



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.3.2003
COM(2003) 113 final

**COMMUNICATION FROM THE COMMISSION
TO THE COUNCIL, THE EUROPEAN PARLIAMENT, THE EUROPEAN
ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE
REGIONS**

EUROPEAN DEFENCE - INDUSTRIAL AND MARKET ISSUES

Towards an EU Defence Equipment Policy

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EXECUTIVE SUMMARY

In 1996 and 1997 the Commission produced two Communications to encourage industrial restructuring and greater efficiency in the European Defence Equipment Market. Some of these ideas came to fruition. But Member States did not act in a number of essential areas – feeling, perhaps, that the proposals were before their time. Following a period of transformation in this sector and in the institutional framework of the EU, including the beginnings of a real European Security and Defence Policy (ESDP) the European Parliament, in a Resolution of 10 April 2002, invited the Commission to present a new Communication.

These issues have been brought into sharper focus by the Convention on the future of Europe. A working group on defence has made substantive recommendations which will be the subject of further work over the coming months.

Strengthening the industrial and market situation of European defence companies will greatly improve the EU's ability to fulfil the Petersberg tasks in the accomplishment of ESDP. It will also benefit collective defence by strengthening Europe's contribution to NATO.

Whatever the long-term prospects for a full common European defence equipment policy, the Commission is determined to make progress at once wherever this may be possible. The present Communication therefore proposes action in the following fields:

- Standardisation: Stakeholders recognise the need for harmonised European approach to defence standardisation. The Commission is working on this issue with CEN to assist co-operation between Ministries of Defence and industry to develop, by the end of 2004, a handbook cataloguing standards commonly used for defence procurement.
- Monitoring of defence related industries: Stakeholders need a clearer picture of the defence industrial and economical landscape in Europe. To achieve this, the Communication proposes to launch a monitoring activity on defence-related industries.
- Intra-community transfers: It has long been argued that a simplified European licence system could help to reduce the heavy administrative procedures, which impede the circulation of components of defence equipment between EU countries. The Commission proposes to launch an impact assessment study in 2003 and, depending on its results, start elaborating at the end of 2004 the appropriate legal instrument.
- Competition: Competition improves market efficiency and protects innovation. Consequently, and without excluding the possibility of exceptions consistent with the Treaty, the Commission intends to continue its reflection on the application of competition rules in the defence sector.
- Procurement rules: Harmonised procurement rules for defence equipment would also increase market efficiency. On this basis, a reflection on how to optimise defence procurement at national and EU levels should be initiated in the EU. The end goal would be to have a single set of rules for procuring defence equipment in Europe. There have been several important Court judgements in recent years that are relevant to this work - especially in helping to define the scope of Article 296. The

Commission will issue an Interpretative Communication by the end of 2003 on the implications of these judgements. In parallel, it will work on a Green Paper which might be issued in 2004 as a basis for discussion with stakeholders.

- Export control of dual use goods: International export control regimes exist – but in most cases, the EC is not a member. The consequence is that Member States often adopt uncoordinated positions, which may unnecessarily limit export opportunities for EU civil industries and may affect the functioning of the internal market after enlargement. The Communication proposes to raise this issue in relevant Council bodies.

- Research: The Communication proposes to consult Member States and industry in 2003 to identify common needs and to establish a security-related research agenda. In this respect, the Commission intends to launch a pilot project.

The Commission has followed the debate on a possible EU Defence Equipment Framework overseen by an Agency (or Agencies). Such a framework could help to co-ordinate national collaborative programmes and provide a basis for drawing in Member States, which are not presently engaged. Until now, Member States have chosen to conduct most of this work outside the EC Treaty, but there may also be a place for certain Community instruments and mechanisms.

INTRODUCTION

In 1996 and 1997 the European Commission produced two Communications¹ on defence-related industries to encourage restructuring and the setting up of an efficient European defence equipment market. Concrete proposals and actions followed with respect to some of these issues. However, as regards the most essential reforms, Member states considered action on the European level premature.

Following a period of considerable change in the industrial armaments sector and in the institutional framework of the EU, including developments in ESDP, the European Parliament, in a Resolution of 10 April 2002, invited the Commission to address the issue of armaments in a new Communication.

In autumn 2002 the Convention on the Future of Europe set up a working group on defence chaired by the European Commissioner, Michel Barnier. The working party's report² stressed that the credibility of European defence policy depends on the existence and development of a European capacity and a strengthening of the industrial and technological base of the defence sector.

