



CENTRO STUDI SUL FEDERALISMO

RESEARCH PAPER

THE STATE OF THE EUROPEAN DEFENCE EQUIPMENT MARKET

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THE STATE OF THE EUROPEAN DEFENCE EQUIPMENT MARKET¹

1. PRESENTATION

The Europe of defence is a project in its early stage. It is likely to progress, even to accelerate. The European Council has recently expressed “its determination to give a fresh impetus” to the European Security and Defence Policy (ESDP)² and to set the means to develop it. The European Council’s commitment to further promote the ESDP is in line with recent remarkable achievements in the EU regulatory framework concerning the defence items³. Between December 2008 and January 2009 two new directives aimed at enhancing intra-community trade and procurement in defence-related items were adopted by the European Parliament. It is a milestone in the process towards the Europe of defence project.

Based on this assumption, this report focuses on one crucial element of the European Defence and Security Policy (ESDP): the integration of the national defence equipment markets.

A short outline of the ESDP build-up in the last decade explains the growing importance of the integration of the national defence equipment markets for the further progress of the ESDP itself.

It is conventionally agreed that the ESDP was formally established in 1999, at the Helsinki European Council, in the aftermath of the EU failure in the management of the ex-Yugoslavia crisis. The aims were twofold: enforcing a European security policy in order to “preserve peace, prevent conflict and strengthen international security”⁴, and establishing a defence policy aimed at “safeguarding EU values, fundamental interests, independence and

¹ This report has been concluded in March 2009.

² See *Conclusions of the Brussels European Council of 11 and 12 December 2008 on the European Security and Defence Policy*.

³ The adoption by the European Parliament of the new Intra-community and Defence Procurement Directives, in December 2008 and January 2009 respectively, preludes to the formal adoption by the Council, the signing by the Council and the Parliament and the publication in the EU official journal in the near future.

⁴ [Http://ec.europa.eu/external_relations/cfsp/intro/index.htm](http://ec.europa.eu/external_relations/cfsp/intro/index.htm).

integrity”⁵. The ESDP was declared operational in 2001, on the occasion of the Laeken European Council. Since then, the ESDP has consistently advanced.

In its first nine years of activity, twenty operations have been conducted under the ESDP worldwide; the latest is NAVFOR, the first European Union’s naval operation, taking place off the coast of Somalia.

The operations the ESDP has been deploying since 2004 fall under a much larger concept than the traditional concept of “defence”, covering conflict management, peace building, and responses to various sources of instability outside the European Union.

A common definition of defence and security has been developing. In principle, security covers non-military threats, while defence deals with military threats.

Most current threats, such as terrorism, or natural disasters, require both military and non military responses. Also, external and internal threats are becoming increasingly complex and intertwined.

According to EU treaties, there is no obligation for Member States to assist each other in case of security threats, which was the *raison d’être* of traditional military alliances... Nonetheless, due to the fact that today’s threats no longer concern territorial integrity, European countries are *de facto* more and more interdependent as regards their security. Given their overall integration, the new security threats and challenges can hardly be successfully responded only at national level.

The ESDP framework promotes EU States’ cooperation in ensuring both their defence and security.

⁵ Ibid.

The ESDP global activity has been accompanied and sustained by important institutional reforms, which have provided the EU with means and capabilities to launch military interventions, to conduct civilian operations, or to combine both in the different phases of the conflict cycle: prevention, crisis management, and reconstruction.

The ESDP has been provided with permanent political and military structures under the authority of the Council of Ministers: the Political and Security Committee, charged with the task of defining the EU response to crises, monitoring international affairs and exercising political control over military missions; the Military Committee, responsible for providing the PSC with military advice and directing on field operations, and a group of national military experts.

Closer cooperation with NATO was formalised in 2003.

The EU has also command and planning capacity in Brussels as well as pre-identified military units, for instance battle groups of at least 1500 soldiers able to be deployed in 5 to 10 days for a major operation. According to the declaration on capabilities adopted by the European Council⁶, “Europe should actually be capable... of deploying 60000 men in 60 days for a major operation” as well as, inter alia, “of planning and conducting simultaneously two major stabilisation and reconstruction operations....; two rapid response operations of limited duration; a civilian-military humanitarian assistance operation lasting up to 90 days”.

Furthermore, the Lisbon Treaty, if adopted, provides for new arrangements in order to improve security and permanent structured cooperation in the field of defence, which will build on the experience of the battle groups. Such cooperation also aims at harmonising Member States’ objectives in terms of level of investment and expenditure on defence.

At the heart of the ESDP challenges lies the development of the European Defence and Technological Industrial Base (EDTIB). According to the European Defence Agency (EDA), “a fully adequate DTIB is no longer

⁶ See Council Declaration of 8 December 2008 on the enhancement of the capabilities of the European Security and Defence Policy (16840/08).

sustainable on a strictly national basis”, as it cannot compete with the United States and the rising Asian economies; the Union therefore needs “a truly European DTIB, as something more than a sum of its national parts”. Only a DTIB on a European basis could promote innovation; develop and sustain key technologies; produce at lower costs⁷ and remain competitive in the global market. The establishment of a single European Defence Equipment Market (EDEM) is crucial to this effect.

Since the beginning of the ESDP, many important steps have been taken to organize a common defence equipment market within the Union.

However, EDEM is an extremely sensitive issue for national sovereignty. Member States are often resisting the elimination of national preferences. European competition in the field of defence items is thus far from developed.

This report aims at outlining the main peculiarities and challenges of such an “in progress market”. The report will primarily focus on the scope of EDEM, particularly on the supply side of the defence equipment capabilities.

The following paragraphs will focus on the main features that make EDEM so different from any other market: its main players, political interests, budgetary, legal and industrial constraints. An assessment of the achievements will be provided together with some hypothesis on how the establishment of EDEM may affect transatlantic relations in the field of defence.

2. THE EUROPEAN DEFENCE EQUIPMENT MARKET (EDEM)

2.1 Which items fall under the term EDEM?

Several reasons make it uneasy to exactly define the scope of EDEM.

The defence sector has been highly technology and knowledge-intensive in the past. Until the end of the 1980s, military technology was generally in

⁷ See EDA, Characteristic of a strong future European defence and Technological Base (EDTIB), agreed by the Steering Board on 20 September 2006.

advance of civilian technology and created positive spill-over into the civil sector. Cryptography is for instance an area originally developed in the military sector, which has found wide-ranging civil applications.

By the 1990s, the trend had reversed. Military technology started to lag behind the civilian sector in many areas, such as electronics.

As a consequence, now the focus is more on the spin-off of civilian technology into the military sector. Today, defence is increasingly interlinked with, for instance, information and communications technologies, as well as transport, space and nanotechnologies. The frontier between the defence and civilian equipment tend to be therefore grey, making it uneasy to clearly identify a proper defence equipment market.

The changing nature of defence activities is another factor for the civilian technology spill-overs into the defence sector. Today, armed forces are increasingly used for peace building operations. These new activities are redefining military operations. Peace building is carried out of the nations' territory for conflicts requiring a mix of military and civilian capabilities. Military equipment, integrated with civilian means is needed for these operations.

Boundaries between the defence and security markets are fading. Efforts are currently made to extend rules aimed at regulating the would-be EDEM to the sector of security; for example, the EU directive on defence procurement makes a distinction between "military equipment" and "sensitive equipment, works or services". While the first is the equipment "especially designed or adapted at military purposes, intended for use as an arm, munition or war material", the latter are, more generally, "equipment, works and services designated for security purposes".

Notwithstanding similar attempts, the field of security remains harder than defence to define, as in principle it can encompass a wide range of items. Most States are particularly resistant to any effort aimed at limiting their sovereignty in the field of security.

