

THE CHANGING EUROPEAN DEFENCE MARKET

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LEGISLATION BE A GAME-CHANGER FOR FINLAND?

Harri Mikkola, Jukka Anteroinen & Ville Lauttamäki

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WILL THE NEW EUROPEAN DEFENCE MARKET LEGISLATION BE A GAME-CHANGER FOR FINLAND?



Harri Mikkola
Researcher
The Finnish Institute of International Affairs

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Jukka Anteroinen
Researcher
National Defence University



Ville Luttamäki
Researcher
University of Turku, Finland Futures Research Center

- The European defence industrial base is transforming. The changes in the European defence market legislation, the decrease in defence materiel demand and changing defence requirements are redefining the industry in a way that has not been seen in decades.
- The new European legislation in particular poses serious challenges for the Finnish defence industry, including the national market opening and the diminishing possibility for offset arrangements.
- It is likely that the major European states are trying to protect their own defence industrial base. The future of the Finnish defence industry will be determined by whether the European market opens up in the first place, in part or in its entirety.
- There is no going back to the time preceding the new legislation. It is crucial for the Finnish defence industry to find and utilize new market opportunities. Networking with the European system integrators and sub-contracting chains will be of paramount importance.

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Introduction

The European Union is trying to create a “level playing field” for the defence industry but the Finnish industry is in danger of being left out of the game. The European defence market is strongly fragmented in the member states’ domestic markets and the vast majority of the market is not truly open for Europe-wide competition.

However, things are changing and the European defence industrial base is transforming. The forces of change for the market transformation stem from three interconnected dimensions. The first of these is the change in military capability requirements, namely a move from capabilities related to the threat of a conventional large-scale territorial war to those needed in often asymmetrical expeditionary military crisis management operations.

The second force of change stems from financial pressures. The financial crisis which started in 2008 has accelerated and made the European armed forces’ transformation more concrete. The deteriorating economic situation has had a direct impact on defence budgets. At the same time, the technology intensity of defence materiel is increasing, pushing up the price of end-products in the process. This development means that even the largest EU member states are struggling to sustain an adequate and economically viable national defence market and defence industrial base. The third force of change stems from the changes in the European defence trade legislation.

This paper will offer a Finnish small-state perspective on the transformation of the European defence industry and European defence market by focusing on the third force of change – the changes in the European defence trade legislation – and raise some important related issues for the Finnish defence industry and defence administration to consider.

The fragmentation of the European defence market has resulted in the unnecessary duplication of production and wasting resources on overheads, poor economies of scale and weak competitiveness. It has also resulted in maintaining outdated, Cold War-era stockpiles of military capabilities. From the perspective of the EU’s single market and trade policy principles, the defence market has been problematic due to its inherent opacity and unequal treatment

of commercial operators. In order to improve the situation, the EU is getting increasingly involved in the defence sector trade. The Commission’s quest to bring the defence trade under the internal trade regulations, and to create an open internal defence equipment market, are efforts which will have potentially dramatic effects on the Finnish defence industry.

The Commission’s general policy is clear. A stronger, deeper and broader internal market, free from national protectionism, is seen as vital for economic growth also for the defence sector. Stemming from this, the EU is calling for stronger industrial integration, reduction of duplication, specialization among actors, European independence in the production of key technologies, market-based concentrations of excellence, as well as integration between the defence industry and the industries that support it. If these goals were to materialize, they would have a significant impact on the European defence industry’s structure.

Changes in the European legislation

The main clause hindering the development of an open European defence equipment market is Article 346 TFEU in the Treaty of Lisbon (former Article 296 TEC). This Article allows member states to exclude their security and defence procurement from the requirements of the EU’s public procurement directive if these acts are not sufficient to safeguard the member states’ “essential security interests”. The use of Article 346 TFEU in the defence procurement has for decades been a rule rather than an exception. This is due to the strategic importance of the sector and the inadequacy of the EU public procurement directive for the sector’s specific needs. The Commission’s more powerful aspiration to bring the defence trade under the Union’s internal market legislation has also resulted in efforts to limit the use of Article 346 TFEU to a minimum.

The most important EU-level steps towards a European defence equipment market are the changes in the EU legislation brought about by two new directives.

The security and defence procurement directive 2009/81/EC is intended to increase transparency and competition in the security and defence sector

trade, taking into account the complexity and sensitive nature of the sector's products and creating fair and transparent rules for such trade. The directive sets a threshold value for defence and security goods, and service contracts. The contracting opportunities exceeding this threshold should be subject to open Europe-wide competition. The directive also covers security equipment procurement which has defence procurement-like features, which are equally sensitive. The directive regulates public procurement carried out by public authorities, and consequently doesn't apply to subcontracting, for instance. Compared to the past, the directive confers the right for commercial operators to appeal to a national market court (and the Court of Justice of the European Union). The directive also provides a set of possibilities for excluding public defence procurement from public tendering, including government-to-government procurement, procurement based on an international treaty and R&D cooperation agreements.