Taken together, EU Member States spend less than half of what the U.S. spends on defence³. The total US budget comes to an annual \$390 billion, compared to a cumulative budget of €160 billion for EU Member States together. For many years, defence investment in Europe has been significantly smaller than in the USA in procurement (€40bn per annum in Europe compared to \$100bn in USA) and in research (€10bn in Europe compared to \$50bn in USA). But apart from absolute levels of spending which are necessarily a function of their respective objectives, Europe yield much less in terms of operational capabilities. The real military capability of EU Member States is estimated at about 10 per cent of that in the US⁴. This issue has repercussions for the transatlantic relationship. A reinforced European defence and technological industrial base can provide an important contribution to collective security in the context of NATO and other partnerships. Taxpayers should get the most out of the investment they make in security. There is ample evidence that this is not the case at present and that a European defence equipment market would bring significant savings in costs. It is crucial for both civil and defence sectors of the economy that we create an environment in which European companies can give better value for money. That is why the Commission wishes to set the questions of arms trade and production in their industrial context. The scope of concern encompasses all industrial activity in Europe related to components, which may end up in civil and/or military products.

Cost efficiency of defence spending, the maintenance of a competitive defence and technological industrial base, better access for EU manufactured goods to third markets, ethics and fairness in the arms trade, security of supply, and also the need to respect Member States prerogatives in this sensitive area are all important considerations when defining an EU armaments⁵ policy.

¹ COM(96)10 and COM(97)583.

² Final report of working group 8 on Defence: CONV461/02 dated 16 December 2002.

³ Regardless of the increase in the US defence budget from 2003 totalling some 100 billion \$ over a three year period.

⁴ Cf. European Parliament Resolution of 10 April 2002.

⁵ For the purpose of this Communication synonymous with defence equipment policy.

On the military side, the efficiency of multinational corps such as Eurocorps, Eurofor, and Euromarfor requires the highest degree of interoperability of their armaments. To achieve this in a cost-effective way, the solution would be to equip the national units that make up these forces increasingly with the same equipment.

On the industrial side, the survival of a European defence industrial base able to support the ESDP will depend on successful national and trans-European consolidation of the industry as well as transatlantic partnerships between companies. The currently fragmented legal and regulatory framework places limits on the adjustment capabilities of companies or pushes them towards strategies and alliances which put the Union in a disadvantageous position. Failure to safeguard a competitive defence industrial base, and the loss of autonomous design and innovation capabilities, limits available choice and is bound to lead in the long run to higher procurement costs.

For all these reasons, there is a strong case for a more co-ordinated EU defence equipment policy. Just as the ESDP complements, national defence policies and NATO, an EU Defence Equipment Policy would complement corresponding national policies.

One key contribution that the Commission can make in this field is in seeking to improve the quality of the EU regulatory framework governing the treatment of armaments in Europe. This is the purpose of the present communication.

European defence industries compete on a global market. The Commission acknowledges the need to address at a later stage some particular issues such as the improvement of the functioning of the existing Code of Conduct on Arms and wider opening of third country markets to European defence products.

1. RECENT DEVELOPMENTS STRENGTHEN THE CASE FOR A EUROPEAN DEFENCE EQUIPEMENT POLICY

1.1 Recent developments inside and outside the EU

The 1999 European Councils of Cologne and Helsinki gave new impetus to European security and defence policy through the definition of a headline goal to be achieved by 2003; and with the creation of new EU structures such as the Political and Security Committee, the EU Military Committee and the EU Military Staff. The European Capability Action Plan (ECAP), which seeks to fill EU capability shortfalls, is likely to include off-the-shelf procurement and collaborative programmes as well as defence research and technology measures.

A close co-operation is being established with NATO to enable the EU to have assured access to NATO planning assets for ESDP operations. Extensive consultations are taking place in this context in order to ensure maximum compatibility of EU and NATO concepts for this purpose.

Meanwhile, outside the EU institutional framework there has been further substantial restructuring of defence-related industries. Companies – faced by ever-stronger competition, notably from the US – are crying out for a more open and efficient market to improve the competitiveness of the European defence technological and industrial base. Groups of Member States have responded to the new challenges by entering into ad hoc agreements such

as the Letter of Intent (LoI)⁶ and its Framework Agreement which aim to facilitate industrial restructuring; and the “Joint Armaments co-operation organisation” known as OCCAr (*Organisme Conjoint de Coopération en matière d’Armement*)⁷, which aims to improve the management of co-operative armament programmes.

These various initiatives in the field of European armaments trade and production need to be underpinned by a more coherent overall framework in order to bring more legal certainty and attract participation by a larger number of Member States.

The recent adoption of Council regulation (EC) No 150/2003⁸ suspending import duties on certain weapons and military equipment constitutes a step forward towards setting up a European Defence Market.

These objectives have been brought into even sharper focus by the Convention on the future of Europe. One of its working groups had a fundamental debate on defence, and made substantive recommendations⁹ which will be the subject of further scrutiny and debate in the course of the Convention’s deliberations over the coming months.

1.2 European Armaments and industrial policies

There is an intrinsic unity of purpose in the European Union’s internal policy, including the Lisbon targets, and external goals to which all policies and instruments must contribute. The Commission considers that the dynamism of industry is essential for Europe to be able to sustain and increase its prosperity while meeting its wider social, environmental and international ambitions¹⁰. One of the aims of its Communication of 11 December 2002 on Industrial Policy in an Enlarged Europe is to place industry back on the policy agenda. A key message is that Industrial Policy, while being horizontal in nature, needs to take into account the specific characteristics and needs of every individual sector. In that context, the STAR 21 report published in July 2002 contained an in-depth analysis of the situation and challenges facing Europe’s aerospace sector with particular emphasis on the need to address the defence dimension. A similar exercise concerning maritime industries (LeaderSHIP 2015) was launched in January 2003.