For all these reasons, the frontiers between defence and civilian technologies

are blurred. This is confirmed by the fact that most companies operating in the defence sector, especially high-tech companies, tend to extend their activities in the civilian sector. In contrast, companies operating in the electronics and information technologies, which in the past had little if no involvement with arms production, are progressively finding themselves part of the defence industry.

The term “European Defence Equipment Market” is basically a conventional notion referring to the specific features of the markets of defence related items in Europe. EDEM relates to the recent efforts and policies, both private and public, aimed at integrating the European national markets into a single market, governed by common rules. The process is under way and far from completed.

The European Defence Equipment Market is therefore made up of different segments: military products, defence related items, dual use goods and sensitive non military goods. They are governed by partially different rules.

a. The military products

Firstly, defence equipment deals with proper military products, which may range from rifles to ammunitions, explosive, and defence technology. All defence-related items have been kept out of the scope of the internal market. For example, defence procurement comprehends the defence part of sectors such as aeronautics, space, electronics, land system and shipbuilding.

Two different lists provide a detailed description of the items falling under the term “defence equipment”: the 15 April 1958 List, adopted as Council Decision 255/58, and the Common Military List of the European Union, adopted by the Council on 10 March 1998.

Traditionally used to exempt military products from Community competition rules on the basis of Article 296 of the Treaty on the European Community, the 15 April 1958 List contains a detailed enumeration of military items which States have the faculty to exempt from competition rules.

The EU Code of Conduct on Arms Exports is a politically binding instrument establishing "high common standards" for EU Member States in making arms

export decisions and to increase transparency among EU states on arms exports. The 1998 Common Military List covers the equipment relevant for the application of the Code of Conduct. 22 categories of defence equipment are enumerated in this list, which has the advantage of taking into account the developments in defence technology, materials and products occurred since 1958. Overall, the two lists cover the same items.

b. Defence-related services

“Defence equipment” consists also of defence-related services and work. Indeed, the scope of the would-be EDEM will not be restrained to military goods, but it extends to research and development in the defence-related sector, and in services, such as maintenance and repair services, land and air transport services, transport of mail, computer and related services, and so on.

c. Dual-use technologies

The growing importance of civilian technology in the defence field has led to an increase in dual-use items, i.e. items which can be employed for both civil and military purposes. Today an increasingly high share of defence equipment is constituted by dual-use components.

Dual-use items range from nuclear facilities, material, and technology, to aerospace and propulsion systems, equipment, and components. A detailed list of dual-use items is contained in Regulation (EC) No 1183/2007, setting up a Community regime for the control of exports of dual-use items and technology. The List consists of an updated version of the Annex 1 to Regulation (EC) No 1334/2000, which first provided the EU with a set of rules on the export of dual-use items towards third countries. The new List takes account of changes adopted at the international level, such as updated versions of the catalogue enforced through the Wassenaar Arrangement, the Australia Group, the Missile Technology Control Regime (MTCR) and the Nuclear Suppliers Group (NSG).

With respect to intra-EU transfers, dual-use items are subject to the European Community's single market rules: no difference exists between civil goods and dual-use items regime as regards internal integration, apart from highly sensitive dual-use goods and a few exceptions set up by single national governments.

The coexistence of several different regulatory frameworks hampers companies' activities. It prevents market integration from developing. Furthermore, the coexistence of several lists on defence-related items, concerning military and dual-use items, creates a grey zone. The various lists are in some ways linked, and it is often hard to establish which list should be referred to, and the market regime to be applied to every single component.

d. Sensitive non-military goods normally employed in internal security

Certain sensitive non-military goods could also fall under an extended interpretation of the term "defence procurement", such as goods and services normally used for internal security purposes. Examples of similar items are authentication services, cryptographic systems, aircraft designated for civil protection, surveillance systems, video recording devices, etc. Two technological areas are particularly important both in the field of defence and in the field of security. They are information and communication technology and nanotechnology.

According to sources at the European Commission, DG Enterprise and Industry, any attempt to make a list of items and services employed for security purposes is bound to fail, as in principle any item could turn to have security applications. Furthermore, threats to internal security are so rapidly changing that technologies relevant to responding cannot be listed.

Not only can certain security items turn to have defence application, but also in most cases companies operating in the two sectors are the same. This is the rationale at the basis of the efforts aimed at including security items in

EDEM. For example, Finmeccanica has a long tradition of excellence in the production of aircraft, helicopters and telecommunications for both internal security and military use.

2.2 Estimating the size of EDEM proves thus to be a challenging task.

In order to get an idea of the size of defence market, researchers tend to use data on military expenditure, as it is the best measure so far available. According to data from SIPRI, commonly considered one of the most reliable sources in the defence research, the EU Member States' defence expenditure in 2007, and thus the approximate size of the would-be EDEM, was over €200 billion.

Such a measure is far from adequate to define the size of EDEM, as it largely overestimates it. Defence expenditure comprehends pay for personnel and other fixed costs, which cannot be properly deemed as part of the defence equipment market. Moreover, EDEM is not limited to expenditure on defence equipment. For instance, non defence expenditure concerns dual use as well as security items. Data on military expenditure fail therefore to provide the full picture about defence procurement markets.

To the effect of this report, the scope of EDEM will cover proper military products referred to in the 1958 List and the 1998 Common Military List, dual use-items, and security items. Thus, we will retain the size estimation set up by the Subcommittee on Security and Defence of the European Parliament (EP). According to the EP, EDEM is a market worth €91 billion⁸.

2.3 The European Defence Technological and Industrial Base (EDTIB)

The EDTIB concept is fundamental to designate industrial and technological capabilities Europe needs to sustain an autonomous defence equipment market. Such a market de facto survives as long as the technological and

⁸ See Z. Casey, Parliament backs single defence market, 14/01/2009 at <http://www.europeanvoice.com/article/2009/01/parliament-backs-single-defence-market/>

industrial environments adapt themselves to the changing needs of the defence equipment demand. The quality of the internal supply must fulfil the requirements of the defence items users.

It is generally recognized that so far Europe has been able to preserve its indispensable defence technological and industrial base.

Today the EDTIB reveals the qualitative changes occurred in the defence sector since the end of the Cold War. Since 1991, the scope and nature of security threats have constantly evolved. Over the last two decades, have emerged threats such as terrorism, internal violence, and organized crime as well as new challenges, such as peace building and humanitarian intervention.

The European defence industry has responded to the changes in global threats and challenges by increasing the role of new technologies. Telecommunication, information and control technologies, which give commanders unprecedented connectivity and increase their efficiency, play today a greater role. Military capabilities have progressively evolved in order to become more mobile. Nanotechnology, biotechnology, quantum computing, and molecular engineering are all essential items in the current defence expenditure.

As a result, today equipments are smaller, lighter and more sophisticated, even though the role of heavy equipments and traditional armaments should not be underestimated. Key defence sectors continue to be aerospace, shipbuilding and land forces. The point is however that the European Union occupies a leading position in biotechnology, nanotechnology and information technology. Space technology is also progressively gaining ground.

The EDTIB has proved to be able to develop itself to respond to the new Europe defence equipment demand. Moreover, consensus is widespread among EU Member States on the need to strengthen the EDTIB. According to the European Council, it is essential and economically necessary

“restructuring the EDTIB, in particular around centres of European excellences, avoiding duplication, in order to ensure its soundness and its competitiveness”⁹. The EDTIB is a fundamental asset for the European economic development. Moreover, in strictly security terms, it is the indispensable means for Member States to be self-sufficient and well perform in the military equipment of their armed forces.

