binding provisions regarding the willingness of both parties to cooperate. Within the Lancaster House umbrella, only the treaty relating to Joint Radiographic and Hydrodynamics Facilities – i.e. common facilities for the safety of nuclear warheads – contains compulsory provisions. Yet nuclear capabilities, which fall within the collective security mandate, have up until now always been within the jurisdiction of NATO or of individual nations – as is the case with France who is not a NATO Nuclear Planning Group (NPG) member.

Aside from military nuclear capabilities, the most important cooperation within the Lancaster House framework relate to the Future Unmanned Combat Air System programme, the ever-closer integration of the missile sector through the One MBDA project, and the mutualisation of defence research within the High Level Working Group which includes representatives from both countries' armament directorates. It is worth noting that organising this cooperation did not require a treaty. Indeed the HLWG predates the Lancaster House treaty, having been established in 2006 and originally including representatives from the defence industry.

Mutualisation of British and French defence research may be an issue in the future.

Cooperation relating to the Unmanned Combat Air System should not be directly affected by Brexit. In the demonstrator phase since 2016, its perimeter is not set in stone and could be extended to more countries should the programme itself be launched. All the more so as Britain could, in the future, experience difficulties in shouldering the financial commitments attached, due to the combined effect of current procurement plans – F-35 fighter jets and nuclear deterrent renewal – and the drop of the pound amid Brexit fears.

Brexit also puts into question the One MBDA missile sector integration project. The company is not strictly Franco-British but European: it combines the missile capabilities of France, the UK, Italy and Germany. However, it is as part of the Lancaster House treaty that France and Britain have committed to a ten-year strategic plan for the missile sector, which envisages a consolidation of their missile industrial bases through increased interdependence. One MBDA, which is currently the most advanced defence industrial sector integration project, requires concerted funding from both parties in the research field and a commitment to jointly develop new products – or at least to acquire products originally developed for the other party.

It also requires the application of the interdependence principle, which supposes mutually relinquishing competences according to a logic of specialisation and division of labour. This is enshrined in the treaty on Centres of Excellence implemented as part of the

“One Complex Weapons” Sector Strategy, ratified by both parties in 2016 despite the UK having already voted to leave the EU. Paradoxically, MBDA is thus a convincing model of industrial consolidation in the field of European armament, designed to develop European industrial and defence capabilities – but is primarily moved forward by France and the UK.

In principle it would therefore be counter-productive to dismantle existing cooperation at the industry level. As such, Brexit should not have consequences on MBDA since European regulations have little impact on the company. This will not necessarily be the case in the future however. The prospect of the European Commission funding defence research through the EDRP and defence programmes in the demonstration phase through the Defence Industrial Development Programme (EDIDP) could be more problematic for MBDA. British companies will in principle no longer benefit from Community credits outside the EU (see *supra*).

A strict application of Brexit would thus make it possible for MBDA France or MBDA Italy to apply for funding, without the latter benefiting MBDA UK. This would have a negative effect on the company’s integration process and could also cause strain within it. While this issue is particularly acute with regards to MBDA, it can be extended to any future cooperation with the UK in the armament field, whether at the research stage with the EDRP, or at the development stage with the EDIDP. Potential industrial partners may think twice before conducting partnerships with Britain if said partnerships do not permit access to Community funding.

Finally, mutualisation of British and French defence research may also be an issue in the future. It currently ranges from 30 million to 100 million euros per year²⁹. Since 2007, EU member states have set themselves the objective of mutualising 20% of their defence research. It is estimated that little over 10% of defence R&T is currently mutualised in the EU³⁰, which falls short of the stated objective. Should this 20% objective be included as a commitment in a Permanent Structured Cooperation framework³¹ (see *supra*), problems will arise with countries such as France, where over half of total defence R&T mutualisation is performed with the UK. Total R&T volume spent in Europe will decrease roughly by a third with Britain’s exit from the EU, thereby impacting the mutualised R&T to total R&T ratio. This will no doubt present difficulties for countries such as France, that until now have conducted mutualisation of their defence R&T mostly in a bilateral, French-British context.

Beyond the observable results of French-British defence cooperation, which have not significantly improved since the signing of the Lancaster House treaty, there is an unquantifiable element which depends on the perceptions of actors in this cooperation, who often mention a climate of mutual trust between the two countries. This is

particularly the case for defence R&T cooperation, where French and British officials have taken up a habit of talking to one another since the establishment of the HLWG in 2006, and with regards to the Unmanned Combat Air Systems project. Officials from both countries have realised that they have a relatively compatible appreciation of defence R&T, despite French and British structures tasked with conducting defence R&T being different. Many French officials consider that the experience of bilateral dialogue was useful to help build the EDRP's work programme. If Brexit is carried through, it will be missed³².