In that spirit and with a view to the Spring European Council on 21 March 2003, proposals were made by the Commission and also by Member States on structural reform and modernisation in Europe with a view to strengthening economic competitiveness and guaranteeing employment opportunities for all. *Inter alia*, measures were proposed to lift barriers regarding market and competition conditions, to rapidly conclude legislation on the internal market which is currently being reviewed, with a view to obtaining results that truly open up the markets, to enhance research results and to establish clearer links between research institutes and business creation.

6 The Letter of Intent and its Framework Agreement include six countries namely: France, Germany, Italy, Spain, Sweden, and the United Kingdom. Its aims at facilitating the industrial restructuring process.

7 The OCCAr includes four countries, namely: France, Germany, Italy, and the United Kingdom. This international organisation aims at improving the management of co-operative programs.

8 A Council Regulation on the basis of Art. 26 TEC was adopted in January 2003 suspending import duties on certain weapons and military equipment OJ n° L25 of 30.1.2003, p. 1.

9 Final report of Working Group VIII - Defence of 16 December 2002; CONV 461/02

10 COM (2002) 714 on Industrial Policy in an Enlarged Europe dated 11 December 2002.

Failure to enhance the contribution of Community policies, especially on trade, development, internal market, research, and competition policy will result in sub-optimal solutions in terms of the effectiveness of the ESDP. In turn failure to develop a European dimension to the defence equipment market, and to invest in research, is certain to have a negative effect on the competitiveness of high technology enterprises. Knowledge and innovation are essential elements in enabling those enterprises to compete and to co-operate on an equal footing with international competitors such as U.S. companies which themselves enjoy a far higher level of backing of their governments.

Although some EU companies are world-class innovators, a low share of European patent and R&D activity vis-à-vis the EU's main competitors means that, overall, Europe's innovative performance remains too weak. These facts lie behind the less encouraging competitiveness performance of the EU in some of the highest value added segments of the economy. Different measures of comparative advantage reveal that the EU tends to specialise in medium-high technology and mature capital-intensive industries. If it is essential to keep the strengths in these sectors, which represent a higher share of total output and employment, the EU should seek to improve its position in enabling technologies such as ICT, electronics, biotechnology or nano-technology, where it often lags behind its main competitors. Technology-driven industries are not only a source of knowledge and technological spill over throughout the economy, they are also the ones which exhibit greater productivity growth. The European industry's relative weakness in these fields as well as their low share in the economy weigh on the overall growth and productivity performance of the EU.

The reality is that a major contribution to security and defence systems now comes from industries and SMEs developing their products and services primarily for civil applications.

The defence-related industries could benefit from the approach proposed in the EU industrial policy communication.

1.3 European armaments policy and the Treaty provisions

Questions of trade and production of armaments lie at the intersection of defence and industrial policies. In the past, it has proved difficult to reconcile industrial and defence imperatives. The European armaments industry has suffered as a consequence. A more appropriate framework needs to be defined.

Over the years wide application of Art. 296 ECT¹¹ has led to fragmentation of markets and industries at national level. However, it should be possible to improve the situation within the provision of the current Treaties. With sufficient will, it should be possible to frame a common set of rules on defence equipment, which will take due account of the specificities of armaments thereby progressively limiting recourse to Article 296. Some of the rules required

11 TEC article 296 :

1. The provisions of this Treaty shall not preclude the application of the following rules:

(a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

(b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.

2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.

may either fall under pillar one (the EC treaty) or pillar two (Common Foreign and Security Policy) of the EU treaty¹².

2. OBJECTIVES OF A EUROPEAN DEFENCE EQUIPEMENT POLICY

Armament policy issues¹³ can be conveniently grouped under four headings:

- (1) Defence equipment demand: harmonisation of the military and other security-related requirements as well as the planning and procurement of defence-related equipment.
- (2) Defence equipment supply: completion of the industrial consolidation process (primarily the responsibility of industries themselves); supportive policies and actions by the Commission and Member States towards the creation and maintenance of a competitive industrial structure in Europe.
- (3) Defence equipment market: an appropriate regulatory framework addressing internal and external aspects; appropriate rules for cost-efficient procurement of goods and services both by member states defence procurement Agencies and by any future European Agency(ies); and economically efficient export controls. All this needs to be developed while preserving ethical standards and promoting reciprocal market access.
- (4) Research: co-operation and coherence of defence-related research at European level; exploitation of civil-military synergies.

Community action is most likely to be able to add value in the third and fourth areas above.

12 TEU Article 17

1. The common foreign and security policy shall include all questions relating to the security of the Union, including the progressive framing of a common defence policy, which might lead to a common defence, should the European Council so decide. It shall in that case recommend to the Member States the adoption of such a decision in accordance with their respective constitutional requirements.

