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**ACCESSING THE US MARKET: A EUROPEAN
PERSPECTIVE**

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Introduction

The idea that the transatlantic arms market is a “one way street” is as old as NATO itself. This one-way street - it has been argued - is characterised by a European arms market that is open to US companies and technologies but with little reciprocity from a US arms market which is closed to outsiders and dominated by a “Buy American” policy.

Whilst it is true that Europe imports considerably more arms from the US than it exports, the last fifteen years have seen European companies establish a presence in the US market and win a number of high profile contracts from the US Department of Defense and other US government agencies. In this paper, I consider whether recent developments - not least the \$40 billion decision of the United States Air Force to purchase tanker aircraft from an Airbus-Northrop Grumman consortium - undermine the idea of a one-way street.

Such matters are of more than economic and commercial importance. I argue that they go to heart of the future transatlantic relationship; NATO capabilities; and policy towards the European Defence Technological and Industrial Base (EDTIB) and European Defence Equipment Market (EDEM).

1. Europeans are Gaining Access to the US Market - but it is Too Early to Claim the End of the One -Way Street

The last fifteen years have seen European companies establish a presence in the US market and win a number of high profile programmes.

Programme wins

The Airbus-Northrop Grumman success on the USAF air tanker programme is the latest and largest in a series of European programme wins that include the US Presidential Helicopter programme and the US Coastguard Deepwater programme. In each case, a European company has partnered with a leading US company to win the programme. EADS has also announced that it will partner with Raytheon to bid for the US Army's \$3 billion contract for a battlefield cargo aircraft. EADS also plans to bid for the Army's \$2 billion light-utility helicopter contract.

European acquisitions

Beyond that, European companies have made a series of acquisitions in the United States. UK companies have been notably active and BAE Systems now does more business with the US government than it does with the UK MOD. But other companies have established positions also including Finmeccanica; Thales; and EADS and they have stated that they wish to increase their US presence in the future.

The response to the USAF tanker announcement reminds us of the power of protectionist arguments

The decision of the USAF to award its tanker contract to the Airbus-Northrop Grumman team is important. The programme award calls for 179 aircraft with an estimated contract value of US\$ 40 billion. The initial KC-45A contract for Northrop Grumman covers four System Design and Development aircraft and is valued at US\$ 1.5 billion.

The announcement generated a storm of political protest in Congress and prompted Boeing to refer the procurement process to the Government Accountability Office. The GAO is expected to make its decision by mid-June.

The Democratic candidates for president, Senators Hillary Rodham Clinton and Barack Obama, argued that the Boeing loss was just the latest example of policies that have resulted in jobs moving offshore. One Congressman whose district has strong Boeing interests declared: "It's outsourcing our national security. An American tanker should be built by an American company with American workers." A Senator from Washington State argued: "We really have to wake up the country. We are at risk of losing a major part of our aerospace industry to the Europeans forever".

2. Arguments about a “One-Way Street” Continue to Play A Role in the Thinking of Some Europeans

The final decision on the USAF tanker deal is important because the idea that the transatlantic arms market is a “one way street” continues to play a role in the thinking of some Europeans when it comes to policy debates about the European arms industry and market.

The spectre of US defence technological dominance

The idea is as old as NATO. In the 1960s and 1970s, European concerns about an over mighty U.S. defence industry prompted the growth in European weapons cooperation. European governments increasingly recognised that the escalating costs of weapons design and development meant that they could not develop advanced weapons systems on their own. They turned to European armaments cooperation with the aim of spreading costs, achieving economies of scale in weapons production and providing some degree of European autonomy in defence technology.

Today, European governments are concerned about the operational consequences of acquiring US arms. There are fears that acquiring US technology will have security of supply implications and limit the operational sovereignty of governments to use their weapons how, where and when they choose.

The imbalance in the transatlantic arms trade remains...

