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The EU Defence and Security Procurement Directive: A Step Towards Affordability?

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EXECUTIVE SUMMARY

The European Union's Defence and Security Procurement Directive provides a framework for cross-border defence procurement within the EU. The directive is due to be transposed into EU-wide national legislation on 21 August 2011. Its aim is to facilitate the development of an EU defence equipment market that will increase industrial competition, reduce duplication and lower prices. A key difficulty the European Commission faces in upholding the directive is the culture of national defence-industrial protectionism that has been facilitated through the use of Article 346 of the Lisbon Treaty. Article 346 states that 'any member state may take such measures as it considers necessary for the protection of essential interests of its security which are connected with the production of or trade in arms, munitions and war material'.

In financially constrained times, the success or failure of the directive will depend to a large extent on its ability to add value by making defence-industrial manufacturing more efficient and affordable. This paper analyses the ability of the directive to tackle affordability and reaches the following conclusions:

- In the short term the European Commission is likely to use the directive to tackle offsets – additions, such as investment or technology transfers, over and above the delivery of the equipment. It is difficult for member states to claim that offsets are essential to security interests when technology is imported from abroad. This will have a significant effect on the main EU defence equipment importers (Finland, Greece, Poland, Portugal and Spain). These member states will be forced to base off-the-shelf procurement decisions on the price and quality of equipment rather than the attractiveness of the offset package. This should result in consolidation, fairer competition and lower equipment prices.
- In the long term the Commission will probably adopt a more cautious approach to tackling national programmes procured within national boundaries by the main EU arms-producing nations (France, Germany, Italy, Sweden, and the United Kingdom). The Commission will want to be seen as the long-term protector of the EU defence industry by helping to reduce equipment prices and will slowly build up case law for non-sensitive national programmes over the long term. This should also result in increased consolidation, improved competition and lower prices for non-sensitive national programmes.
- In the very long term, over this century, equipment prices can only be significantly reduced by tackling industrial duplication in the EU. This will require a shift in thinking as member states struggle with both reduced budgets and pressures to reduce protectionism. Sharing more projects to reduce costs and avoid possible legal wrangling may eventually create an environment in which member states invest in shared capability clusters. This will then allow them to focus investment in certain areas and buy off-the-shelf equipment from other clusters within the EU. Trust, cooperation and an acknowledgment of shared interests will be required for this change to become reality.

INTRODUCTION

The single market has been arguably the greatest success of the European Union; the free movement of people, goods, services and capital has led to lower prices and a significant increase in trade.¹ However, the European Commission has struggled to impose these basic economic freedoms on the EU defence industry, which remains highly fragmented along national lines – 75% of defence equipment in the EU was procured within national boundaries in 2009.² Concerns about the affordability of defence equipment, static defence budgets and the realization that military intervention continues to play a large part in global politics have acted together as a stimulus for the Commission to address protectionism in the EU defence industry. The Commission believes that free-market principles will result in less duplication, larger economies of scale, increased industrial competition and the resulting lower prices.

The EU Defence and Security Procurement Directive 2009/81/EC was adopted by the European Commission in 2009 in order to facilitate the development of a EU defence equipment market by creating an official framework for cross-border defence procurement within the EU.³ The directive specifically tackles the sensitive issues around security of information and security of supply⁴ and must be transposed into national legislation by 21 August 2011. The hope is that it will open up the EU defence industry to cross-border competition. However, member states still have the possibility to use Article 346 of the Lisbon Treaty. This article states that ‘any Member State may take such measures as it considers necessary for the protection of the essential interests of its security’. This effectively exempts the defence industry from EU public procurement law, which stipulates that procurement over a certain value must be opened up to competition in the EU market unless an exclusion such as Article 346 applies.⁵ The European Commission has clarified in an interpretive communication⁶ that Article 346 should be treated as an exception rather than a standard; however, the reality is that it is very difficult to define what constitutes ‘necessary for the protection of the essential interests of its security’.

1 ‘Safeguarding the free movement of goods’, *Enterprise & Industry Online Magazine*, 10 January 2011, http://ec.europa.eu/enterprise/e_i/news/article_10863_en.htm.

2 ‘Defence Data 2009’, European Defence Agency, 2010, <http://www.eda.europa.eu/WebUtils/downloadfile.aspx?fileid=1252>.

3 ‘Defence Package – Towards an EU Defence Equipment Policy’, Defence Industries Reference Documents, 25 January 2011, http://ec.europa.eu/enterprise/sectors/defence/documents/index_en.htm.

4 ‘New directive on defence and security procurement enters in force’, *Europa*, 25 August 2009, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1250>.

5 Article 346, The Lisbon Treaty, 2008, <http://www.lisbon-treaty.org/wcm/the-lisbon-treaty/treaty-on-the-functioning-of-the-EU-union-and-comments/part-7-general-and-final-provisions/589-article-346.html>.

6 ‘Interpretive Communication on the application of Article 296 of the Treaty in the field of defence procurement’, Commission of the EU Communities, 7 December 2006, <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0779:FIN:en:PDF>.

PROTECTIONISM IN DEFENCE

The EU defence manufacturing sector is currently best described as a set of independent national markets, each with a distinctive set of supply and demand arrangements.⁷ Each member state with indigenous industrial capability ensures that it spends the majority of any investment in defence equipment domestically to protect the industry from any competition and to sustain what has long been seen as a manufacturing sector of strategic significance nationally. In order to understand why protectionism dominates the EU defence industry it is important to analyse how it has developed since the Second World War.

The EU defence industry

The development of the EU defence industry since the Second World War can be split into three broad periods. The first, from 1945 to 1960, was characterized by rebuilding capabilities with the support of the United States. In the second period, from 1960 to 1990, member states broke away from the US relationship and moved towards EU collaboration. The third period, from 1990 to the present, has been dominated by reduced defence spending and a movement towards EU frameworks in an effort to reduce costs.