The policy of the Union in accordance with this Article shall not prejudice the specific character of the security and defence policy of certain Member States and shall respect the obligations of certain Member States, which see their common defence realised in the North Atlantic Treaty Organisation (NATO), under the North Atlantic Treaty and be compatible with the common security and defence policy established within that framework.

The progressive framing of a common defence policy will be supported, as Member States consider appropriate, by co-operation between them in the field of armaments.

2. Questions referred to in this Article shall include humanitarian and rescue tasks, peacekeeping tasks and tasks of combat forces in crisis management, including peacemaking.

3. Decisions having defence implications dealt with under this Article shall be taken without prejudice to the policies and obligations referred to in paragraph 1, second subparagraph.

4. The provisions of this Article shall not prevent the development of closer co-operation between two or more Member States on a bilateral level, in the framework of the Western European Union (WEU) and NATO, provided such co-operation does not run counter to or impede that provided for in this title.

5. With a view to furthering the objectives of this Article, the provisions of this Article will be reviewed in accordance with Article 48.

13 These were already addressed in the Commission's 1997 Communication on armaments which findings and recommendations are still valid.

2.1 Defence equipment demand

New common security risks will increasingly be dealt with by multinational coalitions, requiring interoperability between national forces.

In the ESDP context, in consistency with NATO, there is also an urgent need to enhance the harmonisation of defence equipment requirements. To be beneficial in economic terms, this should be translated into common defence equipment programmes with common technical characteristics and seamless procurement schedules. The number of defence equipment programmes and subsequent procurements that could be undertaken jointly by the largest possible number of Member States should be increased.

That process should help to deliver economies of scale in production and savings from increased bargaining power in acquisition leading to reduced costs, in addition to the advantages which arise from increased interoperability. More predictability and consistency at European level on planning and acquisition would enable industry to anticipate and better adjust its production capability.

Given the long lifetime of defence equipment, harmonisation of the planning and procurement of equipment will also depend on an improvement in the current European Capabilities Action Plan (ECAP) which should help to bring a longer-term perspective.

Overall guidance, monitoring of progress and matching financing methods to ECAP proposals will require the active involvement of both the European Council and Defence Ministers in order to maintain impetus and to provide the necessary political authority to ensure rapid decisions.

2.2 Defence equipment supply

As noted above, there has been steady consolidation in defence-related industries in recent years. This is especially so in aerospace which, in the course of its rationalisation, has reinforced its European dimension. There have not yet been comparable levels of rationalisation of land-based systems and naval shipyards. Major consolidation in these sectors is now required in order to maintain Europe's capacity in areas, where Europe has traditionally been strong and technologically advanced.

Enlargement will bring special challenges in that the defence industries in the new Member States are for the most part loss-making. Restructuring and rationalisation are necessary to bring them to viability. This process could be facilitated by social and regional policies using the Community Structural Funds in accordance with existing modalities.

The need to share the huge development costs of new systems, and to gain insight into essential technologies, has driven European and American firms into partnerships, such as the Lockheed Martin-led Joint Strike Fighter, now renamed F-35: the biggest defence programme in history, worth \$200bn over the next 30 years. It is a programme that is likely to dominate defence industrial relations across the Atlantic for many years to come. The project offers participating countries the prospect of work for their local industry in advanced aerospace technology. Four EU member states have signed up to participate in the programme and committed around €4bn to it. The Pentagon has ordered 2900 aircraft. To illustrate the gap in transatlantic purchasing power, the largest European order amounts to only 150 aircraft.

However, in the meantime, three fighter jets are currently produced in Europe: the Eurofighter, which is a joint venture between Germany, Italy, Spain and the UK; the French Rafale; and the Swedish-British Gripen.

Such European projects do have certain advantages. They can also enter service more quickly than the F-35, as Rafale and Gripen are already in service, and Eurofighter is scheduled to arrive in 2003.

Such choices on key defence equipment programmes may have negative industrial policy consequences regarding the ability of Europe to sustain a competitive and indigenous fighter jet industry. This is likely to have an impact on civil business and commercial transport aircraft industries.

The results for European firms are very variable. Non-US firms are generally treated less favourably when they seek to supply or partner US firms in supplying to US procurement agencies. Firms from Europe also have to adopt special local arrangements in order to observe rules on ownership of defence firms in the United States. And even where European firms, or in some cases their governments, have invested heavily in new weapons systems to be developed in the US, their level of access to the key design and development phases is rarely satisfactory. In addition to the potential loss of the ability to keep companies with prime contracting status within the EU, the future of thousands of SMEs' throughout Europe which are directly or indirectly linked to these contractors will be adversely affected.

There is a danger that European industry could be reduced to the status of sub-supplier to prime US contractors, while the key know-how is reserved for US firms.