The most likely conclusion is that Brexit will have little or no consequence on current bilateral or multilateral cooperation between the UK and EU member states. This will be different however for future cooperation.

Nevertheless, French-British cooperation should not be overrated compared to other bilateral partnerships within the EU. Issues raised in the context of the Lancaster House treaty are also to be found in British bilateral cooperation with other EU member states, such as Germany, Italy or Sweden. In particular, Italy's Leonardo Helicopter Division and Leonardo Airborne & Space Systems, comprising Selex ES, will face the same difficulties. The latter's installations are mainly located in the UK. Neither should one overestimate British bilateral or multilateral cooperation with EU states compared to bilateral R&T cooperation with the United States. The UK has always favoured the latter over European cooperation.

Multilateral Cooperation

As regards current multilateral armament European partnerships, Brexit is unlikely to be disruptive. The Meteor missile, Airbus A400M, Marine Mine Counter Measure (MMCM), PAAMS, and Eurofighter programmes are either managed by OCCAR (A400M, MMCM, PAAMS), by NATO structures (NATO Eurofighter and Tornado Management Agency, NETMA), or by the British Defence Equipment and Support Agency (Meteor missile). These programmes are therefore organised according to specific rules, which are unrelated to the European Union.

As a rule of thumb, the older the bilateral or multilateral cooperation, the lesser the potential impact from Brexit. Once again however, EU member states could balk at future cooperation with the UK should it present obstacles to accessing Community credits offered by the European Commission as part of the European Defence Fund. Similarly, the criteria that may be adopted in the framework of PESCO (see *supra*), should the commitments from article 2 protocol 10 of the Lisbon Treaty be upheld, will not encourage member states to cooperate with the UK in the field of armament if they wish to uphold their commitments. Finally, potential integration of OCCAR into Community

institutions, by bringing it closer to the EDA, would also have an impact. It would entail the renegotiation a specific agreement with the UK that would allow London to continue delegating the management of common programmes it takes part in, in the framework of an OCCAR integrated into the EDA.

The most likely conclusion is that Brexit will have little or no consequence on current bilateral or multilateral cooperation between the UK and EU member states, but that this will be different for future cooperation. Brexit takes place at a time when EU member states wish to structure themselves more strongly together in the realm of armament. Because the UK possesses significant industrial and technological capabilities in the field, Brexit is unwelcome news for EU member states. It is no doubt worse news however for the UK, which will end up excluded from this process.

Put succinctly, the defence industrial sector in the UK is calling for a 'soft Brexit'.

DEFENCE COMPANIES

The uncertainties generated by Brexit do not make life easier for the multinational European defence businesses operating in the UK. Airbus, Thales, Leonardo and MBDA (see *supra*) are responsible for sensitive and strategically significant technologies such as airborne radars and helicopters (Leonardo), sonars (Thales), satellites and large aircraft wings (Airbus). While the UK branches of these firms are to some extent separate businesses, they are also integrated in many ways, such as in the Anglo-Italian mechanisms for the support of the EH.101s sub-systems.

Obviously, much hinges on the terms and timing of the settlement terms for the UK leaving the EU and adopting a new relationship with the Continent. Defence industry worries are not confined to European multinationals but also cover the major British firms, which are involved in collaborative projects such as Tornado, Typhoon, and the A400M, and Rolls Royce of course has subsidiaries in Germany in Spain. BAE Systems land armaments business in Europe is focused on its Swedish Haglunds subsidiary.

Maintaining Competitiveness

Individual firms have said little in public. The industrial association Aerospace, Defence and Security (ADS) however, through a statement in November 2016 by its Chief Executive, has issued a set of the sector's needs from the future relationship with the EU. A key extract reads: "We need a relationship with Europe that retains access to the customers, suppliers, skills, R&D and influence that underpins our sector's global

competitiveness”³³. A leading priority for aerospace is ensuring that the UK remains an influential part of the European Aviation Safety Agency (EASA), which certifies the safety of aircraft products for sale.

Remaining a member of EASA is a far easier and less costly route than relying on the Civil Aviation Authority to develop the required certification. The ability for UK companies to participate in EU R&D projects gives them a significant advantage in the global marketplace. The opportunity for collaboration, alongside access to funding and facilities, ensures UK companies can maximise connections to customers and suppliers. Collaboration with European partners helps UK technologies to be highly competitive in the global market. Pooling expertise and funding, which the UK does not have access to on its own, develops technologies which can compete with products from established and emerging markets.