US collaboration: 1945–60

After the Second World War European countries were keen to build up shattered national economies and maintain sovereignty in defence owing to the political uncertainty in the region. The development of West European defence industries was dominated during this period by collaboration with the United States because these countries found they were unable to both rebuild their economies and rearm.⁸ This collaboration was facilitated through production under licence and technology transfers enabling countries to gain access to and use US technology. These bilateral programmes helped restore the defence-industrial base in Europe but did not encourage collective European activity.⁹ The separate national defence industries that had developed since 1945 were cemented in place in 1958 when member states of the newly formed European Economic Community agreed that rules on competition and the free movement of goods should not apply to military and security equipment when 'essential security interests' were at stake. This agreement, enshrined in article 223 of the 1958 Treaty of Rome, later became Article 296 of the 1999 Treaty of Amsterdam and then Article 346 of the 2009 Treaty of Lisbon. It has created a legacy whereby EU nations economically protect their national defence industries.

EU collaboration: 1960–90

EU defence industries had recovered sufficiently by the 1960s to produce goods without the need for American technology transfers. This period marked a shift in emphasis from US to EU collaboration as member states strove to compete in foreign markets with American defence contractors.¹⁰ Although member states collaborated on defence projects the demands of industrial protectionism imposed severe barriers to any significant amount of EU integration in arms production.¹¹

7 Keith Hartley, 'A single EU market for defence equipment: organisation and collaboration', University of York, <http://web.cenet.org.cn/upfile/53045.pdf>

8 Aleksandar Kešeljevi and Erik Kopa, 'Globalisation of Regionalisation of the Defence Industry in the EU Union', University of Ljubljana, <http://oliver.efri.hr/~euconf/2005/files/1st%20session/5th%20keseljovic%20kopac.pdf>

9 Ethan B. Kapstein, 'Global Arms Production: Policy Dilemmas for the 1990's', Harvard University, 1992.

10 Marc DeVore and Sandra Eisenecker, 'The Three Ages of Armaments Collaboration: Determinants of Organizational Success and Failure', 2010,

<http://stockholm.sgir.eu/uploads/The%20Three%20Ages%20of%20%20Collaboration%20SGIR.pdf>.

11 Elizabeth Sköns, 'The EU Defence Industry CIAO Case Study', SIPRI.

EU frameworks: 1990 to the present

The end of the Cold War signalled a significant reduction in EU arms production, in West European members, in response to a reduced security threat. This period has been characterized by the need to reduce costs through the privatization and mergers of defence companies and the creation of new EU institutions aimed at fostering integration. Both strategies, however, have generally failed to address appetites for protectionism and the resulting duplication of industrial capabilities in the EU.

In 1996 the *Organisation Conjointe de Coopération en matière d'Armement* (OCCAR) was established by France, Germany, Italy and the United Kingdom. The aim was to set out a procedure for collaborative defence programmes using the *juste retour* principle. The principle stated that the defence industry of a member state must receive work worth at least 66% of its government's financial contribution to a programme.¹² The principle has been successful in that it enables the pursuit of projects which individual nations would find too costly to fund alone. However *juste retour* results in an awkward and inefficient arrangement whereby the programme is divided into different parts which each nation should design and manufacture. OCCAR has now renounced the analytical calculation of industrial *juste retour* on a programme-by-programme basis and replaced it by the pursuit of an overall and flexible multi-programme/multi-year balance of work-sharing.¹³ Despite this, *juste retour* practices continue to be pursued in the EU, with each nation expecting to receive what it considers to be a fair return from the amount invested.

In 1998 the EU's six main arms-producing states (France, Germany, Italy, Spain, Sweden and the United Kingdom) signed a letter of intent to establish a cooperative framework to facilitate the restructuring of the EU defence industry. This became a framework agreement in 2000.¹⁴ The six countries agreed that harmonization was required to avoid unnecessary duplication of development and production. This involved collaboration on seven issues:

- *Security of supply*: The supply of defence articles and defence services must be maintained in times of crisis and war if rationalization across national boundaries is achieved.
- *Export provisions*: The restructuring of the EU defence industry should not hinder the ability of the participants to export defence articles and defence services.
- *Security of information*: Adequate security provisions for the protection of classified information must be in force in a transnational defence company without placing unnecessary restrictions on the movement of staff, information and material.
- *Research and technology*: These are indispensable for maintaining an effective EU defence industry and the limited resources available for defence-related research and technology must be used in an efficient and effective manner.
- *Treatment of technical information*: Technical information cannot be disclosed by the participants of the agreement without the authority of the owner.
- *Harmonization of military requirements*: Proceeding from identified capabilities of common interest, participants should identify areas in which harmonization is considered possible.
- *Legal framework*: Participants should have the firm intention to pursue the objectives of the agreement and to adopt specific arrangements to underpin the effective application of the principles laid out in the agreement.¹⁵

12 Daniel Keohane, 'The EU and armaments co-operation', Centre for EU Reform, December 2002, http://www.cer.org.uk/pdf/wp408_armaments.pdf.

13 'Global Balance Policy Statement', OCCAR-EA, 12 December 2006, http://www.occar-ea.org/media/raw/PP14_2_A_Global_Balance_Policy_Statement_issue1_121206.pdf.

14 'Letter of Intent-Framework Agreement', Select Committee on Defence Written Evidence, 23 July 2003, <http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmselect/cmdfence/694/694we15.htm>.

15 'Letter of Intent between 6 Defence Ministers on Measures to Facilitate the Restructuring of the EU Defence Industry', GRIP, 11 October 2000, <http://www.grip.org/bdg/q1015.html>.

Pan-EU projects based on *juste retour* practices have shown that, although these seven goals are difficult to meet, nations are willing to find a way to achieve them if budgetary constraints are tight enough. The Eurofighter offers a good example: different parts of the aircraft are being built in Italy, Spain, Germany and the United Kingdom, and each partner country then assembles its own aircraft using parts built all over the EU. This results in duplicated manufacturing facilities across the EU but allows each nation to receive a fair financial return from its investment in the project.