Decisions on restructuring in Europe will be taken in the first place by firms themselves as a function of market realities, including the interests of their shareholders. But there are limits to what companies alone can deliver in terms of further efficiency as long as the framework in which they operate remains unchanged. The interests of security of supply mean that Member States individually and collectively have a clear interest in a competitive industrial structure for the needs of national armed services and ESDP. Public interest also requires us to take account of the important spin off effects in terms of civil applications of these high tech industries.

2.3. Regulating the EU defence equipment market

European defence-related industries are currently at a critical stage in their development, and decisions taken now can be expected to determine their future prospects and strengths for decades to come. A further complication is that many of the same companies are involved in producing for both the civil and defence markets, which are governed by two separate regulatory frameworks.

It is vital to reduce the handicap of European companies vis-à-vis their competitors, in particular from the US, arising from the fact that the regulations governing defence-related activities are not homogeneous at EU level but fragmented at national level. As regards market access outside the EU, the fact that problems are normally dealt with at the level of individual Member States means an important loss of negotiating strength. The collective inability of European firms and their governments fully to exploit the weight of the Union, which comes from acting together, can only be to the detriment of European industry.

To overcome these problems Member States should aim to create a genuine European Defence Equipment Market. This would be in line with the objective already set by Member States which are members of Western European Armaments Group – WEAG¹⁴. In practice, the absence of binding commitments has weakened the achievement of this objective. That deficiency could be remedied by an EU framework of rules bringing legal certainty and uniform implementation of legislation. Such a framework could also pave the way for the involvement of a larger number of Member States.

2.4. Research

European Armament Organisation (WEAO)¹⁵ has any responsibility for managing cooperative defence-related research programmes but it handles only 2.5% of European investment in this area. Neither OCCAR or the LoI cover research at present.

European countries invest four to five times less than the US, and this gap is accentuated by the and fragmentation and compartmentalisation of European research. This allows the Americans to impose quality standards that Europeans often find hard to meet because of the failure to invest in certain key technologies.

In Europe there is a fairly strict divide between civil and military research. Technology transfers from the civilian sector to the defence sector remain low while there are significant transfer from European defence research to civilian activities. We need to multiply such synergies by creating a snowball effect that will strengthen European industrial competitiveness and help achieve the goal laid down by the Barcelona European Council of March 2002, namely 3% of GDP devoted to financing research by 2010.¹⁶

Defence-related research plays a major role in innovation in the US; it benefits the whole of industry, including the civilian sector. This interpenetration of defence and civilian research has benefited both the American arms industry and civilian users in terms of market access and costs. Note that the US military's procurement of advanced technology, whereby it shoulders the risk and the costs of demonstration and depreciation, has also benefited American suppliers and facilitated the integration of such technologies into civilian applications: the internet, the "Windows-icons-pointer" interface, the RISC microprocessor (found today in mobile telephones) and GPS (Global Positioning System) are all systems that were originally financed by American military research, notably through DARPA (Defence Advanced Research Project Agency).

3. Proposals for Action

Developing an EU defence equipment policy will be a long-term process involving many different stakeholders. The present Communication focuses on a number of specific measures, which the Commission believes can make a contribution to achieving broader EU objectives. The proposed measures are intended to encourage industrial restructuring and consolidation,

14 Their Defence Ministers have already approved a set of principles laid down in the Coherent Policy Document (CPD) in 1990 and in an updated CPD in 1999 aimed at making their armaments activities WEAG-wide.

15 The WEAO has 19 members (European members of NATO): Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, Sweden, Turkey, United Kingdom. The Netherlands took over the chair on 1 January 2003 for two years.

16 COM(2002) 499 final.

to promote the establishment of a European defence equipment market and to enhance competitiveness of the European industry, and to achieve broader socio-economic objectives.

3.1 Towards a European defence equipment market.

3.1.1. Standardisation

While work on standardisation of defence equipment is largely a technical matter, it is an important precondition for the opening-up of national markets and the gradual establishment of a single European market. Both manufacturers and public authorities (Ministries of Defence) will benefit from a common reference regarding standards elaborated in consistency with NATO works. It will help to enhance cost efficiency and interoperability. That necessity has been recognised by all those stakeholders who are participating on a voluntary basis in the development of a "Defence Standardisation Handbook". It will contain references to standards and standard-like specifications commonly used to support defence procurement contracts as well as guidelines on the optimum selection of such standards.

The action currently under way with the participation of the MoDs and industry and with the assistance of CEN is funded under the framework contract for standardisation of 1998. The Commission will ensure that the European Handbook is ready in its initial phase by the end of 2003 and in a first operational version around the end of 2004.

The next phase should be to give formal status to the Handbook so that, once approved in terms of content, its use will be systematic in defence procurement contracts. The Commission would then propose appropriate complementary measures to ensure the upkeep of the Handbook and its use.

3.1.2. Monitoring of defence-related industries

In accordance with the Community's task to ensure the conditions for competitiveness of industry (Art. 130 TEC), the Commission should keep the situation under permanent review in all industrial sectors. In order to monitor the economic situation of the defence industrial base at EU level (including new Member States), including its ability to support the supply requirements of ESDP, the Union needs regular access to the relevant data. Levels of competitiveness and design expertise, geographic distribution of expertise, R&D investment, etc. need to be known and measured in order to allow benchmarking and to contribute to the development of relevant policies. Moreover, producers need a better knowledge of the market conditions in which restructuring can take place.