Member States are increasingly conscious that they must cooperate if the EDTIB is to be strengthened. There is a shared awareness in the different EDTIB constituencies (governments, the industry, the scientific community, etc.) on this point.

A modern, internationally competitive and capability-driven defence industry is no longer economically sustainable on a national approach basis. Today national defence budgets are generally shrinking, and overall EU spending on defence is unlikely to increase in the future. Yet costs for research, development and production are hugely growing because of the rising sophistication of weapon systems.

Fragmentation into national markets prevents economies of scale, and it is the main cause for duplication of defence products and low levels of specialisation. Moreover, as no European country can bear on its own the current huge costs of defence technology, a sufficient volume of production is far from guaranteed.

Overseas competition, too, calls for a robust strengthening of the EDTIB. EU needs to improve the competitiveness of the European equipment if it is to maintain an adequate share in the defence international market, and be less dependent on imports for defence technologies.

In order to attain such ambitious goals in terms of internal supply and international competition, the EDTIB needs more integration between Member

⁹ See Council Declaration of 8 December 2008 on the enhancement of the capabilities of the European Security and Defence Policy (16840/08).

States and more cooperation with the civilian industry sector. The EDTIB must become less duplicative, more efficient, and interdependent at all levels of the supply chain. The rationalisation of industrial and technological capacities, and the sharing of research, development and technology resources are fundamental to this respect.

3. THE EDEM ACTORS

The main actors shaping the defence equipment market range from institutions, both at national and European level, to major defence companies and sub-contractors. Attitudes towards the completion of EDEM vary from one actor to the other.

a. National Governments

The role States play in the field of defence has no equivalent in any other market. States set the rules governing the domestic market and provide companies with legal protection and occasionally with financial support. Thus States act as main customers, investors, and, to a lesser extent, as owners in the defence market.

Over the last decades the field of defence has been affected by huge privatisations; however, in many cases States continue to be the majority stakeholders of defence companies. While in the UK and Germany defence industries are today mainly privately-run, most Italian and French defence industries are still publicly-owned.

In 2007 the average national defence expenditure-to-GDP ratio was 1.78%. However, within the European Union, national expenditure differs consistently from one Member State to the other, ranging from a minimum of 0.5% of Ireland to a maximum of 2.6% of the United Kingdom.

The largest arms-producing EU Member States are the UK, France, Germany, Italy, Spain, Poland and Sweden. The UK, Germany, France and

Italy account for about 90% of the total European defence expenditure. They dominate most of the major pan-European companies created over the last two decades. The UK, Germany and France lead the overall defence R&D activity in Europe.

Since 1997, the proportion of national output intended for defence has generally decreased, and no expansion of the total European expenditure is likely to occur in the near future.

Nevertheless the general trend has affected in different ways the main European countries. Germany's defence budget will grow in the next years; similarly, the UK defence budget is expected to increase at an annual rate of 1.5%; France defence spending will not decrease, according to the 2008 White Paper on Defence, but is neither likely to expand. Italy's defence expenditure is bound to remain roughly unchanged. Swedish defence spending has remained unchanged over the last decade, but there are now proposals to reduce it.

National governments role in the EDEM remains today crucial. On one side, they are led to play an increased role in the out of area peace support operations. On the other, they have to organize their capabilities to respond to the new security challenges. On both accounts they are largely contributing to shape new demands on the European defence equipment market.

b. Eu Institutions

Over the last decade, the role of the European institutions has widely increased. It is likely to further develop in the near future. This is a major development, since for decades Member States were firm in keeping EU institutions far off from defence related issues.

The EU first and second pillar are both relevant in the establishment of a single EDEM. The first pillar is original "European Economic Community" pillar. In matters under this pillar like trade, customs, procurement,

competition areas, decisions are taken on the basis of the stringent Community procedures. Under the second pillar, which refers to the common foreign and security policy, decisions are taken by unanimity in the Council.

First pillar initiatives in the field of defence have been resisted for a long time by Member States on the account of the security nature of the defence equipment market. Only recently important Commission proposals have produced relevant measures. The beginning of the European Union involvement in the sector has taken place under the second pillar cover.

Important results have been achieved in this respect, notably through the actions of the European Defence Agency (EDA) under the authority of the Ministers of Defence. Even today it can be safely assumed that the role of the Council is bound to remain predominant, as the field of defence is mainly dealt with in the intergovernmental framework. The intervention of European Community instruments will occur as a complement to it.

A recent development is the European institutions joint working with industrial and research actors of the European defence equipment market. The Seventh Framework Programme of the European Community for research and technological development for the period 2007 to 2013 addresses the need for a strategy encompassing both civil and defence security developments. For the first time research and technological development in the field of security is part of a Community research programme. The Commission manages this programme with the support of Member States and the participation of the main European industrial complexes.

The Seventh Framework places greater emphasis than in the past on research that is relevant to the needs of European industry. Security related research is expected to generate new knowledge. The spill over of new technologies in other fields, such as transport and civil protection, will reinforce the competitiveness of the whole European industry.

Since its establishment, the European Parliament has been encouraging Member States to better integrate their defence production, notably through recommendations, studies and meeting of experts promoted by the EP Subcommittee on Security and Defence. The European Parliament is expected to play an increasingly important role in shaping EDEM, thanks to its co-decisional authority in the field of industry and internal market.

In the early 1990s the European Commission has joined the Parliament in its efforts, despite the fact that the main institutional actor in the field of defence continues to be the Council. However, constant case-law by the European Communities Court of Justice has made clear that Treaty rules relative to the internal market (first pillar) may apply to defence –related products.

The Commission has repeatedly called Member States to move towards a single European defence market¹⁰. In the 1990s it has submitted several policy proposals to this effect. It has regularly convened the chief executive officers of the major European industries to encourage them to cooperate and to lobby in favour of EDEM. Yet the opposition and reluctance from Member States actors has long frustrated its attempts, with the exception of the enforcement of competition and merger law with respect to defence companies, where the Commission has been more successful due to its autonomous powers. Over the last years, the Commission has been more proactive in specific areas, thanks to the greater openness shown by Member States and cooperation with EDA. The Commission has taken recently ambitious initiatives aimed at promoting the industrial sector, intra-EU trade, defence-related research, and EU defence competitiveness.

The European Defence Agency has been of paramount importance in the process towards a single EDEM. EDA was created in 2004 “to support the Member States and the Council in their effort to improve European defence capabilities in the field of crisis management and to sustain the ESDP as it

¹⁰ See the 1992 Study -The Cost of Non Europe in Defence Procurement carried out by K. Hartley and Andrew Cox for the European Commission.

stands now and develops in the future”¹¹. The Agency has four functions: developing defence capabilities, promoting Defence Research and Technology, promoting armaments co-operation, creating EDEM and strengthening the EDTIB.

Since its establishment, in 2004, EDA has attained satisfactory results in lowering the existing barriers to competition in defence, in promoting research, bolstering the EDTIB, and increasing European military capabilities. The achievements already attained by EDA seem to confirm that the EU framework is likely to successfully replace previous attempts¹² to cooperate in the field of European defence, whose results have been modest insofar.

c. Industry

The European defence industry’s turnover amounts to approximately €65 billion. About 800,000 people are employed in the industry, either directly or indirectly¹³. The biggest employer is BAE Systems: about 408,000 people work in its 750 plants¹⁴.

The largest European companies by revenues are EADS, whose revenues in 2007 were approximately 61.7 US \$ billion; BAE Systems (28.5); Finmeccanica (18.2); Safran Group (17.7); Thales (15.6)¹⁵.