In 2004 the European Defence Agency (EDA) was created under a joint action of the Council of Ministers. The aim was to improve EU defence capabilities in the field of crisis management and to sustain the evolving European Security and Defence Policy (ESDP). Within this remit the EDA has four functions:

- Developing defence capabilities;
- Promoting defence research and technology;
- Promoting armaments cooperation; and
- Creating a competitive EU defence equipment market and strengthening the EU's defence, technological and industrial base.¹⁶

In 2006 the EDA launched a voluntary code of conduct for defence procurement, which 25 states have agreed to observe. These nations have committed to open all non-essential defence contracts worth over one million euros to foreign bidders using a website to advertise contracts to potential suppliers.¹⁷ The aim is to ensure that EU defence companies can compete for defence contracts in the EU which are not considered sensitive. The website, known as the electric bulletin board, has had some success: 385 contracts have been awarded under competition, a third of them cross-border.¹⁸

The frameworks and institutions created by member states since 1996 have been generally aimed at reducing costs by encouraging industrial integration in the EU. It has been difficult to achieve this goal since member states have been intent on maintaining national defence industry jobs regardless of the inefficiencies of duplicated facilities across the EU. The consolidation of the US defence industry offers a good example of protectionist practices and illustrates that, as in the EU, political power is the main driver in defence procurement.

Protectionism in the US defence industry

In 1993 US Defense Secretary Les Aspin invited 15 defence industry executives to a dinner that famously became known as the last supper.¹⁹ Amid the context of falling defence budgets after the Cold War the Department of Defense (DOD) ordered the industry to consolidate to survive. Consequently, whereas in 1993 the top five US contractors received 14% of the DOD procurement total, this had doubled to 30% by the end of the consolidation period in 1998.²⁰ The DOD believed that the balance between economies of scale and competition had been reached and stopped supporting large-scale consolidation after 1998. However, it is difficult to find evidence that this consolidation period has translated into lower equipment costs. In a study of 358 major defence acquisition programmes between 1985 and 2007 it was observed that 'an obvious quantitative impact on the cost growth of programmes cannot be observed'.²¹ Defence acquisitions have been

¹⁶ 'Approach towards SDR EU Certification for the benefit of military users', EDA, 2007,

<http://www.etsi.org/website/document/Workshop/SoftwareDefinedRadio/SDRworkshop2-1MichelGari.pdf>.

¹⁷ Erkki Alto, Daniel Keohane, Christian Molling and Sophie de Vaucorbeil, 'Towards a EU Defence Market', Institute for Security Studies, November 2008, <http://www.iss.europa.eu/uploads/media/cp113.pdf>.

¹⁸ 'Report by the head of the EU Defence Agency to the Council', EDA, 23 May 2011,

http://www.eda.europa.eu/Libraries/Documents/Report_by_the_Head_of_the_Agency_to_the_Council_-_23_May_2011.sflb.ashx.

¹⁹ Norman R. Augustine, 'The Last Supper Revisited', *Defence News*, 26 June 2006,

<http://integrator.hanscom.af.mil/2006/June/06292006/06292006-13.htm>.

²⁰ Ioannis A. Stratogiannis and Christos K. Zahos, 'Defence Industry Consolidation and Weapon System Cost Growth', Naval Postgraduate School, 2008, http://edocs.nps.edu/npspubs/scholarly/theses/2008/Jun/08Jun_Stratogiannis.pdf.

²¹ Ibid.

on the high-risk list of the US Government Accountability Office (GAO) since 1990, with cost growth and delivery delay continuing to be major problems. It seems that consolidation has not translated into a slowdown of cost growth in defence programmes in the United States.²²

One reason for this may be that the rationalization of production facilities was not easy to achieve; after 1998 the number of shipyards remained constant and the number of aircraft plants actually increased by one.²³ The US nuclear submarine industry provides a good example; in 1999 a proposed merger between General Dynamics and Newport News would have combined the two US nuclear-capable shipyards. The merger was blocked by the DOD and Newport News was instead acquired by Northrop Grumman. The DOD gave three reasons for the decision to maintain this excess capacity.

1. *Competition*: The Northrop Grumman deal maintained competition between two contractors.²⁴ This is a weak argument in that the current production of the Virginia Class submarine is shared between the two shipyards. Northrop Grumman builds the stern, living compartment, machinery spaces, torpedo room, sail and bow, and General Dynamics builds the engine room and control room. The two shipyards then alternate to build the reactor plant as well as the final assembly, test outfit and delivery.²⁵ This sharing arrangement does not promote competitive practices and seems a result of the DOD ensuring that each shipyard has enough work to maintain its relevant workforce.

2. *Industrial surge*: There is an argument that excess capacity is required to provide an industrial surge at a time of national emergency. However, it is difficult to justify the expense required to maintain both shipyards when currently the two shipyards together produce one submarine a year while each has the capacity to produce four a year.²⁶

3. *Catastrophic event*: In 1996 congressional hearings on future submarine acquisition, the US Navy cited a natural disaster as a secondary reason for supporting the maintenance of two nuclear shipyards rather than consolidating construction at a single yard.²⁷ In a 2004 report for Congress it was reported that 'it's no longer practical to consider building all subs at a single shipyard' and that 'moving total construction to a single yard is not even viable at this point in the program' because 'each yard now specializes in building particular parts of subs'.²⁸ It seems that even if there were a catastrophic event or attack on one shipyard it would be difficult to start building complete nuclear submarines at the other yard.

As a result of the DOD's reluctance to close production facilities, defence companies in the United States became broadly diversified over the consolidation period rather than merging with companies with similar capabilities and consolidating. So-called pork-barrel politics is the most likely driver behind this, with Senators from states that are home to defence facilities using aggressive lobbying and obtaining seats on committees that oversee or provide funding for the DOD.²⁹ Such protectionist practices in the United States make it very difficult to rationalize and close production facilities. This experience offers a stark warning to the European Commission in its drive to tackle protectionism in the EU defence industry.

22 'Defence Acquisitions Assessment of Selected Weapons Programmes', US Government Accountability Office (GAO), 2009.

23 Scot A. Arnold, Patricia F. Bronson and Karen W. Tyson, 'Infrastructure rationalisation in the US Naval Ship Industrial Base', Institute for Defence Analysis, 2008,

<http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA492605&Location=U2&doc=GetTRDoc.pdf>

24 'Newport News Shipbuilding', *Global Security*, http://www.globalsecurity.org/military/facility/newport_news.htm.

25 'Navy Attack Submarine Force-Level Goal and Procurement Rate: Background and Issues for Congress', *CRS Report for Congress*, 11 June 2007, <http://cstsp.aaas.org/files/RL32418.pdf>.