Despite directive 2009/81/EC, the use of Article 346 TFEU is still legitimate in many cases. Such use should be limited, however, and needs to be justified on a case-by-case basis. Both the Commission and the European Union Court of Justice have taken a strong position according to which the use of the Article is always a serious political and legal issue, and its use should be restricted to exceptional and clearly defined cases of securing essential security interests. It is likely that the new European legislation will limit the use of the Article in a more restrictive way compared to the past due to the possibility of using legal protection measures. In practice, this means that the scope of Article 346 TFEU will be set by the EU's Court of Justice decisions.

The other major legal change affecting the defence industry's operating conditions is the new defence export directive 2009/43/EC. The export directive aims to facilitate the Union's internal defence equipment transfers by simplifying and harmonizing the rules and procedures related to intra-Community transfers of defence-related products. The defence export sector has traditionally been under the independent foreign and security policy discretion of the member states, and is going to remain so in the future. The export directive, however, marks a significant change from the past because the Commission and the internal market policy will for the first time operate in the defence export

sector as well. The directive makes a conceptual distinction between the "transfer" and "export" of defence equipment. "Transfer licence" refers to a licence under which the suppliers can transfer defence-related products to a recipient in another member state, while "export licence" denotes a licence to supply defence-related products to any third country. With this conceptual distinction, the Commission is trying to better integrate the defence equipment market into the EU's (EEA's¹) common internal market, while the trade to third countries will remain under the former export control and under the foreign and security policy discretion of the member states.

European legislation from the Finnish defence industry's point of view

Perhaps the biggest challenge posed to the Finnish defence industry by the European legislation lies in the European Commission's stance on the offset arrangements. In Finland, the offset requirements were previously linked to defence procurement when a certain financial threshold was exceeded. They were often also directed at the civilian products trade (e.g. the paper machinery trade). Today, civilian offsets are no longer possible. Moreover, offset arrangements are no longer possible in procurements carried out under the new defence procurement directive. The possibility for the direct military offsets will however continue, albeit with notable limitations. They are not "offsets" as such – that is a financial compensation – but rather technology transfers realized under the procurement directive's security of supply requirements, or under Article 346 TFEU.

It is essential to note that offsets are important for countries such as Finland, which don't have a comprehensive national defence industry base and which acquire a large percentage of their defence materiel from abroad. Direct military offsets support the sustainment of defence systems throughout their whole life cycle and create repair and maintenance capabilities for the national industry. In addition to this, offsets balance the national economy, support and develop national industrial competitiveness

1 The new directives are also in force within the larger European Economic Area.

and promote export. The importance of the offset arrangements has been vital for some Finnish companies, but less so for others. It can be estimated that, on average, 25 per cent of the Finnish defence companies' turnover comes from offset arrangements, but for some companies the ratio is up to 100 per cent. In light of these figures, the diminishing possibility of offset arrangements will hit Finnish companies hard.

Article 346 TFEU provides a lot of room for manoeuvre in technology transfers. This is due to the concept of "essential security interest". Traditionally, legislative concepts are defined as precisely and universally as possible. However, a universal definition of the concept of "essential national security interest" does not exist, the scope of this concept cannot be in any way exhaustively defined, and it is different in every country. In other words, as long as this concept is in Article 346 TFEU, it will never be possible to reach a universal interpretation of the Article, although the case law of the European Court of Justice will make the scope of the Article increasingly precise.

In addition to the transactions carried out under Article 346 TFEU, the procurement directive also presents opportunities for setting specific requirements for securing the national security of supply. Although it is basically up to the producer to decide the manner in which it fulfils these requirements, and although it is not possible to demand, for instance, that spare parts and maintenance capability must be sought from a Finnish company, it is nevertheless perfectly possible to require, say, a specific response time inasmuch that the maintenance and repair capability and spare parts must be obtained within 24 hours. This might require that the repair capability must be found in Finland. In any case, the security of supply consideration needs to be set early on at the tendering stage. In addition to the security of supply issues, the security of information considerations is an even more legitimate reason to use Article 346 TFEU. When it comes to the core national defence capabilities, the use of the Article is natural due to the large amount of classified data involved.