An increasingly high number of companies are now trans-national, as a consequence of a rise in mergers and acquisitions in the last decades. Along with the main companies, there is an increasingly large number of sub-contractors. Most companies operate in both the civilian and defence sectors.

¹¹ <http://www.eda.europa.eu/>

¹² See para. 4

¹³ See Michael Fishpool, European Defence Industry, Europeandefence.co.uk, 2008.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

The European companies' share of the world market is approximately 24%, far behind the US, which still dominates with 51,8%¹⁶. European defence exports consist mainly of armoured vehicles, naval vessels, aircraft (notably helicopters), ammunition, electronics, and components.

Aerospace, defence and security industries, such as BAE Systems, EADS and Finmeccanica have been performing strongly over the past two years. The naval sector in particular has been stimulated by a rise in exports to new countries. The major companies have attained positive results; revenues and orders have increased, and expansion in the US market has continued. The international standing of companies such as EADS, Thales and MBDA has improved in recent years, and some of the main European providers of defence technology have now an international, or even global, reach. The space industry, which underperformed in the last years, is now showing signs of recovery.

The Aerospace and Defence Industries Association of Europe (ASD) is another influential actor. ASD represents aeronautics, space, defence and security industries in Europe in all matters of common interest. ASD aims at promoting the development of the sector of defence through a cooperative approach. According to the 2007 ADS Press Conference, the Association "fully supports" the initiatives aimed at paving the way towards an integrated EDEM. It considers these initiatives essential to shape the global competitiveness of the EDTIB.

d. Foreign Players

The EDEM process will greatly depend on defence cooperation with third countries. As the only defence customers are governments, the more foreign countries interrelate with an integrated EDEM, the more EDEM is likely to progress.

¹⁶ *Ibid.*

The establishment of EDEM is bound in particular to impact on transatlantic relations. Some consider EDEM as a means to favour deeper cooperation with the US because it would make negotiations with the US on a transatlantic defence market easier. Others consider EDEM as a threat, as it could result in a single protected European market of more difficult access for US exports.

The US has a national defence market worth €196 billion, with a single strong security policy, while EU suffers from a fractured defence market, with several currencies, valued at €91 billion.

On several accounts – political, economic, and industrial- the US has in the past objected to EDEM. It has rather supported the establishment of a transatlantic market as an alternative to the selective European integration process. However, this project has been stalling for years, due to a lack of serious involvement and political will on both sides of the Atlantic. According to sources at EDA, the US is now more open to the EDEM project, as it is aware that a transatlantic equipment market for defence is an unrealistic goal. Such a change in US attitude has been favoured by the perception that the measures adopted to create EDEM make no discrimination between foreign companies implanted in Europe and European companies. For example, in only two cases contracts awarded under the EDA Code of Conduct on defence procurement have been limited to European companies.

Industry itself has long wavered between the prospect of a larger transatlantic market and EDEM opportunities. According to sources at the defence industry, for many European companies transatlantic cooperation still takes priority. In particular, industry insists that EDEM should be coupled with the opening of a “two-way street” across the Atlantic¹⁷. Thus, they support both integration projects, provided they move in parallel, which is not often the case.

¹⁷ ASD, ASD Press Conference, 2008.

It is generally recognized that the American market not only is far from being fully open to European players but it is often unpredictable because of the interference of powerful internal lobbies. European industries have been successful in penetrating it mainly through the acquisition of US firms.

Ukraine and Russia are among the third countries that could most benefit from a single EDEM. Over the last years, the Ukrainian government and EADS have already signed agreements of cooperation on a few fields, such as aerospace, defence, and secure communications. Aerospace cooperation may be extended to include the field of defence. The Member States military cooperation with the Russian Federation has increased. Russian companies have concluded contracts with European counterparts, such as EADS, BAE Systems, Finmeccanica, Sagem, Snecma, Dassault Aviation, and Thales.

4. THE OBSTACLES TO EDEM CONSOLIDATION

Member States are primarily responsible for the obstacles having slowed down EDEM consolidation. Defence industries have on their side de facto traditionally supported the fragmentation of the European market in nationally protected niches favourable to their monopolistic positions.

The major leverage to this effect has been the extensive recourse to (and misuse of) Article 296 of the Treaty on the European Community, which allows national authorities to exempt the production and trade of defence items from the EU internal market rules.

Under Article 296 Member States are allowed “to take such measures as they consider necessary for the protection of the essential interests of their security which are connected with the production or trade in arms, munitions or war material”. The letter and the spirit of the provision are clear in justifying national derogatory measures only by virtue of “essential security interests”. Commercial, industrial or other reasons are no ground for exemption. Moreover, the article goes on stating that protection measures “shall not adversely affect the conditions of competition in the common market

regarding products which are not intended for specifically military purposes”. Again it is very clear that national regimes are allowed only for strictly military items (not for dual use items, for instance). Finally the 296 provision does not provide a blanket exemption from the internal market rules for all military items. This applies only to the categories of items indicated in a specific list to be adopted unanimously by the Council on the Commission proposal.

The EEC experts in the Council finalised in 1958 an ad hoc list for the purpose of art. 296. This list included strictly military items and not dual use goods. However, the list has been ever since considered deprived of legal force on the ground that it was never formally adopted by the Council. Legally it is a sort of “non list”, with no official status. Member States have consequently claimed that in the absence of a commonly agreed list, they could autonomously decide the categories of goods eligible to the exemption.

The reality has been that on the basis of claimed “national security interests”, States have long had recourse to Article 296 in order to protect their national industry, even at the price of increasing costs of procurement. They have done so by extending the derogation well beyond the items included in the 1958 list. The abuse of the exemption is at the basis of European defence market fragmentation, inefficiency, and products duplication.

A second obstacle on the process to EDEM consolidation lies in the differences in national practices and legislations which have generated de facto fragmented defence markets. Confidentiality and security of supply imperatives favour national suppliers. Each State autonomously imposes the requirements companies should possess to be eligible for competition in its domestic market. Timescales for advertising, criteria for selecting bidders, granting authorisations and awarding contracts may consistently vary from one State to the other.

Accordingly, each State retains strict control over the arms trade within the European market by means of national export licences. Licensing requirements vary from one country to the other in terms of scope, competent

authorities, procedures and timing. Licences in intra-Eu transfers appear to exceed the real needs, as it is proved by the fact that, according to the 2007 Commission's Impact Assessment, not a single licensing request has been formally rejected since 2003.

Third, governments are also the main defence investors and customers. Each country has its own priorities, programming and procurement cycles. Rarely have they been harmonised with other EU countries. Each country funds almost all national defence research, technology, and development. Therefore, it is no surprise that governments show a clear preference for their own national defence industry.

A few Member States have started to open their markets to competition from external suppliers. Yet they still spend almost 85% of their equipment budget domestically, whereas producers from other countries have only limited access, or no access at all, to domestic defence markets¹⁸.

Fourth, European governments have reserved to themselves specific powers in setting the share of national defence companies that can go under foreign ownership. Legal provisions set the threshold foreign companies cannot exceed when they acquire shares of a national defence company. Although European governments have rarely made use of this legislation, the legal framework has long acted as a deterrent for defence markets' penetration by foreigners¹⁹.

Fifth, the defence equipment is decided nationally on the basis both of operational and economic requirements. This favours the establishment of ad hoc national suppliers, leading to duplication of R&D programmes and products.

¹⁸ M. Fishpool, *Eu Defence Industry*, European defence.co.uk, Shepreth, 2008.

¹⁹ *Ibid.*

Notwithstanding the above obstacles, examples of cross-border cooperation between European industries exist, especially in the aeronautics, space and electronics sectors. Yet here again Member States have often imposed practices, such as *juste retour* and offsets that distort competition.