26 Ivan Eland, 'Reforming a Defence Industry Rife with Socialism, Industrial Policy, and Excessive Regulation', *Policy Analysis*, 2001.

27 'Navy Major Shipbuilding Programmes and Shipbuilders: Issues and Options for Congress', *CRS Report for Congress*, 24 September 1996, <http://www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA317249&Location=U2&doc=GetTRDoc.pdf>.

28 'Navy Attack Submarine Force-Level Goal and Procurement Rate: Background and Issues for Congress', *CRS Report for Congress*, 2 June 2004, <http://www.fas.org/man/crs/RL32418.pdf>.

29 Ivan Eland, 'Reforming a Defence Industry Rife with Socialism, Industrial Policy, and Excessive Regulation', *Policy Analysis*, 2001.

TACKLING PROTECTIONISM

Frustrated by defence market protectionism and keen to assert its authority on defence matters, the European Commission released a communication on EU defence in 2003 that culminated in the defence and security procurement directive in 2009. The Commission believes the directive provides for the first time a regulatory framework that removes a major obstacle towards a common EU defence equipment market and opens the door to increased compliance with open market principles.³⁰ This section analyses how far the directive goes in addressing protectionism and how the practice can be tackled further.

Implications of the directive

The directive offers procurement rules for cross-border defence and security contracts in the EU taking into account questions concerning security of supply and information. Its success in tackling protectionism hinges on the interpretation of Article 346 (formerly Article 296) in cases brought to the European Court of Justice. Since 1958 member states have used Article 346 and its predecessors freely to exempt any defence contract from EU procurement rules. The article states:

1. The provisions of the Treaties shall not preclude the application of the following rules:
 - (a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;
 - (b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes.
2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.³¹

In an interpretive communication in 2006 the European Commission made it clear that member states must assess each procurement contract to determine whether an exemption from community rules is justified. The communication states that the 'it is the member states' responsibility to define and protect their security interests' but Article 346 is only in place to 'deal with exceptional and clearly defined cases'.³² Despite this member states have continued to procure the majority of defence contracts within national boundaries and thus the directive has been produced to encourage greater compliance. The list referred to in section 2 of the article is a comprehensive list of military equipment, which is also referred to in the directive. Items on this list can only be exempted from the directive if the conditions for the use of the article are fulfilled. Thus member states must now justify how a closed or selective procurement process is necessary for the protection of essential security interests. In order to analyse how effective the directive will be in tackling protectionism, this section examines the EU defence industry in three areas: national programmes, cooperative programmes and intra-EU exports.

National programmes

Member states procure, design and manufacture defence equipment within national boundaries to keep complete sovereign control in defence and maintain a national defence manufacturing

30 'New Directive on defence and security procurement enters into force', *Europa*, 25 August 2009, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1250>.

31 Article 346, The Lisbon Treaty, 2008.

32 'Interpretive Communication on the application of Article 296 of the Treaty in the field of defence procurement', Commission of the EU Communities, 7 December 2006, <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0779:FIN:en:PDF>.

industry. Equipment procured within national boundaries in the EU amounted to 75% of total procurement in the EU in 2009.³³ The European Commission is keen to reduce the number of national programmes in the EU by encouraging open procurement. In order to ensure governments retain the incentive to invest in research, nationally procured research and development projects are exempted from the directive. Thus national R&D contracts are not required to compete in the open EU market and investment can remain within nationally based research centres. However, once the risks of new technologies can be reasonably assessed the directive states that fair competition should be used in the later phases of the life-cycle of a product.³⁴ Thus once a new item of defence equipment has been developed and moves from a research project into a mature design ready for bulk manufacture, the manufacturing contract should be opened up to EU competition if it does not fall under Article 346. The concern that may arise with this system is that member states are reluctant to invest in R&D if there is uncertainty over whether the resulting manufacturing contract will be won by a nationally based defence company. The decision over what equipment member states can procure within national boundaries and what equipment should be opened to EU competition will be based on the interpretation of Article 346 in the European Court of Justice. But since there is currently no case law available it will need to be built up in order to understand where the line will be drawn, and this will depend on how many cases the Commission and defence contractors decide to pursue. The latter may choose to challenge closed procurement decisions made by foreign governments in the European Court of Justice if they feel they could win the contract if it was opened up to EU competition.

If the Commission and defence contractors decide to take on member states, then the battle in court may be played out as follows. Member states will undoubtedly argue that maintaining defence-industrial capability is essential for national security interests. They must, however, be able to show that maintaining such capability is essential to security interests and is not simply economic protectionism. The argument will thus be focused around the technology that is considered essential to security interests and too sensitive to be produced outside national boundaries. It could conceivably be argued that there are three categories of equipment so sensitive they must be kept within national boundaries:

- Nuclear power and weapons;
- Complex weapon systems; and
- Complex communication, detection and stealth systems.

The Commission might then argue that the sensitive parts of a defence project involving the three categories above could be stripped out and the rest of the contract opened up to competition. Member states would strive to demonstrate that complex platforms such as main battle tanks, aircraft carriers and air supremacy fighters that include one or more of the three categories above are integrated to such a level that they could not be practically split into separate contracts of differing security levels. Thus the Commission would be left to argue the case for openness for platforms or equipment that are not inherently linked to the three categories above, such as armoured personnel carriers, patrol boats and air-to-air refuelling systems. In sum, therefore, the directive will probably have an effect on these non-sensitive national programmes depending on how far the Commission and defence contractors are willing to fight member states in the European Court of Justice.

Cooperative programmes

The directive contains an important exclusion in that cooperative programmes with an R&D phase conducted by at least two member states are excluded from the directive. This phase must be included to ensure that the product involves new technology and is not simply an off-the-shelf product that is being modified. Cooperative programmes can include the participation of non-EU

³³ 'Defence Data 2009', EDA, 2009.