For this purpose, it is proposed that a monitoring activity be launched on defence-related industries using data available in EUROSTAT and in the European Statistical System (ESS) as well as other relevant sources of information, including industrial associations, while respecting existing rules of confidentiality.

3.1.3. Intra-Community transfers

The Commission is all too aware that intra-Community transfers of defence equipment are time-consuming and involve a lot of red tape because of the number of national procedures. These procedures take the form of individual licences for firms, import/export licences, checks on delivery and in some cases end user certificates. What is more, these procedures apply equally to transfers of defence equipment to Member States as to exports to non-member countries. One of the reasons for these complications is the desire of Member States

to control the final destination of defence equipment, especially in the case of non-member countries.

The Commission has therefore tried, working with national experts to identify possible ways of simplifying intra-Community transfers of defence-related goods. For example, one possible way would be to align national licensing systems by adopting the principle of a global authorisation that would apply to intergovernmental programmes and industrial cooperation programmes.

An impact analysis is thus needed to establish the value added of any Community-level legislative initiative. This would also be an opportunity to draw lessons from the transfer arrangements for military equipment for the armed forces under the relevant NATO agreements. In the light of its findings the Commission will propose an appropriate legislative instrument (Regulation of Directive). Work on this will start at the end of 2004.

3.1.4. Competition policy

Competition policy is an essential element of the common market and does not represent an obstacle to technological change or a hindrance to private initiative. Moreover, it must ensure that changes brought about by market forces, such as through mergers and acquisitions, do not lead to the creation or strengthening of dominant positions, but result instead in benefits in terms of innovation and value for money.

Insofar as purely military mergers have been notified to the Commission under the EC Merger Control Regulation (ECMR), the Commission has not objected to such operations. Recently however, complex cross-border mergers have occurred, which call for a thorough assessment of their overall impact on competition, notably with respect to dual-use or civil products. Both industry and governments would appreciate greater clarity. Producers need a stable and transparent framework in which restructuring can take place. Equally, the interests of other market participants, and in particular customers, competitors and subcontractors from other Member States, also need to be taken into account.

Due to its specificities and in particular to the close relationship with public authorities, the defence sector may benefit, directly or indirectly, from public support constituting State aid. Under the provisions of Art 296 TEC, to the extent that the companies concerned produce only military equipment, Article 87 TEC concerning State aids control has not so far been applied. Neither has there been any notification of such aid based on the argument that it contributed to the “execution of an important project of common European interest” as set out by Article 87(3)(b) TEC. Public financial support for defence production should in any case not alter competitive conditions in the common market of goods, which do not have a specific military purpose. This aspect is of particular relevance when the companies in question manufacture both strictly military and non-military products. It is necessary in particular to ensure that there is no cross-subsidisation between these two activities. Aid to non-specifically military products falls within the ambit of the standard provisions regarding State Aid.

The Commission intends to continue its reflection on the application of competition rules in the defence sector taking due account of the specificities of this field and the provisions of article 296 ECT.

3.1.5. *Spending better in defence procurement*

Removing inefficiencies in the European defence equipment markets would bring benefits from increased competition, from international trade, less duplication in R&D and both economies of scale and learning effects in manufacturing.

Further opening of defence procurement at EU level will ensure that all companies would be dealing with the same interfaces and processes for developing, delivering and supporting equipment as well as bidding for contracts. EU Member States that are also members of WEAG have already endorsed this approach and attempted to open their respective markets by establishing national procurement focal points and by publishing their defence procurement needs in national "Official Journals". However, the lack of any binding commitment has weakened that effort.

A first step towards harmonising public procurement rules should be to look into the various practices and develop a common approach.

On this basis, a reflection on how to optimise defence procurement at national and EU levels should be initiated in the EU. This would concern products procured by Ministries of Defence in the Member States, or by any European Agency that might be created in the future. The end goal would be to have a single set of rules for procuring defence equipment in Europe.

There have been several important Court judgements in recent years that are relevant to this work - especially in helping to define the scope of Article 296. The Commission will issue an Interpretative Communication by the end of 2003 on the implications of these judgements.

In parallel, it will work on a Green Paper which might be issued in 2004 as a basis for discussion with stakeholders. The aim would be to seek an agreement on procurement rules to apply to defence goods depending on the level of sensitivity of the equipment.

With the creation of a European defence equipment market operating on the basis of fair competition among European companies, offsets (ie practices involving industrial compensation required as a condition for purchases of defence equipment and/or services) would no longer be required. However, due to existing contractual obligations, transitional arrangements would need to be put in place. The above-mentioned Green Paper will also address the issue of offsets in both its intra-EU and external dimensions.