The principle of *juste retour* (or principle of fair industrial return), largely applied in promoting multilateral cooperative programmes, implies that national companies should be granted the amount of work correspondent to the financial contribution of their national State to the project. Basically, the share of contracts awarded to one State's companies under each programme should be roughly equivalent to the overall funding this State has granted to the programme. This practice has been source of inefficiencies and wastes as concerns the technological and industrial base. Each State taking part in a European programme has been de facto entitled to support its often unproductive enterprises. Moreover, far from promoting EDEM, the *juste retour* principle tends to maintain fragmentation and to prevent economic comparative advantages from emerging by the specialisation process.

The offset practice implies that Member States subordinate their defence imports to compensatory purchases or investments by the exporter country.

There are two kinds of offsets. Through "direct" offsets, the purchaser receives work or technology directly related to the weapons sale, typically by producing the weapon system or its components under license. "Indirect" offsets involve barter and counter trade deals, investment in the buying country, or the transfer of technology unrelated to the weapons being sold.

Both types of offsets, as well as the *juste retour* practice, produce comparative disadvantages in defence items competitiveness. They are hard to eliminate because they provide security of supply, industrial growth and employment to the countries concerned.

Representatives of the defence industry call for countries "to spend more together" by pooling their resources. Yet most Member States still resist greater consolidation of both demand and supply sides. A study in 2006

estimated that they cooperate in defence research for a value less than 1% of the overall research spending²⁰. Most joint projects continue to run on ad hoc basis.

Relevant changes in the origin of defence spending are not foreseeable in the near future. Defence spending is bound to remain national; only a modest proportion on Member States' budgets will be devoted to cooperative projects. However, the current economic recession could turn to be a stimulus for pooling defence resources, that are decreasing, and spending them more efficiently through cooperation.

Inefficient companies resist the establishment of a single EDEM. They lose national protection allowing them to remain in the market despite being less productive than other competitors. Intense lobbying from these companies slow down governments progresses in the integration of national defence markets.

There are also more practical difficulties.

Serious obstacle prevent small and medium sized enterprises from taking advantage of the opening of national defence markets. Such obstacles range from language barriers, the cost to compete internationally, delay in payments, and lack of confidence and adequate information.

Contracts in a foreign language may be a huge disincentive for an enterprise to bid: often small and medium sized enterprises' offices are not even bilingual. Many companies still hesitate to participate in cross-border bids, as it may turn to be quite expensive. Procedures may be particularly complicate for small and medium-sized companies.

Another problem occurring quite often relates to time of advertising, which differs from one country to the other. When companies have to officially translate the text of advertised contracts, the advertising time may be too short.

²⁰ See A. Beatty, Aiming for a common defence research fund, 09/03/2006, <http://www.europeanvoice.com/Article/54308.aspx>

Furthermore, delays in payments, likely to occur often in cross-border bids, may be a huge obstacle for SMEs wishing to compete internationally.

Many enterprises are still unaware of the opportunities EDEM can provide them with.

In addition, an adequate level of confidence still needs to be established among States. Only in a really trustful environment can product duplication be eliminated and economies of scale arise.

Finally, EDA faces major resistances to playing its leading role. EDA has produced an ambitious list of initiatives for the creation of a single EDEM. Despite recent achievements, EDA still lacks appropriate resources to consolidate the EDTIB. One of the main obstacles lies on the decision-making procedure, based on unanimity. Sincere commitment by Member States is essential if EDA is to shape a Europe-wide industrial basis.

5. STEPS TAKEN TO REALIZE EDEM CONSOLIDATION

Over the years a number of initiatives have been implemented with the aim of integrating national defence markets. At first, attempts have been promoted by small groups of States on ad hoc issues. They were focused on consolidating the demand side. More recent attempts have been taken at the EU level. They involve the majority of Member States, on the basis of a more ambitious goal: to create a single market for defence items through progressive liberalization on the supply side.

In 1976, NATO European States, with the exception of Iceland, created a forum for armament cooperation, the Independent European Programme Group (IEPG). This arrangement did not produce real breakthrough in European armament cooperation. In the 1990s there were several attempts to better organize the European armament cooperation; these attempts were

essentially moving on the assumption that the jointly demand of defence items would produce economies of scale and better organise the supply. In 1993, 13 IEPG Member States agreed on transferring the tasks of the IEPG under the umbrella of the West European Union, which was, according to the Maastricht Treaty, the defence arm of the newly established European Union. The Western European Armaments Group (WEAG) was thus established. Integrated by other European States, it was operative until 2005. Its purpose was to strengthen the European defence technological and industrial base and to promote cooperation in research and development. In 1993 WEAG created an ad hoc commission to advance proposals about the establishment of a European defence agency, while in 1996 was created the Western European Armaments Organisation (WEAO), an executive body charged with managing research projects. Again WEAG and WEAO, while useful to promote cooperative projects, were not successful in organising an integrated demand of European defence equipment. Both bodies' functions were transferred into the EDA.

Another arrangement for joint armament projects was the "Organisation Conjointe de Coopération en matière d'Armement" (OCCAR). It was established in 1996 by France, Germany and Italy, UK. Belgium and Spain joined later, in 2003 and 2005 respectively. The Netherlands, Luxembourg and Turkey are currently participating in a programme without being members of the organisation.

States parties to OCCAR continue to collaborate in armaments programmes, while coordinating R&D in some joint projects. OCCAR has contributed to limiting recourse to the *juste retour* principle, and to coordinating national defence policies. OCCAR acts for its members as a multi-national agent on collaborative projects, such as the Airbus A400M military transport aircraft, the Tiger helicopter program, and the Roland radar-guided surface-to-air missile.

Despite these activities, OCCAR has not been able to realize an effective rationalisation of defence production at the European level. One of the reasons is the small number of its participants. Another reason is that

OCCAR's action is limited to ad hoc projects run on a purely voluntary basis.

EDA, lacking procurement powers, has recommended that OCCAR manage its programmes, such as the ad hoc cooperative projects²¹ promoted by Member States or the Agency's Chief Executive. Yet to date OCCAR supervision has been limited to programmes funded by its members.

In 1998 the EU six largest arms-producing countries signed the so-called Letter of Intent, which was followed by the Farnborough Framework Agreement. Both aimed at promoting reforms in order to restructure the European defence industry and to simplify transfers of defence-related products. In its promoters' view, the Lol would make it easier for companies of one State party to operate in the other parties' markets, and for governments to launch cooperative projects. Measures envisaged in the Lol would comprehend the harmonisation of national research and development programmes and exchanges of information on the subject in order to avoid unnecessary duplication; joint research, development and procurement projects; identification and harmonisation of capabilities of common interest. Yet the Lol's impact on defence integration has been modest insofar.

Under the 2000 Farnborough Framework Agreement the Six committed themselves to applying simplified export procedures to transfer military-related equipment intended for collaborative projects.

OCCAR and the Lol are still in force, and operate next to EDA legal and political framework. EDA has the great advantage of adopting a broader and more homogeneous approach to defence matters. Moreover, EDA benefits from being an EU institution and having a larger political basis: with the exception of Denmark, the Agency includes all EU Member States.

EDA has provided EU Member States with a vision of future defence and security challenges. It has offered guidelines to develop the military

²¹ See p. 25.

capabilities required by the ESDP in the next 20 years. The Long-Term Vision report published by EDA in 2006 stresses the need for the EU Member States to cope with increasingly limited resources and higher interoperability. “The notorious fragmentation of the European defence industry” has to be overcome, and the whole range of resources available in the enlarged Europe have to be exploited. This means selecting what production must be preserved and developed. Cooperative projects are essential: harmonisation of technical requirements may be difficult or impossible, while equipment standardisation could ease multi-national military operations.