³⁴ 'Guidance Note Research and Development', Directorate General Internal Market and Services, http://ec.europa.eu/internal_market/publicprocurement/docs/defence/guide-research_en.pdf.

states as long as at least two member states are involved.³⁵ The aim is to increase the number of cooperative programmes in the EU in order to foster increased harmonization of military equipment. EU collaborative defence equipment procurement amounted to 22% of total procurement in the EU in 2009; the EDA has stated that this should increase to 35%.³⁶ Increasing the number of cooperative programmes in the EU would increase the harmonization of military equipment but would have little effect on protectionism. *Juste retour* contracts would continue to be used as member states ensure that a proportion of investment in defence returns to the national manufacturing industry. However, most non-sensitive equipment programmes such as the manufacture of basic ammunition and maritime escort vessels do not have the size or complexity to warrant cooperation. Thus if the directive did open up procurement in this area it would help to reduce protectionism as member states buy the cheapest and best-quality equipment in the EU regardless of where it is manufactured.

Intra-EU imports

When a country decides to import defence equipment the contract usually contains offsets – additions, such as investment or technology transfers, over and above the delivery of the equipment. These are considered commonplace but can skew the market as importing countries may base their procurement decisions on the value of the offsets rather than the price or quality of the equipment. Offsets can be split into two types. Direct offsets are of a military nature and concern the subject matter of the contracts directly – such as the industrial participation of local companies in the production of the equipment procured.³⁷ Indirect offsets are not linked to the imported defence product or service and can be split into indirect military offsets and indirect non-military offsets. Indirect military offsets could involve subcontracts awarded by the supplier to local defence companies for other military products. An indirect non-military offset usually includes the supplier's commitment to mobilize foreign investment in civil sectors of the buying country's economy or to purchase civil goods in that country (hence it is sometimes described as 'counter-trade').³⁸

Offsets have been targeted by the European Commission as an area that must be eradicated from intra-EU defence imports since 'they violate basic rules and principles of primary EU law'.³⁹ The Commission takes the view that public procurement in the EU should be an open competition in which the decision to place the contract is based on the price or quality of the equipment and not on the value of offsets. The Commission has stated it will make a case-by-case assessment of the use of offsets justified by Article 346 under the directive. As a statement of intent it has already questioned the use of offsets for a Greek defence contract under the standard EU public procurement rules:

Supply contract for submarine battery kits (2009): In the public procurement contract for six submarine battery kits the call for tenders included a requirement that 35% of the material used for the batteries should be produced in Greece. The Greek authorities claimed that this was necessary on national security grounds. The Commission decided the Greek authorities were in breach of EU rules on the basis that they failed to explain how the use of the standard EU public procurement rules would endanger Greek security interests.⁴⁰

35 'Guidance Note Defence- and security-specific exclusions', Directorate General Internal Market and Services, http://ec.europa.eu/internal_market/publicprocurement/docs/defence/guide-exclusions_en.pdf

36 'Defence Data 2009', EDA, 2009. <http://www.eda.europa.eu/WebUtils/downloadfile.aspx?fileid=1252>.

37 'Guidance Note: Offsets', Directorate General Internal Market and Services, http://ec.europa.eu/internal_market/publicprocurement/docs/defence/guide-offsets_en.pdf.

38 Ibid.

39 Ibid.

40 'Public procurement: Commission calls on Greece to amend procedure for awarding supply contract for submarine battery kits', *Europa*, 2010, <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1558&format=HTML&aged=0&language=en&guiLanguage=en>.

This case illustrates that it is difficult to argue how the use of offsets is essential to a nation's security interests when the technology is being imported from another country. Governmental attitudes to the use of offsets for intra-EU defence contracts can be split into four main groups:⁴¹

- France and Germany do not accept offsets as a matter of policy and imports are fairly limited.
- Italy, the Netherlands, Sweden and the United Kingdom are net exporters but also have considerable imports. They import mainly from the United States and rely on indirect military offsets as a tool for providing opportunities to their sizeable defence industries.
- Finland, Greece, Poland, Portugal and Spain are the main EU defence equipment importers and attach a high importance to direct offsets.
- The other member states are relatively small actors that tend towards indirect civil offset owing to their limited defence industry capacity.

Clearly, the removal of offsets would have the biggest impact on the defence industries in Finland, Greece, Poland, Portugal and Spain. The investment in equipment procurement and R&D by these countries amounted to 16% of the EU total in 2009.⁴² EU contractors exporting to these countries will not be able to include in their contracts offsets such as the use of local subcontractors, technology transfer or investment in R&D programmes. The result should be a loss of some defence-industrial capacity in these importing countries, and consolidation on the EU level as contractors choose to use existing suppliers and facilities elsewhere to avoid duplication. There is evidence that offsets allow foreign defence companies to gain access to new lower-cost suppliers, leading to increasing competition in the EU-wide supply chain.⁴³ Thus in order to maintain the trans-border industrial relations that are stimulated by offsets, the EDA and OCCAR may have a role to play in encouraging defence contractors to make use of the EU-wide supply chain.

The Commission has already moved to discourage member states from procurement outside the EU to avoid the rules of the directive. Member states that purchase defence equipment from the government of a third country should 'not to use such contracts for the purpose of circumventing the provisions of the directive', particularly where 'market conditions are such that competition within the internal market would be possible'.⁴⁴ Thus member states should not procure from outside the EU with the sole aim of including offsets in the contract. This creates an imbalance in that member states importing defence equipment will probably not be able to accept offsets but member states exporting outside the EU will still need to include them. This will have the greatest effect on Italy, Sweden, the Netherlands and the United Kingdom, which are net exporters but also have considerable imports from the United States that include indirect military offsets. The Commission will be keen for these member states to use open procurement for imports to ensure that offsets are not included in the contract and that EU defence companies can be included in the competition. This would result in a reduction of industrial capability previously supported by indirect offsets. These member states will continue to include offsets as part of their exports to nations outside the EU (as noted, they are commonplace in defence contracts).

Shaping the EU defence industry

The directive will have the biggest impact on equipment that is considered non-sensitive and on intra-EU exports. These two areas of the EU defence industry will be open to attack from both the Commission and defence contractors if member states decide to use selective procurement

41 E. Anders Eriksson, 'Study on the Effects of Offsets on the Development of a EU Defence Industry and Market', EDA, 2007.

42 'Defence Data of EDA participating Member States in 2009', EDA, 2011,

http://www.eda.europa.eu/Libraries/Documents/National_Defence_Data_in_2009.sflb.ashx.

43 Gueorgui Ianakiev and Nickolay Mladenov, 'Offset Policies in Defence Procurement: Lessons for the EU Defence Equipment Market', http://www.city.academic.gr/special/events/economics_and_security09/abstracts/ianakiev.pdf.