The changing and more complex procurement procedures require changing the somewhat cemented culture and practices of the contracting authorities. In particular, the application of Article 346 TFEU demands training and sufficiently detailed and clear

guidelines. National procurement activities must be streamlined, uniform and also in accordance with the legal procedures set in the procurement directive. This will help to avoid unnecessary legal processes, and to ensure that the purchased materiel is consistent with the capability and defence system development, and that security of supply issues can be taken into consideration in an appropriate manner. It is clear that the challenges for contracting authorities are increasing. Although avoiding errors in tendering is extremely important, large financial interests guarantee that legal transactions will likely increase in the future. It may very well be that the greatest control factor in the application of the procurement directive won't be the EU Commission but the companies that have lost in the tendering process.

The procurement directive offers a possibility to bypass the directive's requirements in the case of multinational R&D projects, which in Finland can be carried out under the Nordic Defence Cooperation (NORDEFECO) framework, for example. While the Nordic countries are geographically and culturally close to each other, differences in defence and security policy priorities and difficulties in defining the common capability requirements and division of labour, as well as industrial policy considerations, make cooperation relatively difficult.

Opportunities for R&D collaboration within the NORDEFECO framework are also limited. The main problem is that the possibilities to exclude procurement from the scope of the procurement directive mostly exist for the countries that finance the development phase of a piece of equipment. The Finnish national defence research funding is modest, however, and Finnish defence procurement is largely based on purchasing off-the-shelf systems or subsystems. Although multilateral R&D cooperation might provide some opportunities for supporting the Finnish industry, these opportunities are relatively limited, at least when compared to the larger states' opportunities to support their national industries through the procurement directive's R&D exclusion clause.

As elsewhere in Europe, the new European defence export legislation also has impacts on the Finnish defence sector. The defence industry always faces a degree of uncertainty over export licensing. It's possible that prepared defence trades may be

jeopardized by the rapidly changing conditions in the destination country for a protracted period of time. The granting of export permits is considered on a case-by-case basis. In the “problematic” cases, the general guideline should be abstinence, namely the refusal to issue an export licence to countries which do not fulfil the EU’s defence export criteria.

However, in practice, case-by-case consideration may end up with a strong emphasis on national industrial policy interests. Case-by-case considerations usually have a wide margin for interpretation. This can be seen, for example, in the implementation of the EU Council’s common position on arms export (2008/944/CFSP). The common position doesn’t in any way ensure that the common criteria are always applied in the same way in all member states. In other words, although the EU has common criteria for arms exports, the Union doesn’t have a common arms export policy. Rather, defence export decisions will be taken, and the associated security policy discretion will be exercised at the national level. It is perfectly possible that even within the EU some other country may grant an export licence for a product which was refused by the domestic operator under the Finnish export considerations.

In addition to the arms export, there might be problems with the defence materiel internal “transfers”, which may indeed inhibit the creation of a “level playing field” for the commercial operators. The danger is that different countries may have different products under different licence types, as countries consider them from their industrial and security interests point of view, in which case the licence contents between countries do not always match.

European changes and the future of the Finnish defence industry

The Finnish defence industry’s future is somewhat blurry. It is nevertheless clear that the challenges are great and the future business environment for the Finnish defence companies is changing drastically. The changes in the European defence market legislation, the decrease in defence materiel demand and changing defence requirements are redefining the industry in a way that has not been seen in decades. As long as new major security threats don’t emerge, the most certain force of change will be the diminishing defence budgets.

It can be estimated that the decline in the financial resources will lead, at least in the short term, to a situation where the European armed forces’ procurement is carried out first and foremost by the national industry by utilizing the procurement directives’ exclusion clauses. It is highly likely that the major European states with a strong national defence industry are trying to protect their own defence industrial base in the face of a myriad of challenges. Also, there’s a high probability that Finland (and other small EU countries) will have to face the disadvantages resulting from the new regulations while the benefits might be few due to the objective (and the political ability) of the major EU countries to protect their own national defence industries.

It is possible to be quite pessimistic about the impact of the new legislation on the Finnish defence industry. Although all EU member states will have the same legislative framework through the new directives, one could raise the issue that European countries will interpret the directive in different ways and that the larger countries will be allowed to take the exclusion measures more lightly, and interpret the directive more loosely than the small countries. To narrow it down, this would mean that the Finnish defence industry and its customers would face prohibitively high entry barriers in the foreign market.

Also, it should be noted that the different practices and delays in the member states in bringing the directive into force may challenge the Finnish industry. By complying with the implemented directive, the Finnish defence market will immediately open up to foreign operators. At the same time, the offset arrangements will become more difficult. Another country’s stalling over the directive’s implementation can keep its own market closed for a significant period of time. In this case, the Finnish defence industry, acting in accordance with the directive’s requirements, would face increased competition and decreased offset arrangements, while the industry’s competence to compete in other European countries’ markets would remain poor. The threats are imminent, but the opportunities might be out of reach, at least in the short term.