The Long-Term Vision has set EDA’s medium-to-long term agenda.

The European Defence Ministers, meeting as the Steering Board of the EDA, adopted in 2007 the Framework for joint Strategy on Defence Research and Technology. The Strategy describes how Member States intend to invest collectively on technologies that are crucial for European defence. Within this framework Member States have established criteria to select technological and industrial capabilities that should be strengthened, as well as methods to harmonize investments and provide armed forces with homogeneous equipment. They have first identified key technologies to invest in and then the appropriate strategy to improve overall EU performance in defence. This strategy mainly consists of different forms of collaboration, technology and coordination with other European R&T organisations. Member States agreed on voluntary benchmarks to increase investment in the field of defence and to promote collaborative spending: for example, they established that European collaborative equipment procurement should be 35% of overall equipment procurement, while European collaborative defence R&T should be 20% of overall defence R&T expenditure.

The programmes currently under way within the EDA framework have already produced satisfactory outcomes. Positive results have already been attained by the Code of Conduct on defence procurement, the Code of Best Practice in the supply chain, and cooperative research and technology projects.

26 countries (all EDA Member States except Romania, who may join later, plus Norway) have agreed on a Code of Conduct on defence procurement, which opens national markets to suppliers from other subscribing countries on a voluntary and reciprocal basis.

The Code of Conduct applies when conditions for the application of Article 296 are met. The Code covers contracts with a value of at least 1 million euros excluding VAT. The most sensitive defence procurement contracts, such as contracts on the procurement of chemical, radioactive and bacteriological weapons fall out of the scope of the Code.

With respect to contracts covered by the Code, subscribing States undertake to provide to foreign and national defence suppliers the same treatment. They guarantee transparency and accountability in their selecting criteria.

According to sources at EDA, the Electronic Bulletin Board (EBB1) on the EDA's website, through which the regime on defence procurement works, has been greatly successful, taking into account that it is very recent (2006).

The second section of the Electronic Bulletin Board is devoted to the enforcement of the Code of Best Practice in the Supply Chain. This Code has been established to promote the principle of the Code of Conduct on Defence Procurement at the level of small and medium-sized enterprises (SMEs). Industry-to-industry offers are there advertised.

In addition, EDA has launched new forms of R&T cooperation among Member States, such as the 2006 Joint Investment Programme on Force Protection. Unlike previous collaborations on R&T, a single budget funds the whole programme. The selection of the individual projects is decided by a management committee.

EDA promotes two kinds of projects: "Category A" and "Category B". The first are ad hoc collaborative projects aimed at involving all 26 States. They are proposed by Member States or the Agency's Chief Executive. The latter are

also promoted by Member States, but they generally involve a smaller number of participants.

The Commission has also been active in promoting EDEM consolidation. Along with several recommendations and studies aimed at encouraging industrial restructuring and further integration, the Commission has produced an Interpretative Communication on defence procurement in order to prevent abuses in the recourse to Article 296. The Communication provides contract authorities with guidance on how to correctly enforce the exemption provisions, in the light of the European Court's case law, which has constantly made clear that internal market rules do, in principle, apply to defence-related items. Thanks to the Interpretative Communication, the use of the exemption has partially decreased. Restricting the usage of Art. 296 to include only basic defence-related items is essential for the development of EDEM.

By contrast, the directive 2004/19/EC on public procurement has had only limited impact on integrating the defence market. The directive covers all public contracts, but their provisions are ill-suited to meet the defence procurement specificities. Many governments have continued to exempt their defence contracts from the Community market rules as set up by the directive.

6. THE RECENT ACHIEVEMENT: THE DEFENCE PACKAGE

In December 2007 the Commission launched its "Defence package". The term refers to two proposals of Directive and a Communication relating to EDEM.

The Directive on Defence Procurement and the Directive on intra-Community transfers are likely to be adopted by the Council before the election of the new European Parliament in 2009.

The two Directives have recently been approved by the European Parliament, and are now under the Council's examination as part of the co-decision procedure. The amendments by the Parliament were formulated in agreement

with the Council, so that a first reading adoption is to be expected.

Once adopted, the two Directives will be legally binding on Member States: they will have to adopt the laws, regulations and administrative provisions necessary to implement them. The Commission will monitor the measures taken by Member States in view of the transposition of the Directives, and report to the European Parliament and to the Council on the development of EDEM.

Key to the Directive on Defence Procurement is the attempt to extend the general discipline on public procurement to the field of defence.

The Directive on Defence Equipment covers public contracts concluded between European counterparts. According to text approved by the Parliament, the Directive “shall apply to contracts awarded in the field of defence and security for

- (a) the supply of military equipment, including any parts, components and/or subassemblies thereof;
- (b) the supply of sensitive equipment, including any parts, components and/or subassemblies thereof; works, supplies and services directly related to the equipment referred to in (a) and (b) for any and all elements of its life cycle;
- (c) works and services for specifically military purposes, or sensitive works and sensitive services”²².

With respect to military equipment, it “should be understood in particular as the product types included in the list of arms, munitions and war material adopted by the Council Decision of 15 April 1958”. However, the list is extremely generic, so the Parliament encourages that the term “military equipment” be interpreted “in a broad way in the light of the evolving character of technology, procurement policies and military requirements leading to the development of new types of equipment, for instance on the basis of the

²² See art. 2, European legislative resolution of 14 January 2009 on the proposal for a directive of the European Parliament and of the Council on the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security (COM(2007)0766-C6-0467/2007-2007/0280(COD)).

Common Military List of the European Union”²³. Moreover, also goods originally designed for civilian use can fall under the category of “military equipment” when used as arms, munitions or war material.

One of the main provisions of the directive concerns the obligation to advertise contracts. To date, they are mostly dealt with in a secretive way. All contracts falling within the field of application of the Directive have to be awarded, unless exceptions are justified “on grounds of public security or necessary for the protection of essential security interests of a Member State. This can be the case for contracts in the fields of both defence and security which necessitate so extremely demanding security of supply requirements or which are so confidential and/or so important for national sovereignty that even the specific provisions of [the] Directive are not sufficient to safeguard Member States’ essential security interests, the definition of which is the sole responsibility of Member States”²⁴.

In case the application of the Directive would oblige Member States to disclosure particularly sensitive information, they can continue to have recourse to the protection offered by art. 296 of the EC Treaty.

Moreover, contracting authorities may require commitments from prime and sub-contractors to protect information according to the national laws’ requirements.

Only contracts over a certain threshold level will fall under the Directive. According to art. 8, the Directive shall apply to contracts whose value is estimated to be no less than €412.000 for supply and service contracts, and €5.510.000 for works contracts.

The Directive does not apply to contracts awarded under an international agreement or arrangement concluded between one or more Member States and one or more third countries²⁵. For example, cooperative projects

²³ See “whereas” 10.

²⁴ See “whereas” 15.

²⁵ See art. 12

managed by international organisations, such as OCCAR, are out of the scope of the Directive.

The Directive on intra-Community transfers aims at providing the EU with a common legal framework on defence trade. A similar attempt, although on a smaller scale, has already been made through the Letter of Intent. However, the results have been modest. The Directive aims at overcoming some of the Lol system shortcomings. For example, it will introduce sanctions for States and companies failing to respect its provisions.

Today most Member States make no difference between transfers to the EU and to non-EU States in requiring the issuing of export licences. The directive aims at relaxing regulations in intra-EU transfers and harmonising the rules and procedures for intra-community transfers, “in order to ensure proper functioning of the internal market”.