44 'Guidance Note: 'Defence- and security-specific exclusions'.

methods. Equipment considered essential to national security interests will continue to be protected by Article 346. In the long term budgetary pressures, rising costs and the indirect effects of the directive may create industrial clusters for sensitive equipment.

The directive

Its targeting of Greek offsets in 2009 indicates the Commission is likely make the removal of offsets its first priority after the directive comes into force. This will have significant implications for the five main EU defence importing countries, which will be forced to make off-the-shelf purchases and will be unable to use direct offsets to support their indigenous defence industries. Defence-industrial strategy in these countries will have to be re-evaluated with a possible focus on specific domestic industries in which they have some competitive advantage in the EU. Off-the-shelf purchases will then supplement the rest of the nation's military equipment requirements. This would have the desired effect of curbing protectionism, since member states will be unable to use offsets to maintain industrial capabilities that are duplicated in the EU.

Addressing the issue of non-sensitive equipment will be more difficult as it is more of a grey area than the use of offsets. The Commission may hope that a tough stance towards offsets will encourage the main arms-producing nations (France, Germany, Italy, Sweden and the United Kingdom) to think more carefully about confining procurement within national boundaries. If member states fail to open up procurement the Commission will have to build up case law over the long term. However, it will want to tread carefully to avoid a strong reaction from member states and being seen as the destroyer of the EU defence industry. Thus a long-term approach will probably be required to encourage member states to embrace the new rules. Defence companies may also be interested in challenging closed procurement decisions in the European Court of Justice but they too will want to tread cautiously to avoid angering potential future customers. Thus the impact of the directive on protectionism in the area of non-sensitive equipment will be limited at first and grow in the long term as case law is built up.

Industrial clustering

Sensitive equipment that can be proved in court to be essential to national security will remain protected by Article 346. In the short term member states are likely to maintain indigenous industrial capability in this area by procuring from within national boundaries. In the long term the number of cooperative programmes in the EU may increase, for three reasons:

1. Cost pressures:

Budgetary pressures and rising equipment costs will force member states to consider more cooperative programmes that allow increasing development costs to be shared.

2. Threat of liberalization:

Liberalizing the market for non-sensitive equipment creates an environment in which defence contractors may challenge closed procurement decisions made by member states in the grey area between sensitive and non-sensitive equipment. Member states then face a risk in that they could invest in R&D for a new project but then be forced to open up the project to competition at later phases of the product's life-cycle. This would make it difficult for member states to justify investment if there is uncertainty over whether the manufacturing contract would be carried out domestically. As noted above, cooperative programmes with an R&D phase are exempt from the directive and thus can avoid the problem.

3. Military harmonization:

Liberalizing the market for non-sensitive equipment could increase military harmonization in the EU, resulting in similar equipment being used by different member states. Open procurement will establish the lowest price and best-quality equipment; this will be

preferred among member states and thus more units will be sold. This may in turn have an effect on the harmonization of sensitive equipment that interacts with non-sensitive equipment. This could act as a further incentive to undertake cooperative programmes.

In the very long term, over this century, an increase in cooperative programmes could create 'industrial clusters' of strong indigenous industries with similar equipment requirements in the EU. Examples could be France and the United Kingdom focusing on destroyers and amphibious vessels; Italy, Germany and Sweden on unmanned air vehicles,⁴⁵ Spain and the Netherlands on diesel submarines etc. If these industrial clusters became dominant in the EU, further budgetary pressures might encourage member states to focus investment in their own clusters and buy off the shelf from other clusters. The end result should therefore be less duplication in the EU as member states focus investment on dominant industrial clusters and close non-core capabilities that are duplicated by other clusters. Industrial capabilities are still protected by member states but they are protected on an EU scale that allows for a reduction in the number of duplicated facilities.

45 'Germany, Italy and Sweden hold advanced UAV project talks', *Air Attack*, 11 July 2006, <http://air-attack.com/news/article/1866/07-11-2006-Germany-Italy-and-Sweden-hold-advanced-UAV-project-talks.html>.

ACHIEVING AFFORDABILITY

'In the year 2054, the entire [US] defense budget will purchase just one aircraft. This aircraft will have to be shared by the Air Force and Navy 3½ days each per week except for leap year, when it will be made available to the Marines for the extra day.'

Augustine's Law⁴⁶

The Eurofighter Typhoon went into service in 2003 and has an estimated unit production cost of £69.3m. The Tornado F2 went into service in 1986; its estimated unit production cost was £39.4m at 2005 prices.⁴⁷ This 'inter-generational inflation' is generally accepted to be between 3% and 5% above 'normal' inflation for major defence projects.⁴⁸ The problem with inter-generational inflation is that if defence budgets rise in line with inflation the number of units that can be afforded slowly declines. The fear is that eventually member states will not be able to afford the military capability they need for national security and to project power globally if required. Indeed if the trend is followed to its absurd conclusion, according to Augustine's law eventually each member state will only be able to afford a very small part of a very advanced military capability – a Starship Enterprise, perhaps. The drive towards an EU defence equipment market is a response both to protectionism and to the need to address affordability in the EU defence industry. This section analyses the main drivers of high costs and inter-generational inflation in the defence industry and assesses the impact of the directive and industrial clustering on affordability.

Cost drivers in the defence industry

This section divides the main cost drivers in the defence industry into three areas: national champions, customer management and technology.

National champions

Breaking the national boundaries that fragment the EU defence industry is the main aim of the directive. The Commission's proposition is that duplicated defence programmes and facilities controlled by nationally based monopolistic companies across the EU would benefit from the increased efficiency an open market can offer. There are a number of reasons why national champions increase the cost of defence equipment:

- A defence equipment monopoly or 'national champion' exists in most defence-producing member states. The lack of competition means there is no incentive to increase operational efficiency or control costs.
- Security of supply means that the lack of competition flows down through the supply chain. Certain important suppliers may also have to be encouraged via financial incentives to continue supplying the defence industry in economically uncertain times.
- Relatively small numbers in production batches do not allow for economies of scale.
- Similar defence products are often produced in each member state, which results in duplication of R&D, production facilities and the supply chain.
- *Juste retour* practices result in an inefficient system overall, in which one product is designed and manufactured in a number of different international facilities so that member states receive a fair return from the amount invested.