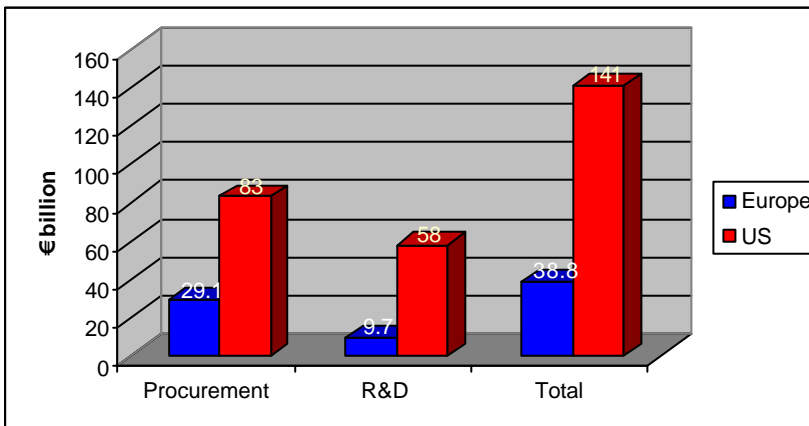
There is little doubt that the figures show an imbalance. A 1996 US Government Accountability Office study summarized the situation (note that these figures relate to all imports and exports and not only those involving Europe):

“The United States sells significantly more defense articles and services to foreign entities than it buys. Between 2000 and 2004, U.S. defense exports averaged \$11.5 billion a year, versus imports of \$1.8 billion a year; DOD military sales averaged \$12.6 billion a year, versus purchases of \$1.5 billion a year. During the same period, DOD purchases of defense articles and services from foreign companies have decreased from 2.4 percent to 1.7 percent of all such DOD purchases”.

.... but it reflects - in part - an imbalance in transatlantic investment in procurement and R&D

Should we be surprised that such an imbalance exists? After all, the United States invests almost three times as much in defence procurement as Europe and six times that of Europe in Research and Development (see Figure 1). US spending means that the US government can - in most respects - find most of what it needs from within the US defence industrial base. All other things being equal, there is simply less need to go outside the US except in circumstances where foreign technologies are clearly superior and at a higher technology readiness level than that available from US sources.

Fig 1: US & European investment expenditure (equipment procurement and R&D)



(Source: European Defence Agency)

3. The Nature of the Transatlantic Arms Market has Important Implications for Military Capability and Public Policy

The relative openness of the US defence market to Europe and the extent to which we are moving towards a true transatlantic arms market is a matter whose importance goes well beyond the economic and commercial interests of industrial companies. By a true transatlantic arms market, I have in mind a situation in which there is reciprocal access to the US and European markets and in which military technology - whilst being subject to necessary controls - can flow across the Atlantic in both directions.

Military capability

Strategically, NATO has sought such a situation since the 1960s noting the benefits of standardization of military equipment; the transfer of technology to strengthen military capabilities; as well as the economic benefits of industrial specialization and economies of scale.

These issues remain live today. A recent study for the NATO Industrial Advisory Group (NIAG) argues that:

“if the NATO Alliance is to meet the ambitious but vital transformational and partnership capacity objectives articulated in the CPG [Comprehensive Political Guidance] and underscored in the US QDR, its states must not only commit sufficient resources to match the requirements, they must also act to remove barriers impeding enhanced transatlantic cooperation among defense industries on both sides of the Atlantic”.

US public policy

The Clinton Administration encouraged such efforts promoting the US-UK Defence Trade Initiative and permitting a number of important acquisitions of US defence companies by European (mainly UK) companies: Rolls-Royce acquired Allison; GEC Marconi acquired Sanders; BAE Systems acquired the Electronic Systems businesses of Lockheed Martin. The Administration argued that a transatlantic arms market would strengthen NATO military capabilities, allow the US to access increasingly globalised technologies and that allowing foreign access would stimulate competition in an increasingly consolidated US defence market.

The US Congress showed a lot more skepticism and the Clinton initiatives stalled. The issue has rarely been on the radar screen of the Bush Administrations reflecting its preoccupation with the “Global War on Terror” and the War in Iraq. Significantly, there have been no high-level NATO-sponsored conferences on transatlantic defence industry issues since 2003. The only substantive policy development has been the US-UK (and US-Australian) Defense Trade Cooperation Treaty of which more later.