According to art. 4, the transfer of defence-related products between Member States has to be subject to prior authorisation, while no authorisation is necessary for the passage through States other than the destination country.

Under the Directive, each State should provide a new regulatory framework on licences: Member States have the power to determine “all the terms and conditions of transfer licences”, and each company wishing to export should obtain a label to be able to export. Companies with no certification will not be allowed to go international.

In some cases Member States can exempt transfers of defence-related products from the requirement of prior authorisation, for example if “the supplier or the recipient is a governmental body or a part of armed forces”, when “the transfer is necessary for the implantation of a co-operative armament programme between Member States”, or when “the transfer is necessary for or after repair, maintenance, exhibition, or demonstration” ²⁶.

²⁶See art.4.2.

The Commission formulated the proposal for this directive to partially replace the current regulatory framework based on ad hoc licences, under which a single licence is required for each transaction, by a system of general authorisations.

Only suppliers meeting the criteria set by each Member State can transfer defence-related products across borders. Licences will specify terms and conditions for companies to be eligible, the defence-related products that can be transferred and the categories of recipients located in another Member State.

According to art.6, Member States could also decide “to grant global transfer licences to an individual supplier, on its request, authorising transfers of defence-related products to recipients in one or several other Member States”. Eligible companies will thus need one licence to operate within the European Union. The global licence will be granted for three years and will be renewable.

This reform will be completed by a control regime aimed at preventing the risk that items from one country will be re-exported by the acquiring country in a third State against the will of the first. Member States can set any limitations on the export of defence-related products to recipient in third countries and request end-use assurances. According to art.8, suppliers will have “to inform recipients of the terms and conditions of the transfer licence, including limitations, relating to the end-use or export of the defence-related products”. Member States will also have to guarantee the reliability of recipients established in their territories. They should ensure that these companies are able and seriously committed to respect the transfer limitations set up by other Member States.

The Directive aims at regulating intra-community transfers of “all the defence-related products which correspond to those listed in the Common Military List of the European Union including components and technologies”²⁷.

²⁷See “whereas” 37.

Originally, the proposal of Directive made only reference to the 1998 List, which has been created under the second pillar. Yet in 1994 the European Court of Justice ruled that a first pillar instrument could not refer to a second pillar one. So, a new List has thus been drawn up in the annex to the proposal formulated by the Parliament. Defence-related items falling under the Directive are listed in the Annex. The Commission has the duty to regularly update the Annex, so that it strictly corresponds to the Common Military List of the European Union.

One of the most delicate issues relates to re-export. Member States' external policies differ from one to the other. Some States fear foreign companies may re-export imported products towards third countries on their black list. In order to reduce this risk, each State could make a list of countries where re-export would be accepted. Companies failing to respect the list will be sanctioned. Both the Commission and the industry have supported this solution.

7. THE WAY AHEAD TOWARDS EDEM

In addition to the significant existing acquis²⁸, more building blocks are currently under way in the process of achieving an integrated EDEM. The most important are the ones arranged by EDA. The adoption of the Lisbon Treaty could produce further changes.

Several initiatives have been brought about by EDA in 2008, and even more projects are to be expected in the near future, as in 2009 the Agency's budget will increase to over € 30 million. Larger sums of money will be invested in research, and new staff will be recruited.

In May 2008 EDA has launched a number of initiatives aimed at building awareness about its activity.

²⁸ See previous para.

One of these initiatives is the European Call centre project to inform defence-related companies about the online portal for contract opportunities. More than 4000 companies will be contacted. Another initiative concerns organising events involving networks of national defence industry associations and governments, as well as regularly publishing brochures, leaflets and reports.

In July EDA has endorsed the first Capability Development Plan, which aims at determining the future military needs and priorities of EDSP. States have undertaken to make reference to the Plan when deciding about national defence investments. Although the plan is not going to replace national defence plans, it will encourage a cooperative approach leading to better coordination in defence programmes. Some of the priority actions indicated in the Capability Development Plan have already been selected as potential subjects of future researching.

In October the Steering Board of EDA agreed on a voluntary Code of Conduct on Offsets. The aim is both to make the use of offsets more transparent and to progressively reduce them.

The Code applies to compensation practices resulting from purchasing of defence items. It will be enforced in July 2009. Member States accepting the Code will neither call for nor accept offsets exceeding the value of the contract.

In November European defence ministers launched a series of initiatives aimed at improving the European military capability, such as the European air transport fleet project, a project relative to the replacement of the maritime mine counter-measures and a project on the maritime surveillance. Furthermore, the Steering Board of EDA endorsed the so-called “European Defence Research and Technology Strategy” to enhance cooperation in research projects, and a road map for the helicopters training programme which is going to run from 2010.

The Lisbon Treaty

Major changes are to be expected from the entering into force of the Lisbon Treaty. Its reforms may be a great contribution to the ESDP and EDEM.

The Lisbon Treaty includes EDA among the European bodies aimed at shaping the new Common Security and Defence Policy (CSDP). It provides the Agency with a solid legal basis. It is the only European agency to be mentioned in the treaty. EDA is assigned a major role in the field of “defence capabilities development, research, acquisition and armaments”. According to art. 28A, EDA “shall identify operational requirements, shall promote measures to satisfy those requirements, shall contribute to identifying and, when appropriate, implementing any measure needed to strengthen the industrial and technological base of the defence sector, shall participate in defining a European capabilities and armaments policy, and shall assist the Council in evaluating the improvement of military capabilities”.²⁹

The Agency is deemed to play a significant role in matters relating to Permanent structured cooperation (PSC), which is undoubtedly one of the most significant new instruments to be introduced by the Treaty. PSC will allow a core group of EU MSs to decide to cooperate more closely within the common security and defence policy. It is bound to act as a stimulus for EDEM, as it requires States to develop and integrate military capacities, to harmonise military investments and needs, to promote openness of their defence markets. In addition, it encourages cooperative programmes and specialisation. States joining the PSC will build their own permanent military framework, provided that they met the criteria on funding and capabilities set out in the Protocol to Permanent Cooperation. Other Member States could later join the original group.

²⁹ See also art. 28D

The objectives of a PSC in the field of defence are twofold: to proceed “more intensively” with capability development, and to supply part of a battle group by the end of 2010. Article 2 of the Protocol on Permanent Cooperation sets a series of commitments for States taking part in a PSC: they have to agree on a certain level of joint investment in defence equipment; to “bring their defence apparatus into line with each other as far as possible” by harmonizing military needs, pooling and “where appropriate” specialization; to raise their forces’ availability, interoperability, flexibility and deployability setting “common objectives regarding the commitment of forces”; to take part in equipment programmes in the context of EDA³⁰.

8. THE LEVEL OF INTEGRATION IN THE EU DEFENCE SECTOR

Several indicators highlight the level of integration between Member States’ defence markets: the size of the intra-EU trade in defence procurement, Member States’ participation in EDA’s activities, the weight of international consortiums, joint ventures and merges.

First, the size of the intra-EU trade in defence equipment reveals Member States reciprocal openness.

Recent trends³¹ indicate a progressive rise in intra-EU transfers of defence-related items, although they are still subject to national licences. According to the EU Ninth Annual Report in conformity with Operative Provision 8 of the EU Code of Conduct on Arms Exports, 12,677 export licences were issued for transfers within the European Union in 2006. Only 3 licences were refused. Such a bureaucratic burden is pointless: a part from generating extra-costs and many delays, it weakens EU industrial competitiveness.

³⁰S. Biscop, Permanent Structured Cooperation and the Future of ESDP, The Royal Institute for International Relations, Egmont, 2008, p. 5.