46 'Aircraft Cost Growth And Development Program Length: Some Augustinian Propositions Revisited - Statistical Data Included', *Acquisition Quarterly Review*, 2000, http://findarticles.com/p/articles/mi_m0JZX/is_3_7/ai_78360113/.

47 'Defence Inflation: Reality or Myth?', RUSI, 2009, http://www.rusi.org/downloads/assets/Comment_Defence_Inflation_Myth_or_Reality.pdf.

48 Ibid.

- There is an incentive for a monopolistic national champion to under-value the cost of defence projects because the customer will pay for cost overruns to ensure the completion of projects that are essential for national security.

It has been suggested that a liberalized EU defence market would save 10% in equipment costs.⁴⁹ This figure assumes complete liberalization of the EU defence industry through market forces; however, for national political reasons this seems unlikely. But there are three areas of savings that would result from liberalization: consolidation, competition and economies of scale.

1. Consolidation

Germany, Sweden, France, Spain, Italy and the Netherlands all manufacture diesel submarines for their respective navies.⁵⁰ Thus a design and manufacturing capability is maintained in each country to produce six similar defence products. The cost to design and manufacture a product can be split into direct and indirect costs. Direct costs can be attributed to a particular product line – for example, salaries for project staff and materials. Indirect costs or overheads are defined as costs attributed to the general operation of the business rather than a particular product line – for example, indirect labour, IT, utilities and facility maintenance. Consolidating the diesel submarine industry in the EU from six production facilities to, say, two would require some sort of expansion at the manufacturing facilities, where production would be increased, but would result in a reduction in direct and indirect costs for each submarine, and hence lower unit costs.

2. Competition:

Competition in the commercial goods sector generally results in greater product diversity and lower costs as companies compete to win market share. However, achieving competition is difficult when individual firms have a large influence over the market and political imperatives ensure firms have enough work to survive. In the United States, for instance, the DOD tries to maintain competition by keeping at least two contractors in each capability. As a result it must ensure each contractor has enough work to survive regardless of the quality of work produced. Boeing lost the Joint Strike Fighter contract in 2001 but the DOD ensured that the company had enough maintenance and repair work to survive in the military aircraft business to maintain competition against Lockheed Martin. Thus defence companies in the United States as in the EU have little incentive to control costs and increase efficiency because they are guaranteed work. There is some export competition in the EU defence industry but national champions are guaranteed work by governments regardless of their export success.

3. Economies of scale:

The savings associated with economies of scale are generally attributed to bulk buying, labour specialization, lower interest borrowing and maturity of technology. These savings are less applicable to the defence industry than to commercial goods because technology updates are often added in the lifetime of an equipment platform and the first unit produced can often be very different from the last. The US defence industry generally has larger batch sizes than those in Europe. The US defence budget is twice that of the combined EU budget,⁵¹ and there are also fewer major defence programmes (in 2005 there were 27, as opposed to 89 in the EU).⁵² However, the United States and the EU have similar problems with cost growth in defence programmes. This indicates that other factors such as customer management may be more important.

49 Hartley, 'A single EU market for defence equipment'.

50 Kai Oscar Torkelson, 'Comparative Naval Architecture Analysis of Diesel Submarines', 2005, <http://dspace.mit.edu/bitstream/handle/1721.1/33587/63761809.pdf?sequence=1>.

51 'The EU Defence Package: Towards Liberalisation and harmonisation of the EU Defence Budget', The Flemish Peace Institute, April 2008.

52 'Lessons learnt from EU Defence Equipment Programmes', European Union Institute for Security Studies, October 2007, <http://www.iss.europa.eu/uploads/media/occ69.pdf>.

Customer management

Customer management refers to the ability of government defence ministries within member states to procure defence equipment and manage the procurement process. Ineffective customer management could be a significant driver of cost growth in defence programmes. The problems with customer management in the defence industry may be summarized as follows:

- Changing specifications through the life of the project in response to pressures on the defence budget.
- Uncertain batch size over the life of the project, making it difficult for contractors to benefit from economies of scale.
- Gold plating – defence ministries are often accused of trying to procure the 100% solution where an 80% solution may be more cost-effective and easier to export while still operating effectively.⁵³
- Insufficient planning, which means the customer does not fully understand the project at the start, possibly resulting in price increases over the life of the project and sometimes the cancellation of projects at huge expense owing to budget pressures.
- Rivalry among the armed services, which can result in projects being pursued regardless of affordability.

It often seems that governments go ahead with projects when they are unsure whether resources match requirements, whether the product design is stable or whether the manufacturing processes are mature.⁵⁴ The result can be a difficult relationship between the government and defence contractors; a relationship which might not produce good results in terms of project time and cost.

Technology

Technology is the third area used to justify the high cost of defence equipment. It is the only area that can be readily attributed to inter-generational cost increases because it is the only one that consistently changes from generation to generation. National champions and poor customer management are relatively constant factors in defence but technology is continuously improving. The following points offer some explanation of why technology is blamed for high costs:

- Continuously increasing technological complexity of defence equipment is required to keep up with adversaries. Employing cutting-edge technology adds an unknown element to design and production.
- Increasingly complex technology requires ever-longer periods of development, testing and manufacture, which affects cost.
- The cost of high-performance materials, which are often used in the defence industry, has grown considerably as commodity prices have risen.
- Defence companies often complain of a shortage of skilled labour with the experience to work with cutting-edge technology.
- The increasingly rapid change in technology complexity results in designs being changed during the life of the programme.

The nature of technology in defence means that the highly advanced technology is widely considered essential in order to maintain initiative and advantage over actual and potential adversaries. The result is a product which is constantly changing and difficult to design and manufacture. Continuously changing technology is inherent in defence equipment and the directive

⁵³ Bernard Gray 'Review of Acquisition for the Secretary of State of Defence', October 2009, <http://www.ndi.org.uk/files/file/Publications/MoD,%20Government%20and%20Industry%20Reports/Gray%20Report.pdf>.
⁵⁴ 'Defence Acquisition Assessment of Selected Weapon Programmes', US GAO, 2010.

or EU-wide consolidation will not reduce the difficulties contractors face in working with advanced yet untried technology.