For aerospace, eliminating or minimising non-tariff barriers after Brexit is essential to maintaining global competitiveness. Quickly resolving the EU and UK’s schedules at the World Trade Organisation (WTO) will be critical to ensuring that aerospace is covered by the WTO agreement which removes tariffs on most aerospace goods. New customs and border controls are likely to increase administration costs and potentially introduce commercial costs as a result of delays. Negotiations should seek to ensure that the UK can retain membership of the Single Market or, at the very least, retain a customs union relationship with the EU. The UK needs to remain attractive and flexible to the best researchers and engineers in order to stay at the leading edge of innovation, which is why retaining freedom of movement is so important. From an operational perspective, problems are often solved by mobile teams operating at sites across Europe including the UK. Curtailing this through increased administration would prove costly and onerous.

Whatever shape Brexit takes, on exiting the EU, UK industry will need a transition period to manage the inevitable commercial consequences, that is why they are pushing the government to negotiate as soon as possible an agreement on the transitional period with the EU negotiators³⁴. The harder the Brexit, the greater the commercial risk, and so the longer that transition should be. To ensure industries with pan-European supply chains and customers do not lose global competitiveness the UK needs to use the two years period following Article 50 to agree transition arrangements until a comprehensive Brexit deal is in place. In the interim the pragmatic response means looking beyond political rhetoric and focusing on achieving the economic momentum and sustained investment needed so that UK companies thrive once outside the European Union.”

The uncertainties generated by Brexit do not make life any easier for the British and European multinational defence businesses operating in the UK.

Mitigating Risk

Put succinctly, the defence industrial sector in the UK is calling for a 'soft Brexit'. Obviously, from the multinational corporate perspective, the easier people, goods and intellectual property can be moved across borders, the easier it is for a company to be efficient and competitive. Despite the aforementioned directive, national restrictions on information movement still exist and export licences for some intra-European movements remain a duty for businesses. However, over time, within continental Europe the restrictions will likely diminish further. If the UK stays outside such an evolution, it will be harder for defence firms operating in the UK to succeed.

For European defence multinationals, the Brexit choice does not spell doom for UK operations – indeed, much may continue as usual. However, it introduces many more elements of risk, which are unlikely to be clarified for two years, and possibly more.

The British Government has made clear that it wants to play a full role in European defence cooperation outside the EU framework, and is looking in particular for more collaboration with France and Germany. By allowing the EDA budget to rise and taking part in two of the first three EU-funded defence projects, it has also signalled that it has not ruled out some association with the EDA and its research agenda. Whereas collaborative platform projects in Europe do not have a reputation for efficiency and effectiveness in the UK, pressure for renewed attention to such areas of cooperation may grow from the combination of the technical and even commercial success of collaborative missiles generated by MBDA, and the difficulties that have been experienced in getting such missiles integrated onto US platforms. Integration is most challenging in the complex and confined spaces of aircraft.

The concern must be that, if the wider Brexit negotiations become hostile, there will be negative spill over onto defence cooperation. However, for all defence firms in the UK, a central and continuing concern will continue to be the size and use of the British defence budget, and the extent that buying off the shelf from an external supplier prevails over UK development and collaborative projects. Since 2001, the UK has defined defence firms adding significant value in the UK as 'British', so such firms are looking at defence spending and the upcoming statement of defence industrial policy, while the Brexit situation will continue to be dominated by uncertainty.

In its Election Manifesto, the ruling Conservative Government has promised to maintain defence spending at 2% of GDP, and to increase it in real terms by 0.5% a year above inflation. It also has underlined that it has an Equipment Plan to spend £178 billion over the next decade, tasked the Ministry of Defence to contribute to the 'prosperity agenda',

and said that it will shortly generate a Defence Industrial Policy statement. While all this is positive, it remains the case that the Equipment Plan is widely perceived to be over-committed, not least because of the cost of the deterrent replacement and the devaluation of the pound. Moreover, there are commitments in the Equipment Plan to much US equipment, including P.8s, Apaches and of course F.35s. There will also be a need to address the Airborne Early Warning/Command and Control capabilities of the British ageing AWACs fleet.

There is a generic risk that disputes and the high emotion associated with the negotiations poison the atmosphere in which defence and security cooperation must operate.