On the other hand, if Finland is able to create a list of the critical capabilities maintained domestically, and if other European countries interpret the

directive with the same precision as Finland, Finnish industry may benefit from the new market legislation. Furthermore, from the point of view of the defence forces' procurement activities and Finnish defence system development, the changes are not necessarily all bad. If actualized in accordance with the Commission's intentions, creating more open competition and a more level playing field, the new European legislation will allow for more cost-effective procurements in principle.

In any case, the new international market environment will most likely lead to increased international competition for the Finnish defence forces' procurements, which may pose a severe threat to the companies who were protected against international competition until now. The effects of the directive depend to a large extent on the size of the company, its status in the production chain, and its ability to produce internationally competitive products. The defence procurement directive only regulates public procurement, and it won't dramatically affect the subcontracting between companies. Thus, the change for Finnish niche companies, already inside the international subcontracting chains, will not necessarily be severe – other than perhaps indirectly if the large companies' market decreases.

The market changes also include the opportunity to challenge the tendering processes by using legal protection measures. Company size determines the resources available for the legal processes. Small and medium-sized enterprises often do not have sufficient resources to address the complex and often long-running judicial processes, which serves to increase the relative competitive advantage for larger companies. Even though the EU Commission officials see legislative measures as the best way to guarantee true market opening, the Finnish industry may be relatively reluctant to use those measures. This is mainly due to a company's fear of losing its reputation in the eyes of a major client. This would pose a problem for the Finnish industry if or when other players were able to make use of legal measures.

In practice, the future of the Finnish defence industry will be determined by whether the European market will open up in the first place, in part or in its entirety. If the "level playing field" endorsed by the Commission is not implemented to the full, and if the major European states continue to protect their

own defence industries, Finland must do everything at its legal disposal to protect its own industry. The situation in which foreign companies could freely enter the Finnish market, but in which Finnish companies couldn't enter the foreign market, would have dramatic consequences for the Finnish defence industry's chances of survival, and also for the development of the Finnish defence capability, built in part by the Finnish defence industry.

The European industry is consolidating and the competitiveness of non-European countries is growing. It is likely that, regardless of the new directive, the market-based consolidation and "pruning" of the European defence industry that has been taking place during the last couple of decades will also continue in the future. If the pruning of overcapacity were to take place exclusively on the basis of the quality of products and cost-effectiveness, one could estimate that the Finnish defence industry's chances of success would be reasonably good. However, due to the market power of major industrial players and states in the sector, the markets may be reformed in favour of the large European states in many currently inefficient business sectors.

The domestic industry still has notable advantages over the foreign companies. Domestic companies are familiar with the domestic military system, regime and culture. The best prospects for success for the Finnish defence companies are with few larger national operators, who will most likely succeed also in the future as a partner of the armed forces and with certain internationally competitive products. The smaller Finnish companies can succeed either by producing state-of-the-art technology or by producing competitive modular parts that are attachable to larger systems. However, it is realistic to predict that the future of many Finnish small and medium-sized defence enterprises lies in being bought by larger companies (from abroad), trying to find new markets, or quitting the business altogether.

The domestic client, namely the defence administration, has traditionally been the bedrock of the Finnish defence industry. In the future, the Finnish defence industry will not be in a position to cope by relying solely on the domestic market. The increasing global consolidation of the defence industry bolsters the importance of large industrial groups in international competition. Despite the efforts to

create a networked national defence industrial base, the Finnish defence industry is still fragmented and relatively small.

In these circumstances, it could be tempting for the domestic actors to try to circumvent the new European legislation to a certain extent, or to slow down its implementation. However, it is highly unlikely that we will witness a return to the time preceding the new legislation. That is why it is crucial for the Finnish defence industry to seek out and utilize the potential new market opportunities. The Finnish defence sector has certain “spearheads” and niche areas of expertise. The most appropriate thing for the Finnish companies to do would be to direct their energy in developing capabilities towards ensuring success in the changing circumstances as well. It is important for domestic companies to change their focus and integrate with the European system integrators and sub-contracting chains. Invoking the old practices without convincing arguments is not possible, or at least it won't maintain the situation that existed prior to the new legislation. Finland probably won't have a major impact on the formation of the European, let alone global market, so one must be prepared to play by the prevailing rules, or risk being left out of the game.

The Finnish Institute of International Affairs
tel. +358 9 432 7000
fax. +358 9 432 7799
www.fiia.fi

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