Impact of the directive on affordability

The ultimate aim of the directive is to reduce the cost of defence equipment in the EU. The directive will now be split into non-sensitive programmes and intra-EU exports to assess whether these two areas will result in cost savings.

Non-sensitive programmes

Liberalizing non-sensitive programmes would result in increased competition and lower prices as defence companies across the EU are forced to compete for contracts which would have previously been placed within national boundaries. Member states would procure the lowest-priced and best-quality equipment in the EU regardless of where it is designed and manufactured. The result would be consolidation as the market decides where to manufacture non-sensitive programmes and closes duplicated facilities. The liberalization of non-sensitive national programmes would be unlikely to have any effect on the relationship between defence companies and government; the same problems with customer management would still exist. To avoid losing industrial capability owing to market forces, member states have the option of pursuing cooperative programmes which will not produce any increased competition or consolidation. However, the project would have to be large and complex enough to warrant a cooperative programme.

Intra-EU exports

Removing offsets from intra-EU exports should ensure that the cheapest and best-quality products are chosen rather than the most attractive offset package. This would create a consolidating effect as defence companies chose where to manufacture and which subcontractors to use. The investment in equipment procurement and R&D by the five countries which import the most EU equipment amounted to 16% of the EU total in 2009.⁵⁵ A portion of this would be redistributed by the market rather than fall prey to protectionist practices, thus resulting in cost savings for off-the-shelf goods. Removing offsets from intra-EU exports is unlikely to have a significant effect on customer management because off-the-shelf products do not have the same complex customer management issues as newly designed products.

Impact of industrial clustering on affordability

In the very long term, over this century, industrial clustering at the EU level would result in significant cost savings as duplicated facilities are closed across the EU. This could only occur if the number of cooperative programmes increased and cost pressures became significantly worse. If member states decided to pursue more cooperative programmes, this would be likely to exacerbate the problems associated with customer management and increase costs. Collaborative programmes increase the need for EU nations to harmonize military requirements – a goal that could be possible but is certainly difficult. For example, France was originally interested in collaborating on the Eurofighter but decided to pursue the national Rafale programme owing to a disagreement about military requirements. The obvious solution is a single EU defence procurement agency that procures for an eventual single EU military force. However, this would require a harmonization of foreign, security and defence policies and strategies – and this would prove even more difficult than the harmonization of military equipment requirements. Cooperative

⁵⁵ 'Defence Data of EDA Participating Member States in 2009', EDA, 2011, http://www.eda.europa.eu/Libraries/Documents/National_Defence_Data_in_2009.sflb.ashx.

programmes will thus allow customers to share development costs but problems with the complexity of multi-customer management may result in increased overall costs. Industrial clusters will probably not stimulate cost reductions through increased competition: although they would have to compete for export contracts both within and outside the EU, they are guaranteed work by the member states that invest in the cluster regardless of export success. This would follow the current status quo in which national champions are guaranteed work regardless of cost, efficiency or export success. Thus industrial capabilities are still protected by member states but they are protected on an EU scale which allows for a reduction in the number of duplicated facilities.

CONCLUSIONS

The directive is a positive move which provides a regulatory framework for defence equipment contracts and exports within the EU. It will have some success with offsets and non-sensitive programmes but ultimately the European Commission will struggle to create a truly liberal EU defence equipment market. Protectionist practices are commonplace in the EU and considered vital to national security. For the Commission to achieve its aims of lower-priced defence equipment, it will be necessary for EU member states to be willing to foster a more integrated EU defence industry. In the short and medium term this will be difficult for many EU governments to accept. Over the very long term, however, the directive could combine with the effect of diminishing defence budgets to create the basis for a shift from the current protectionist practices.

Early indications are that the Commission will first tackle offsets in the EU as a low-hanging fruit. It is difficult for member states to argue that offsets are essential to national security interests when technology is imported from abroad. This will have a significant effect on the five main EU defence equipment importers (Finland, Greece, Poland, Portugal and Spain). These countries will not be able to support indigenous industrial capability with offsets, which could force them to rethink defence procurement in the future. The likely outcome is that they will focus investment on specific domestic industries in which they feel they have a competitive advantage and buy off the shelf from other countries.

Tackling national programmes in the main EU arms-producing nations (France, Germany, Italy, Sweden and the United Kingdom) will be more difficult. The Commission will probably adopt a more cautious approach, hoping that dealing with offsets will encourage member states to think carefully about closed procurement decisions. If member states continue to procure equipment within national boundaries the Commission will need to slowly build up case law for non-sensitive national programmes over the long term. The Commission will want to be seen as the long-term protector of the EU defence industry by helping to reduce equipment prices rather than as a short-term destroyer of industrial capability and employment in a bid to enforce EU procurement rules. Defence companies may also have a part to play in challenging procurement decisions but will not want to sour possible future relationships with new customers. Enforcing the directive for national programmes will thus be a long-term process which will require the balancing of member states' sensitivities and the desire of both the Commission and defence companies to open up procurement.

In order to seriously reduce equipment prices, industrial duplication must be tackled in the EU. This will require a shift in thinking as member states struggle with both reduced budgets and pressures to open procurement. In the very long term, over this century, sharing more projects to reduce costs and avoid possible legal wrangling may create an environment in which member states invest in shared capability clusters, allowing them again to focus investment in certain areas and buy off the shelf from other clusters within the EU. Trust, cooperation and an acknowledgement of shared interests in defence procurement between member states will be required for these changes to become reality.

The directive should have a positive effect on intra-EU exports in the short term as member states will increasingly make their off-the-shelf procurement decisions on the basis of price and quality of equipment rather than the attractiveness of the offset package. This will result in consolidation, fairer competition and lower equipment prices. In the long term the Commission and defence companies will take a more cautious approach in attacking non-sensitive national programmes. After case law is built up this should also result in increased consolidation, improved competition and lower prices for non-sensitive national programmes. In the very long term industrial duplication must be tackled to significantly reduce equipment costs. This can be achieved if the combination of more cooperative programmes and further austerity measures fosters an environment of shared interests and trust with regard to defence procurement in the EU. If member states want to continue to play a significant role in global military intervention in the future they must find a way to cooperate to reduce the rising cost of defence equipment.

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