As a final and obvious variable, should the UK economy fails to grow significantly or even shrink as a result of Brexit, the 2% will be of a smaller sum, and the harder it will be to justify increases in defence expenditure. For European defence multinationals, the Brexit choice therefore does not spell doom for UK operations – indeed much may continue as usual. However, it introduces many more elements of risk, which are unlikely to be clarified for two years and possibly more.

NATIONAL PERSPECTIVES

London

The European Union is built on key principles on free movement of people, goods and services between member states, with common rights and privileges under EU law. This is aligned with EU-common standards and tariffs applied to those states with which the EU trades. For many politicians in Europe, these principles drive the need for greater integration and formal union, be that in the legal sphere, constitutional, monetary policy with a single currency and future common fiscal policies. The UK politics of Brexit, in contrast, focus on constrained movement of goods, services and, critically, people, across the UK border and the de-coupling of the British legal system from the European Courts. Trade agreements, residency deals, flows of capital and access/travel rights have to be forged from these alternative visions and perspectives. It is a daunting body of work for the governments and EU bureaucracy involved. To complete negotiations for the UK to exit the Union by 29th March 2019 seems ambitious in the extreme: they are set to be amongst the most complex experienced in the modern epoch embracing constitutional, legal, commercial, financial and social concerns across all areas of life and all regions of Europe. The multiple-impacts of this negotiation will be felt also across all areas of the world where Europeans trade, travel and transfer ideas, goods and services.

However, the British Government has been consistent in stating that it wishes the inter-governmental aspects of European cooperation in security and defence to continue and develop at the intergovernmental levels, as well as in organisations such as OCCAR. It has also shown signs of wishing to continue association with the European Defence Agency (see *supra*). Implementation of the Lancaster House agreement with France has continued and new missile projects agreed. However, if the UK chooses to try to use the weight of its security and defence contribution to Europe as a lever in economic negotiations, the separation of Brexit talks from defence cooperation would end. There is also a generic risk that disputes and high emotion associated with the negotiations poison the atmosphere in which defence and security cooperation must operate.

The Brexit decision has increased rather than decreased the salience of defence cooperation with Europeans for the UK. The defence sector will have a significant role in containing the damage from what voters chose on 23 June 2016.

In the medium term, Brexit has the potential significantly to disrupt and weaken UK defence. Both Northern Ireland and Scotland voted strongly in favour of remaining in the EU, and it is conceivable that Brexit might lead to the break-up of the country via Scottish independence or the unification of Ireland. Brexit certainly increases the likelihood of such developments.

The British Government has accepted that, should the devaluation of the pound prove a long-term phenomenon, the costs of defence equipment imports will rise significantly. This will have an impact on the Ministry of Defence's spending power and defence budget. This must be seen alongside the possibility that Brexit will inhibit British GDP growth and even cause output to fall. Making the reasonable assumption that the UK economy will not collapse in the short to medium term, Britain will continue to spend 2 percent of its GDP on defence, and will remain the principal military partner of the US in Europe.

The new administration in the US is not accepted in the UK as causing fundamental uncertainty about the US commitment to Europe, and there is some British sympathy for US demands that Europeans should carry a greater defence burden by spending two percent of GDP on defence. The UK Government's confidence in the US commitment is in contrast to some observers such as Francois Heisbourg, for instance, who has argued that the genie was out of the bottle after President Trump had said that the US commitment to Europe was conditional. The implication was that Europe should have fall-back for its security arrangements – not something that the British political establishment is ready to contemplate.

The British government would like to see increased defence spending in Europe, where Germany is key, and less attention given to projects such as a single EU military

headquarters and staff and standing EU forces, in parallel with NATO. However, there is awareness that as the UK is set on leaving the EU, the principal barrier to greater EU military alignment and cohesion is removing itself. This could assist the remaining European powers to greater military harmony in command and control functions and doctrinal alignment.

What could be of crucial significance in terms of transatlantic relations is not a function of which states actually meet the two per cent criterion, but the extent to which leading European states, especially Germany, increase their defence spending in real terms and raise its share of GDP nearer towards two per cent. The British establishment realises that the German defence budget would be much greater than that of the UK if Germany did move to 2% of GDP. However, this is not an apparent cause for concern, and it is recognised that such an increase is unlikely to happen anytime soon. An upward trend is more important than the level reached at one point in time. This could and should be justified, not as a response to US pressure, but to the changing security situation in and around Europe.