³¹In 2006 the value of the licences was over €5 billion. More than 3 billion consisted of licences on arms exports. Germany issued licences for a value of about €2 billion, followed by Italy (approximately €1 billion).

Second, data on EDA's activities demonstrate Member States and companies' good reactivity to the new means set up by the Agency. Both Member States and companies are cooperative and responsive.

Most States operate under the Code of Conduct Regime for defence procurement. It has had a promising start. The Regime has now been running for two years, with more than 430 contract opportunities advertised for competition on the EDA website, through the Electronic Bulletin Board (EBB1), an on-line platform where Member States can publicise their procurement offers.

To date, some €4 billion worth of contracts has been transparently awarded under the provisions of the Code of Conduct. The total value is out of €10 billion.

States regularly report to EDA about the implementation of the Code of Conduct. France and Poland are the countries having advertised the largest number of contracts.

Although Member States have frequent recourse to the Electronic Bulletin Board, most contracts advertised on the Electronic Bulletin Board are still awarded to companies of the same nationality as the advertising State. This is particularly true with respect to France: the French cross-border rate of awarded contracts falls far below the average (about 6 out of 85 contracts). However, cross-border contract awards are progressively growing. They represent some 25% of all contracts.

Several Member States take part in cross-borders projects promoted by EDA. 20 European governments are involved in the EDA-sponsored Joint Investment Programme on Force Protection (JIP-FP), a three three-year Programme worth €54.93 million and focused on technologies aimed at protecting EU armed forces against certain kinds of threats.

11 Member States are also involved in the Joint Investment Programme on Innovative Concepts and Emerging Technologies (JIP-ICET), a two-year

project worth €15.58 million.

Under the EDA umbrella Member States have already carried out smaller projects, involving limited number of participants, such as “Category B”³² collaborative R&T projects.

Companies are also taking advantage of the means set up by EDA to foster integration in the field of defence, namely through the Code of Best Practice in the Supply Chain (CoBPSC).

Like the Code of Conduct, the CoBPSC runs on a voluntary basis. It has been established in order to apply the principles of the Code of Conduct down the supply chain, favouring cross-border opportunities for all suppliers, including enterprises which cannot compete for the EBB1 opportunities due to their limited size. The CoBPSC has also had a promising start, with about 60 companies currently taking part into the Electronic Bulletin Board 2 (EBB2), the on-line platform where sub-contract opportunities are advertised.

The number of actively participating buying companies in the “Industry-to-Industry business opportunities” has rapidly increased. The major companies seem to particularly appreciate the initiative, whose success ultimately relies on the industry’s willingness to take part into a cross-border bidding. Although at its beginning the Code of Best Practice has mostly favoured the major companies, its positive spill-overs are likely to trickle down all the supply chain, so to benefit SMEs as well.

Third, high levels of integration in the field of defence have been attained by the establishment of numerous international consortiums and joint ventures³³. The rise in the costs of staying in national defence markets, which are relatively small, has led Member States to cooperate on ad hoc projects, such as the A 400 Military Airlifter, the Eurocopter Tiger and the Eurofighter Typhoon. These collaborative programmes have progressively undermined the concept of industrial basis on a national level. However, ad-hoc

³² See p.24 for a description of “Category A” and “Category B” collaborative R&T projects.

³³ Just to mention some of the most recent, three joint ventures, named Torpedo Program JV, Torpedo Manufacturing JV and Sonar JV have been established at the end of 2008. Other European defence companies could be invited to join the new ventures in the future.

collaboration is no longer sufficient. The cooperative system has failed to keep the path with the US technology, is expensive and undermined by the weaknesses of the *juste retour* method.

Fourth, industry consolidation, mainly in the form of mergers, is another important part of the process of integration between national defence markets. The European defence industry is undergoing consolidation and reorganisation both at national and international level. The defence industries have already partially lost their national identity. Although the core defence business remains national, there has been a rise in foreign ownership of minor companies. Outward and inward investments and the supply chain phases are increasingly trans-national.

The process is driven by the recognition that conventional forms of defence industrial collaboration are inadequate. The objective is thus to consolidate the European defence industry into groups able to meet the needs of customers both within and outside the EU. Groups as BAE³⁴, EADS³⁵ and Thales³⁶ need a Europe-wide defence market to operate on the same standard as US counterparts. At the same time, an open market will enlarge the network of SMEs operating in the field of defence.

All data are consistent with a recent move towards closer integration. However data also reflect the lack of a fully-operative European defence equipment market.

On the one hand the chances for intra-Eu trade to expand depend entirely on the elimination of protectionist barriers between Member States. On the other

³⁴BAE Systems is the result of the 1999 merger of Marconi Electronic System (MES), General Electric Company plc (GEC), and British Aerospace.

³⁵In 2000 France's Aérospatiale Matra, Germany's DaimlerChrysler Aerospace AG (Dasa) and Dornier GmbH, and Spain's Construcciones Aeronauticas SA merged creating the European Aeronautic Defence and Space Company (EADS), mainly as a reaction to expansion by the UK's BAE Systems. Initially, EADS was carefully structured to reflect a balance between French and German interests, as it is evident from its double-headed system composed of co-chairmen and co-chief executives from each country. However, in 2007 Germany and France eventually agreed to have a single chairman and a single chief executive in order to improve both EADS and Airbus management. The company's main operating unit is Airbus.

³⁶In 2000, after acquiring [Racal Electronics plc](#), [Thomson-CSF](#) changed its name into Thales and became one of the leading companies in Mission-critical information systems for the Aerospace, defence and security markets. In 2002 Thales and DCSN formed the Armaris Group to market the Scorpène Class SSK submarine and Fremm frigate.

hand cooperative projects, joint ventures and mergers, although being important steps towards integration, are largely insufficient for Europe to remain competitive in the field of defence.

9. CONCLUSION

The adoption of the directives on procurement and intra-community trade on defence-related items is the latest and more ambitious step towards the establishment of an open, competitive and transparent EDEM.

It is far too soon to evaluate the impact the EU Commission's defence package will have in "creating a genuine European defence market".

In the Commission's aims the EU single market should include defence equipment. Yet the process is bound to be long: while the industry has already explored cross-border solutions to European capability shortfalls and encourages the standardisation of military requirements on a European basis, the intergovernmental cooperation in the field of defence is at its beginning.

Member States seem seriously engaged in the effort to standardise EU demand and requirements. Today they are perfectly aware that cooperation and the opening of their defence markets is the only way to overcome their limited defence spending. Yet they still have to take appropriate measures to ensure the removal of the protectionist barriers which have isolated their national military markets for decades.

The directive on defence procurement will still give Member States the possibility to use Art. 296 ECT to exempt contracts from competition rules, so the risk of its misuse has not been completely eliminated, but it will be reduced as the directive establishes mechanisms for Member States to operate in the open market with no risk for their security.

The outcome of the defence package initiative is far from certain. Much will also depend on the follow-up process, particularly on the Commission's ability to envisage complementary measures, such as monitoring the security

of supply and standardisation, which are essential for the success of EDEM.

If fully implemented, the two directives, along with the other measures already enacted both within and outside the EU framework, such as the EDA Codes of Conduct and the Lol, are expected to favour serious structural changes.

An open market and genuine cross-border competition will sustain a solid EDTIB, which is ultimately what the EU needs if it is to play as a reliable military actor in global affairs.

EU has to produce on its own the military means it needs to successfully carry out military activities and civilian operations within the ESDP framework. With no prospect of a rise in European defence procurement spending EU needs to act in a viable, competitive and efficient environment: establishing a truly open and competitive EDEM is a step in the right direction.

RESEARCH PAPER

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