4. Accessing the US Market is Difficult....

There is no doubt that accessing the US market is difficult and costly for European companies. The Buy America Act; onerous controls on companies under foreign

ownership, control or influence; and, US arms export regulations (most particularly ITAR) makes the US market difficult for European companies. However, it would be wrong - indeed even disingenuous - to think that the barriers that European companies face are unique to the United States. Transnational companies in Europe face similar operational challenges when they try to work across European borders and European governments have been equally anxious to ensure security of supply, control foreign takeovers of strategic companies and regulate technology transfer. These are the drivers of on-going European Defence Agency and European Commission initiatives but progress is slow.

Buy American Act

In the United States, “security of supply” arguments have underpinned the maintaining of, and in some cases the extension of, items controlled by the “Buy American Act”¹ and the “Berry Amendment”.² For instance, Congress has incrementally expanded the scope of the Berry Amendment so that it now covers - for example - specialty metals - as well as textile and agricultural products. In some cases, “partnering arrangements” between the DOD and a European supplier requires that supplier to establish a subsidiary company within the United States.

The Buy American Act and the Berry Amendment are clear protectionist barriers to free and open competition that effectively exclude European companies from direct sales of defence equipment to the US government and - in the case of the Berry Amendment - its scope has been extended to secure protection for a wide range of products only tangentially-related to national security concerns.

But such behaviour is not unique to the United States. As a recent report for NIAG notes: “Countries regularly exercise certain exclusionary policies of “national preference” through various legislative or regulatory authorities, often invoking the principle of “security of supply” to direct procurements to host industries and block foreign suppliers”. Thus, the European Commission defence package is seeking to more clearly define the scope for use of Article 296 in this respect.

Exon-Florio and CFIUS

The constraints of the Buy American Act have caused European companies to acquire US companies as a means of accessing the US defence market. In the United States, the Exon-Florio Amendment to the Defense Production Act authorizes the President to suspend or prohibit transactions that could result in foreign control of US companies if that the

¹ The Buy American Act restricts the purchase of supplies, that are not domestic end products, for use within the United States. A foreign end product may be purchased if it is determined that the price of the lowest domestic offer is unreasonable or if another exception applies. The Buy American Act uses a two-part test to define a domestic end product: the article must be manufactured in the US; and the cost of the domestic components must exceed 50% of the cost of all the components.

² The Berry Amendment restricts the Department of Defense from using funds appropriated or otherwise available to the Department of Defense for procurement of: “food, clothing, tents/ tarpaulins/covers, cotton and other natural fiber products, woven silk or woven silk blends, spun silk yarn for cartridge cloth, synthetic fabric or coated synthetic fabric, canvas products, or wool (including in manufactured articles), any item of individual equipment containing any of the restricted fibers or fabrics, or hand or measuring tools...” that are not grown, reprocessed, reused, or produced in the U.S.

transaction threatens to impair national security. The review is undertaken by the interagency Committee on Foreign Investment in the United States (CFIUS). In July 2007, the Foreign Investment and national Security Act amended Exon-Florio to expand the factors considered in deciding what could affect national security. This was in response to the political controversy surrounding the acquisition of P&O (a UK company with a port management subsidiary in the US) by Dubai Ports World.

There have been relatively few cases where European companies have been prevented from acquiring US defence companies. In part this is because they are made aware (by Washington based consultants and through informal discussions with the Department of Defense) of what transactions are or are not likely to find favour with the Administration of the day. Instances where European companies have run into difficulties have tended to be where they were seemingly unaware of the national security dimension of their proposed acquisition (the Dutch company ASM Lithography's acquisition of Silicon Valley Group). US companies acquired by European defence companies are deemed to be under foreign ownership, control and influence (FOCI) and operate under Special Security Agreements between the company and the US government that defines and governs access to proscribed (classified) information. Particularly sensitive technologies may require the establishment of a proxy agreement or voting trust. These proxy companies are governed by specific regulations and staffed by Department of Defense-approved US citizens meaning that their activities are effectively closed to the foreign owner.