Much of the UK's defence industry, and indeed its manufacturing industry as a whole, is owned by companies based outside the UK. In defence, Leonardo, Thales and Airbus' extensive investments in the UK were made in the context of British membership of the EU. The Ministry of Defence, like other Government departments, has a responsibility to promote the national prosperity agenda, a responsibility felt more keenly in the light of Brexit uncertainties and after a period of buying US systems which has led to some concern about the degree of dependence on the US supply base. In light of Brexit, the Conservative Government has changed tack regarding its role in the economy: a national industrial strategy is being developed and, related but separate, so is a defence industrial strategy (DIS).

Formulating the latter will not be easy given the cost and other commitments associated with commitments to particular sectors and industrial capabilities. However, two points can be asserted. The first is that the Government will be keen to keep and even grow the levels of foreign defence investment and employment. The second is that there will be continued and perhaps enhanced readiness to consider collaborative projects as a means of preserving defence industrial capabilities in the UK. Work in the missile area with Meteor and Storm Shadow/SCALP for example, has shown that such projects can deliver to performance and budget. The country is looking outside the EU for partners, including to Japan, Australia and Turkey, but these were options also being explored before June 2016. In the overall context, projects that would strengthen UK ties with Germany would probably be particularly welcome.

In sum, the Brexit decision has increased rather than decreased the salience of defence cooperation with Europeans for the UK: on the one hand, because it is likely to become a key mechanism for maintaining links with EU governments, and on the other, to reduce the possibility that the British decision could prompt other societies to follow the British example. The British Prime Minister Theresa May has argued that ‘it remains overwhelmingly and compellingly in Britain’s national interest that the EU should succeed’ and that ‘we are leaving the EU but we are not turning our backs on Europe’. The defence sector is a crucial element in giving credibility to this latter point. Anecdotally, the British Ministry of Defence was a ‘Remain’ institution – and the country’s defence analysts struggle to see any significant upside for their sector from a Brexit choice. A year after the referendum, that is still the case, but it is now clearer that the defence sector overall, including the industrial part, will have a significant role in containing the damage from what voters chose on 23 June 2016.

Berlin is likely to value its ability to protect the European integration project more than its ability to deflect some of the economic costs of Brexit.

Paris and Berlin

For Berlin, the British decision to leave the EU is a regrettable accident that carries enormous political and economic costs. Nevertheless, the German government is unlikely to offer London much in terms of concessions during Brexit negotiations. In a reversal of roles, Berlin is pursuing a pragmatic ‘one must get on with it’ view of the task, where London seems infused by nostalgia for times long gone, a propensity for navel gazing, and a vague sense, but strong belief, in the opportunity of going it alone.

For Germany, Brexit is a political question first, and an economic question second. The practical implication of this preference set is that Berlin is likely to value its ability to protect the project of European integration and the EU more than its ability to deflect some of the economic costs of Brexit during negotiations. Policy-makers in Germany understand well that Brexit will be expensive. Germany is the largest net contributor to the EU budget, and holes will need to be plugged once the UK leaves. Berlin also expects other economic disadvantages and slower growth because of Brexit. For Germany’s export industries, the UK represents an important market; but not important enough to give preferential treatment of the kind that would lead other market participants to ask why they are not getting the same.

In the policy area of security and defence, German policy-makers focus on the opportunities presented by Brexit. Given the UK’s limited contributions to EU-led crisis management missions in the past, and the fact that the UK can be expected to commit even

more strongly to NATO in a post-Brexit environment, the costs of the UK's decision are perceived to be limited in this arena. When presenting Germany's new defence white paper shortly after the British EU-exit referendum in 2016, defence minister Ursula von der Leyen argued EU member states would now finally be able to make progress on European defence: "We had to be considerate of the United Kingdom for a long time, because the United Kingdom consistently did not want these topics"³⁵.

France is Germany's preferred and logical partner to pursue this ambition. Berlin convinced Paris to support the launch of Permanent Structured Cooperation (PESCO) on defence matters in the EU and make this an inclusive endeavour, in principle aiming for participation from as many EU member states as possible, despite France's concerns that an inclusive PESCO is unlikely to be an effective PESCO. Notably, France and Germany decided in July 2017 to jointly develop a new combat-aircraft programme, which would provide a serious impetus for European defence collaboration and could shape Europe's future military aerospace industry. While Franco-German defence collaboration faces its own challenges, these recent moves put London on notice that Brexit makes London a less credible partner for European defence projects, at least in the eyes of the other two major European powers³⁶.