3.1.6. *Export Control of dual-use goods and technologies.*

Dual-use items are goods, software and technologies likely to have both civilian and military uses¹⁷. Member States control exports of these items and participate individually in a number of informal (politically, but not legally binding) international export control regimes¹⁸.

17 Definition taken from EC regulation n° 1334/2000 of June 22, 2000.

18 The Australia Group controls exports and transshipments that could result in proliferation of chemical and biological weapons.

The Missile Technology Control Regime aims at preventing proliferation of unmanned delivery systems for weapons of mass destruction by controlling exports of missiles and related technologies.

The Nuclear Suppliers' Group controls transfers of nuclear-related dual-use equipment, material and technology in order to prevent civilian nuclear trade from contributing to nuclear weapons acquisition.

The Wassenaar Arrangement controls transfers of conventional weapons and sensitive dual-use goods and technologies, primarily electronic products defined widely. "

The Community Regulation (1334/2000) based on the Article 133 TEC, while supporting the principle of the free circulation of goods inside the EU, provides for legally binding common principles and rules for the national implementation and enforcement of dual-use export controls by Member States. There is a strict link with the export control regimes, as the Regulation comprises a common list of items subject to control, which is directly derived from the consensus decisions taken in the regimes.

Due to differences in the implementation of dual-use export control commitments by the countries participating in the export control regimes (not to mention those countries which are not part of the regimes), great care must be taken to prevent civil industrial sectors such as nuclear, chemical, biological, pharmaceutical, space and aeronautics, information technologies, which are potentially affected by the controls, from being constrained unnecessarily or unequally.

The Community, by transposing in legal terms the decisions taken by the Member States in the export control regimes, imposes export control restrictions on European industries. The Commission is not a member (with the exception of the Australia Group) of the regimes. There is a need for greater Commission involvement in order more effectively to make more effective co-ordination of Member States' positions in the various regimes and to represent Community interests. In particular, the Commission, while supporting the central objective of the security of EU citizens, would also look at the functioning of the single market and the economic interests of a variety of civil industrial sectors.

While the EC imposes export controls on dual use items for security purposes and in accordance with decisions taken in export control fora, consideration should be given to their impact on the competitiveness of the EU defence and dual use industries. There is a need to ensure that all these aspects will be adequately addressed in the perspective of enlargement to ensure that both the dual use single market and the Community Export control regime are not adversely affected.

The Commission will bring up the issue of how to achieve these aims with Member States in the relevant Council working bodies, including the particular challenges stemming from enlargement.

3.2. Towards a more coherent European advanced security research effort

The Commission has had a great deal of experience in managing Community research programmes and coordinating national research activities and programmes. It is willing to offer its expertise for an initiative to promote cooperation on advanced research in the field of global security".

The setting-up of the European Research Area demonstrated that the Union and the Member States would derive greater benefits from national research programmes if they were better coordinated, something which is also true of advanced security-related research. By harnessing efforts at European level with an eye to medium to long-term requirements, advanced technologies that are crucial for Europe could be better developed and a real European value-added gained.

To this end, and as suggested by Parliament in its resolution of 10 April 2002, the Commission will ask national administrations, industry and research institutions with extensive activity in this area to identify in the course of this year an European agenda for

advanced research relating to global security and the most appropriate ways of tackling it jointly.

To prepare for the implementation of this advanced research agenda, the Commission intends to launch a preparatory project that it would implement with the Member States and industry to implement some specific aspects that would be particularly useful in carrying out Petersberg tasks. This preliminary operation lasting no longer than three years would constitute a pilot phase for acquiring the experience for evaluating the conditions and arrangements needed for effective cooperation between national research programmes in the field of global security. It will cover just a few carefully selected subjects of advanced technology together with specific accompanying measures.

4. THEMES FOR FURTHER REFLECTION FOR THE EU AND MEMBER STATES

4.1 EU Defence Equipment Agency proposals

Article 17 of the Treaty on European Union provides that "the progressive framing of a common defence policy will be supported, as Member States consider appropriate, by cooperation between them in the field of armaments." The possibility of creating a European Armaments Agency is foreseen in the declaration on WEU annexed to the Treaties of Maastricht and Amsterdam. The defence working group of the Convention included in its recommendations the creation of an agency on an intergovernmental basis, which would deal with armaments and strategic research and could also contribute to ensuring that capabilities are improved. This proposal has been supported by the Franco-British declaration issued in the context of the summit which was held in *Le Touquet* on 4 February 2003.

Various Member States have already established joint procurement and research initiatives such as OCCAr, the LoI and WEAO. Any EU initiative should build on this base. We should seek to create an EU Defence Equipment Framework, including:

- collaborative programmes on the basis of OCCAr, progressively associating countries that wish to join in such co-operation in accordance with OCCAr rules (ie abandoning “juste-retour”);
- research and technology: The Europa MoU agreed within the Western Europe Armament Organisation framework includes a number of valuable ideas that could be further explored ; in a longer term the EU should consider the creation of a European DARPA (Defence Advance Research Project Agency);
- off-the-shelf procurement. This issue is not currently addressed at a European level. It is time that it was.