Again, these controls may be onerous but they are not unique to the United States. A study conducted by IAI and myself several years ago (which is in the process of being repeated) showed how many European governments have enacted laws and policies to regulate foreign investment in strategic industries. These vary from requiring approval of acquisitions in narrowly defined defence sectors to much broader definition of national security. The issue of strategic controls on foreign investment is a matter of growing interest to the European Commission not least in the light of the emergence of sovereign wealth funds.

Controls on technology transfer: the problem of ITAR

Operationally, a US subsidiary of a European company has to obtain export licenses for the transfer of technology to its European parent company and the same rules apply to internal transfers to the parent as would apply if the technology was being transferred to any other European company. In June 2007, the UK and United States signed a defense Trade Cooperation Treaty designed to cut the red tape associated with US-UK exchange of defence goods and services. The Treaty would end the requirement for every piece of US defence equipment and technology to be granted an individual export license and is designed to speed-up transfers between the two countries. This has been submitted to the Senate and UK Parliament for ratification. The Treaty is bilateral and whether the US will seek similar treaties with other European countries is an open question.

5. But European Companies Will Continue to “Follow The Money” into the Us Market

At the same time, it is important to acknowledge that accessing the US market may be *difficult* but it is not *impossible*.

Accessing the US market is difficult and costly and US controls on companies under FOCI impose substantial administrative burdens and constrain freedom of management action on the part of the European parent. They also mean that transatlantic companies like BAE Systems operate as separate European and US entities and - unlike multinational companies in other industries - they can achieve few transatlantic operational synergies.

Nevertheless, the size of the US market means that European companies will continue to follow the money. EADS and Thales have made clear that their strategy is to increase their presence in the United States. With little prospect of a significant increases in European defence procurement spending we should not be surprised to see a further shift of capital out of the European defence industry in favour of the United States and - increasingly - the Asian market.

6. Implications for European Policy

Politically, the openness of the US market and the willingness of the US to reform ITAR could have important consequences for the debate over the character of the European Defence Technological and Industrial Base (EDTIB) and the European Defence Equipment Market (EDEM).

Calls for reciprocity

Despite the growing European presence, the US-European arms trade imbalance remains and there are some (but by no means all) in Europe who have argued that if the US fails to demonstrate “reciprocity” and open its market to European companies and European arms then European governments are entitled to pursue policies of European preference - excluding US companies from the European market. Spend time in Brussels and listen carefully and you will hear such an argument made in discussions about the future European Defence Technological and Industrial Base or European Defence Equipment Market.

The European defence industry and market needs a strong transatlantic dimension

The EDTIB and EDEM need a strong transatlantic dimension. There is also a need for recognition that the industrial reality is that companies are already operating in the United States and that they will follow the money to strengthen that position in the future. There is also need for a recognition of the political reality that most European governments want to retain the option to buy from the US if that provides better value for money. Thus, talk about “reciprocity” is by-and-large rhetorical and does not reflect the on-the-ground reality of the actually existing European policy in this area.

The future of US procurement policy

A crucial question is what happens next to US procurement policy. One interpretation of the decision to select the Airbus-Northrop Grumman tanker is that the USAF and the Pentagon feel that US defence industry consolidation has gone too far - and that they will look globally to ensure competition.

There are further programme competitions on the way (the US transport aircraft and light-medium helicopter) that will provide indications as to how far a real change is taking place. The comments of some US politicians suggest that they favour competition - but only if US companies win. US Senator Murray of Washington State (the traditional home of Boeing) was quoted in the International Herald Tribune as saying: "I don't disagree with the concept of more competition, but there is a second bigger question and that is military capability and losing military capability."

The danger is that if - after opening the door to European companies - the US government decides to slam it shut again and exclude European companies from bidding on US programmes then it may provoke a response in Europe. The outcome would be higher costs to taxpayers on both sides of the Atlantic and inferior equipment for our militaries.

Getting Europe's own house in order

A final point: those Europeans who argue vigorously about the need for transatlantic reciprocity are often the same Europeans who conveniently ignore that there is precious little reciprocity between some European defence markets. The situation may change of course and this is part of the driver behind EDA and European Commission initiatives to open up the European defence market. Nevertheless, the European argument for the opening of US markets would be stronger if Europe were to first get its own house in order.