Policy-makers in Berlin have nevertheless worked with their British counterparts on a 'Joint Vision Statement' on defence, most likely to be signed after the September 2017 elections in Germany, and have pursued discussions on defence collaboration in a forum known as 'Ministerial Equipment and Capability Cooperation' dialogue. For Germany, pursuing these bilateral initiatives with Britain represents a good opportunity to help London sustain its European credentials.

Broadly speaking, Paris is on a similar wavelength to Berlin – although the devil is hidden in the detail of how exactly the Franco-German couple follows up on its current declarations of intent. France certainly sees Brexit as a political question first and foremost. It is united with Berlin in its desire to protect the project of European integration over the potential economic costs this might entail. The French president Macron multiplied the overtures to his German counterpart over the course of the election campaign, and has followed up in kind. The results of the Franco-German summit on 13 July, which include the decision to build a fighter jet together, showed that both leaders are willing to back up political rhetoric with concrete resolve and get things done in the defence area, but also more broadly in the digital, climate and economic areas. Until the

The UK represents an important market; but not important enough to give preferential treatment of the kind that would lead other market participants to ask why they are not getting the same.

German elections in late September, it will however be difficult for Paris and Berlin to go much further.

There is also a more underlying sentiment in Paris, which may not be quite as present in Berlin and other European capitals, but which also suggests casting Brexit as an opportunity. The perception indeed persists in some circles – including in the French political establishment – that the European project was waylaid to a degree by Anglo-Saxon economic precepts, which steered it away from being a primarily political construction. The single market and EU enlargement are viewed by some in Paris as British objectives at the outset, which contributed to watering down the EU's coherence and potential for consensus. In turn, this is seen as having undermined the capacity of the Union to become a political and strategic power in its own right. That the UK has decided to leave a project it influenced to such an extent is therefore viewed with some degree of perplexity in France. At the same time, Brexit may also represent for Paris an opportunity to steer the EU back to a more political vision of continental Europe, provided it can accept cooperation with Berlin for the long haul, and extend it to key European partners.

In the policy area of security and defence, the bilateral relationship between France and the UK is well established and is likely to continue largely unimpeded (see *supra*). Paris values Britain as a partner in strategic terms. It is the only other European country with a nuclear deterrent, with a strong strategic culture, and with frontline capabilities which enable it to enter first onto an operational theatre. The British indeed remain the preferred partners for the military and industrial parts of the French defence machinery. The perception in Paris is that the UK is the only other EU country that really “gets” military force, knows how to use it, and is willing to do so. This is likely to remain the case in the foreseeable future.

The UK remains the preferred partner for the operational and industrial parts of the French defence machinery: the perception in Paris is that Britain is the only other EU country that really “gets” military force.

Rome and Madrid³⁷

Italy has two key interests at stake in the Brexit negotiations. The first is the large number of nationals living in the UK: before the referendum, around 600.000 Italians lived in the London area alone³⁸. This issue has been one of the most prominent in the meetings between Prime Ministers Paolo Gentiloni and Theresa May³⁹. Secondly, trade relations are important because around 5-6% of Italy's export goes across the Channel. However, this share is below German, French, Spanish, Polish, Dutch or Swedish ones (in percentage terms over national GDP), making Italy a bit less dependent from British imports. Above

all, for Rome the EU single market is more important than the UK market by far. This awareness is epitomised by the sharp reply of Italian Minister of Economic Development Carlo Calenda to Boris Johnson's threat to not allow Italy to export its Prosecco to the UK in case Brexit negotiations will not succeed: "I will sell less Prosecco to one country, and you will sell less fish and chips to 27 countries"⁴⁰.

Having said that, Italy will probably try to make the Brexit negotiations as constructive as possible and avoid antagonising the UK. However, if negotiations become tougher, Italy will side with European Commission, Germany and those willing to avoid that Brexit encourage further attempts to leave the Union. Preserving and developing not only the single market but the whole EU integration process is considered a national interest by the Italian establishment, as well as by the mainstream parties. Moreover, in view of upcoming general elections, those parties are keen to prevent favourable conditions for exiting the Union supporting anti-EU claims by Italian populist movements. Finally, when it comes to Rome's relations with Brussels, Berlin and Paris, Italy's priorities are the softening of austerity and the improvement of EU approach to migration across the Mediterranean sea: two goals that Italy would not jeopardize in order to influence the Brexit negotiations.