Any Agency (or Agencies) established to oversee such an EU Framework should reflect Member States' political choice that much of this work should continue to be conducted outside the current EC Treaty. It would be sensible nevertheless to draw upon Community mechanisms and instruments where Member States agree that the Community has a contribution to make (for example where the work touches on market mechanisms; or where it may be possible to build, in the research area, on experience with the civil Framework Programmes). In the longer run, too, Member States may decide to develop some central financial mechanism to ensure that Member States with disproportionately small national defence budgets nevertheless contribute their fair share to EU capacities.

An additional advantage of an EU Defence Equipment Framework of this kind is that it could, in some cases, would reinforce EU's position when negotiating commercial agreements, thereby strengthening the EU's hand.

4.2 Security of supply

Until recently the issue of security of supply has been addressed primarily by Member States individually. The process of consolidation in the defence field, which is necessary for Europe to maintain a competitive industrial base, is likely to lead to increased sectoral concentration. Governments will be required to accept the loss of some domestic capabilities, to procure directly from foreign or trans-national companies, and to allow changes to the ownership of defence companies. Mutual dependency between nations for the supply of certain armament materials already exists. Some countries buy entire systems from foreign firms, and even where a nation procures from national suppliers, most complex equipment includes some components from non-domestic sources.

By moving towards an EU-wide approach to security of supply Governments could:

- avoid keeping non competitive excess capacity by placing work with national companies,
- be able to allow trans-national mergers involving a change of ownership,
- facilitate trans-national movement and transfers of personnel working on classified matters,
- allow the trans-national transfer of goods and technology.

Such an approach would, *de facto*, help to diversify sources of supply and thereby reduce dependency on any single supplier, such as the United States.

EU progress in this field should build on work already undertaken in other forums such as LoI, NATO and WEAG.

4.3 Defence trade issues

A wider opening of foreign markets, especially the US, to European defence products is a major objective as it is essential for the EU defence industries to maintain and further develop their design expertise and competence in the most advanced technologies. If this does not happen, most of the national European markets will remain open to US manufacturers, while the US market will remain closed, except for a few European-owned but US-based companies.

Greater credibility in this area could be achieved by consolidating national defence markets and exploiting the potential of the combined EU defence procurement budget (national and EU level). This process would create greater negotiating capital for the purpose of working towards enhanced reciprocity and achieving a more level playing field for European companies seeking access to US markets.

Further work is needed on the some these aspects. The Commission will revert to this at a later stage.

On the question of ethics in arms trade, the Council adopted in 1998 the EU code of conduct on arms exports. This Code of Conduct is a politically binding instrument that seeks to create "high common standards" for Member States to use when making arms export decisions and

to increase transparency on conventional arms exports. It also has a specific operative mechanism designed to discourage individual Member States from undercutting sales denied by other EU states. A common list of military goods to which the Code applies has been agreed and serves as a guideline; Member States are free to use their own lists.

A first step towards a practical solution to streamlining export decisions regarding the products of multinational companies has been made by the six signatory nations of the Letter of Intent (LoI). The ideas developed there should serve as a basis for future EU rules. In particular, a decision to export outside the European Union should take account of the need for prior consultation with the Member States involved in authorisations while recognising the political responsibility of the final exporting state.

5. CONCLUSION

This Communication is intended as a further contribution to greater efficiency in the defence equipment industry, which is both an objective in itself and an important challenge if the Union is to develop a successful ESDP. The Commission proposes to:

- provide the necessary financial resources to ensure that the European Standardisation Handbook is ready by 2004 and then propose appropriate complementary measures to ensure the upkeep of this Handbook and its use;
- launch a monitoring activity on defence-related industries using data available in EUROSTAT and in the European Statistical System framework; as well as other relevant sources of information, while respecting existing rules of confidentiality.
- launch an impact assessment study in 2003 and, depending on its results, start elaborating at the end of 2004 the appropriate legal instrument to facilitate intra-Community transfer of defence equipment.
- continue its reflection the application of competition rules in the defence sector taking due account of the specificities of this field and the provisions of article 296 ECT.
- initiate a reflection on how to optimise defence procurement at national and EU levels. Given the important Court judgements in recent years, especially in helping to define the scope of Article 296, the Commission will issue an Interpretative Communication by the end of 2003 on the implications of these judgements. In parallel, it will work on a Green Paper, which might be issued in 2004 as a basis for discussion with stakeholders.
- bring up, in the relevant Council working bodies, the issue of the Commission's involvement in export controls regimes.
- launch a preparatory action for advanced research in the field of global security with a view to implementing with the Member States and industry specific practical aspects that would be useful for carrying out Petersberg tasks in particular;
- to pursue work on a possible EU Defence Equipment Framework overseen by an Agency (or Agencies). This framework will pull together national initiatives - especially in collaborative programmes in Research and development, and in off-the-shelf procurement. It will encourage more Member States to join such programmes and it will enable the EU to draw, where appropriate, on Community mechanisms and instruments.