Regarding the defence sector, Brexit will likely have an important impact on Italy⁴¹. The UK is one of the main markets for Italy's defence companies like Leonardo, whose effective control belongs to the Italian Government. In the last decade, the company has built a strong relation with the UK, especially concerning helicopters and avionics⁴². Similarly to what happened in Italy, a "one-company" approach has been adopted to consolidate the Leonardo industrial footprint over the Channel: in January 2017 Leonardo-WM has brought together Finmeccanica UK Ltd, AgustaWestland Ltd, Selex ES Ltd, and DRS Technologies UK Ltd, and as such it accounts for around 8,000 jobs and 2,000 suppliers in the UK.⁴³ Besides that, British and Italian stakeholders do partner in important procurement programmes – i.e. Eurofighter, Meteor, Future Surface Air System – as well as in transnational defence companies such as MBDA. Such set of relations has been traditionally coupled with an effort by Italy to cooperate with UK also in order to enhance its position towards the Franco-German couple.

Italy will seek to maintain good relations with the UK in the defence field, but not at the expense of deepening cooperation within the EU, particularly with France and Germany.

However, for Italy's defence policy there are priorities more urgent than Brexit. The first one is to team with France and Germany in the deepening of European defence, in institutional and military terms. On the agenda is the implementation of the Permanent Structured Cooperation, the development of EDA role, the establishment of the EU

planning and conduct capability, of the European Logistic Hub, or of the European Medical Command⁴⁴. The second and related priority is playing an active role in a possible restructuring of the European Defence Technological Industrial Base (EDTIB) within the EU defence market, by developing ongoing and new procurement programmes – such as the EUROMALE drone – and by taking advantage of the EC's European Defence Fund. In this regard, Italian state-owned company Fincantieri's will to acquire French STX Saint Nazaire⁴⁵ is an interesting example of potential continental Europe consolidation, which as yet however has not come to fruition. Finally, the fact the EU High Representative/Vice President is an Italian progressive politician does also play a role in fostering convergence between Rome and Brussels institutions in the security and defence field. In the general context of Brexit negotiations, Italy will therefore likely try to maintain good relations with UK in the defence field, but not at the expense of the deepening of cooperation within the EU, and particularly with France and Germany.

Carlo Calenda to Boris Johnson: "I will sell less Prosecco to one country, and you will sell less fish and chips to twenty seven".

Spain is also likely to try to preserve the closest possible relationship between UK and the EU despite Brexit. Prime Minister Mariano Rajoy and Foreign Affairs Minister Alfonso Dastis have repeatedly stated that the Spanish position along negotiations will be focused on achieving the most favourable output on the two fronts. The first is the status of citizens of both countries, since a number of Spanish nationals live in UK but also many British live in Spain. Second, the economic interests of the business community are a key interest, as the two economies are deeply intertwined. Around 700 industries with Britain capital are present in Spain and 300 the other way round, making the UK the first Spanish partner for export, particularly in the fields of automotive, aerospace industry and banking.⁴⁶ It is not by chance that Rajoy government reports are looking to the negative economic consequences of a "hard Brexit", in terms of GDP, employment, tourism – as well as impact on the EU budget which benefits some Spanish provinces⁴⁷.

Madrid will attempt to prevent a Brexit settlement which would encourage secessionist movements or undermine Spanish sovereignty over Gibraltar.

At the same time, in line with its traditional pro-European stance⁴⁸, Spain is interested in preventing any damage from Brexit to the EU integration process. As happens for other member states, the prevailing idea is to avoid any outcome of the negotiations that could be considered as an incentive to more exits from the Union. Because of the sensitivity of Catalan issue, Madrid will also make an effort to prevent a Brexit settlement which could nurture secessionist movements such as the Scottish one. Another specific issue between Madrid and London lies in the status of Gibraltar⁴⁹, which could become troublesome in

light of Brexit. The EU guidelines on negotiations have already raised this issue, by stating that no agreement with the UK on Gibraltar can be reached without Spain's consensus. Madrid will necessarily reject any agreement between Brussels and London that undermines the Spanish sovereignty rights on Gibraltar. For the moment, Rajoy government is trying to ignore the rumours from some British sources on the situation in Gibraltar, but any hardening of the official statements over the Channel would be counterproductive for EU-UK negotiations, and for the bilateral relations between London and Madrid.

When it comes to the defence sector, it should be noted that Spain's defence exports to UK amounted to 860 million euros in 2014 (a quarter of the whole defence export, according to the data of the Trade Secretary). Companies like Airbus, Sener, ITP, Navantia or Santa Barbara Systems, amongst others, are still assessing the possible impact of Brexit on their markets. The biggest share of exports is due to Airbus tankers, being the rest for spare parts and supplies for submarines, helicopters, armoured vehicles, ammunition and others. Given the cooperative nature of some procurement programs, it could be argued that the final impact will be lower than expected. As is the case with most of the issues unpacked in the Brexit debate however, much will depend on the fundamental issue of British access to EU single market – or lack thereof. ■

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³ "Brexit risks pushing UK out of European space contracts", <https://www.ft.com/content/2f0e7a6e-1eff-11e7-a454-ab04428977f9>

⁴ Black, J. Hall, A. Cox, K. Kepe, M. Silfversten, E. (2017). *Defence and Security After Brexit. Understanding the possible implications of the UK's decision to leave the EU*. Santa Monica, Calif., and Cambridge, UK: RAND

Corporation, http://www.rand.org/content/dam/rand/pubs/research_reports/RR1700/RR1786/RAND_RR1786.pdf, p. 43.

⁵ Black, J. Hall, A. Cox, K. Kepe, M. Silfversten, *ibid*, p. 44.

⁶ See amongst others: <https://uk.ambafrance.org/France-and-UK-sign-agreement-on-missile-technology>

⁷ In a sense, Brexit has made government-industry partnership more important for driving defence industry growth via export: <http://www.defensenews.com/story/defense/show-daily/farnborough/2016/07/05/allan-cook-defence-growth-partnership-britain/86707368/>

⁸ Harry Yorke, “Exclusive: Oxford University may break with 700 years of tradition and open a foreign campus - after France offers Brexit sweetener”, in *The Telegraph*, 20th February 2017, <http://www.telegraph.co.uk/education/2017/02/19/exclusive-oxford-university-set-break-700-years-tradition-open/>

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¹² See amongst others: http://www.iai.it/sites/default/files/eu60_9.pdf

¹³ *Proposal for a regulation of the european parliament and of the council establishing the European Defence Industrial Development Programme aiming at supporting the competitiveness and innovative capacity of the EU defence industry*, 7 june 2017

¹⁴ Black, J. Hall, A. Cox, K. Kepe, M. Silfversten, E. (2017). *Defence and Security After Brexit. Understanding the possible implications of the UK’s decision to leave the EU*. Santa Monica, Calif., and Cambridge, UK: RAND Corporation.

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²² Uttley, M.R.H. Wilkinson, B. (2016b). Contingent Choices: the future of United Kingdom defence procurement and defence industries in the post-Brexit era. *Global Affairs* 2/5, 491-502.

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⁴⁷ http://elpais.com/elpais/2017/03/10/inenglish/1489134826_157952.html

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ACRONYMS

ADS : Aerospace, Defence and Security

CSDP : Common Security and Defence Policy

DIS : Defence Industrial Strategy

DTIB : Defence Technological Industrial Base

EASA : European Aviation Safety Agency

EDA : European Defence Agency

EDF : European Defence Fund

EDIDP : European Defence Industrial Development Plan

EDRP : European Defence Research Programme

EDTIB : European Defence Technological Industrial Base

EEA : European Economic Area

FTA : Free Trade Agreement

MMCM : Marine Mine Counter Measure

NETMA : NATO Eurofighter and Tornado Management Agency

NPG : Nuclear Planning Group

PADR : Preparatory Action for Defence Research

SEM : Single European Market

TRL : Technology Readiness Levels

WTO : World Trade Organisation

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#19

Report

THE IMPACT OF BREXIT ON THE EUROPEAN ARMAMENT INDUSTRY

BY

OLIVIER DE FRANCE / Research Director, The French Institute for International and Strategic Affairs (IRIS)

BASTIAN GIEGERICH / Director of Defence and Military Analysis, International Institute for Strategic Studies (IISS)

ALESSANDRO MARRONE / Senior Fellow, Istituto Affari Internazionali (IAI)

JEAN-PIERRE MAULNY / Deputy Director, The French Institute for International and Strategic Affairs (IRIS)

TREVOR TAYLOR / Professorial Research Fellow, Royal United Services Institute

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ARES GROUP

The Armament Industry European Research Group (Ares Group) was created in 2016 by The French Institute for International and Strategic Affairs (Iris), who coordinates the Group. The aim of the Ares Group, a high-level network of security and defence specialists across Europe, is to provide a forum to the European armament community, bringing together top defence industrial policy specialists, to encourage fresh strategic thinking in the field, develop innovative policy proposals and conduct studies for public and private actors.

CONTACT [Pilots]:

Jean-Pierre Maulny, Olivier de France, Sophie Lefeez

ares@iris-france.org

+33 (0)1 53 27 60 60

www.iris-france.org/ares

#AresGroup