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Accompanying document to the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

**on simplifying terms and conditions of transfers of defence-related products within the
Community**

IMPACT ASSESSMENT SUMMARY

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1. POLITICAL CONTEXT

In the past, the Commission has several times highlighted the challenges the European defence industry is facing and has underlined the need to create a European defence equipment market¹ (EDEM). New initiatives taken by the European Defence Agency (EDA) and the Commission since 2004 have highlighted such need. Disproportionate licensing requirements on transfers of defence related products between Member States have long been identified as major impediments for the implementation of such an EDEM.

From a political point of view, despite 50 years of European integration, Member States, when controlling the exportation of defence related products, still make no systematic distinction between transfers to another Member State and exports to third countries.

From an economic point of view, the fragmentation of defence markets along national lines is becoming increasingly unsustainable. The combination of budget constraints and increasing costs for military equipment put European industries into a predicament. The diagnosis is now widely acknowledged for instance by Ministries of defence's through the European Defence Agency: sustainable and competitive defence industries need more integration, less duplication and increased specialisation. The increasing interdependence between defence industries requires easier transfers.

2. PROCEDURAL ISSUES AND STAKEHOLDER CONSULTATIONS

In the wake of the 2003 Communication, the Commission relied on a first fact-finding study entitled "*Intra-Community Transfers of Defence Products*"². The study reviewed all national obstacles to intra-community transfers of defence related products, assessed their direct and indirect costs and identified possible additional measures at Community level.

The consultation process has been launched in the framework of the July 2005 conference "Europe Defence Industries and market place" organised by the European Commission in co-operation with the EDA, during which the findings study were first presented. A public consultation was carried out between March 2006 and September 2006 on the basis of a Commission consultation paper. Seven Member States, ten industry associations and companies, five NGOs and three other organisations seized the opportunity to present their views. A summary can be found on the Commission website².

Finally, throughout the consultation phase between July 2005 and July 2007, a total of 7 workshops (4 with Member States and 3 with industry representatives) have been organised in Brussels by the Commission. These enabled the Commission services to widen and refine their knowledge basis, collect the views of those stakeholders and Member States which had abstained from contributing to the consultation, and test options, from a technical, economic and political feasibility perspective, for the envisaged features of a possible initiative.

¹ COM(97) 583, 12.11.1997; COM(2003) 113, 11.3.2003.

² http://ec.europa.eu/enterprise/regulation/inst_sp/defense_en.htm

3. PROBLEM DEFINITION

All Member States have their own legislation to regulate the import, export and transit of defence related products within the Internal Market. Controlling the dissemination of such products is a key security concern - and a matter of political and/or legal responsibility - shared by all democratic governments. Moreover, civil society's analysis of the human rights and democratic credentials of the country of destination increasingly reinforces the need for a strict and effective export discipline³.

Ex ante licensing schemes are at the heart of these control regimes. All Member States basically implement one, or several of the following three main types of licences:

- an individual licence corresponds to an authorisation granted by a national authority on the request of an individual supplier for one transfer to one recipient;
- a global licence corresponds to an authorisation granted by a national authority on the request of an individual supplier for one or several transfers to one or several recipients;
- a general licence is an authorisation enacted in a general administrative or legislative act and allowing the transfer by any exporter of controlled goods to certain destinations both specified in the licence itself.

National licensing schemes significantly differ in terms of scope, competent authorities, procedures and timing. They impose a significant administrative burden on companies, and require long lead times. The corresponding administrative burden and indirect impact have been estimated respectively at € 433 million/year and € 2,73 billion / year.

This patchwork of strict licensing requirements - and the corresponding administrative burden – clearly appear to be out of proportion with actual control needs, given that license applications for intra-Community transfers are almost never rejected (whilst around 11 500 licences for such transfers are issued annually, not a single request has been formally denied since 2003).

Furthermore, both industry and governmental stakeholders acknowledge that these extensive licensing requirements impede the development of a European Defence Industrial and Technological Base (EDTIB) and undermine security of supply between Member States:

- at industrial level, the need to conform to disparate national licensing regimes hampers the optimization of supply chains. To avoid time-consuming, uncertain and costly procedures, companies indeed tend to prefer national suppliers. This impedes the specialisation of European defence industries and weakens possible economies of scale. Furthermore, pan-European companies cannot enjoy the full benefits of cross-border integration, as long as transfers between a company based in one Member State with its subsidiary in another remain subject to complex and lengthy prior approval schemes;

³ The EU Code of Conduct on arms exports adopted in 1998 builds on eight common criteria for arms exports and also includes a denial notification and consultation mechanism. The adoption of the Code marked a qualitatively new stage in the EU's development of a common approach to arms exports as an important element of the Common Foreign and Security Policy.

- a EU tendering governmental authority cannot take it for granted that export licences will be issued if it wants to procure defence equipment from a supplier established in another Member State. Although licences are hardly ever refused, the "theoretical" possibility that this may happen is an incentive for Member States to prefer sourcing sensitive military equipment to a national producer rather than to its (possibly more advantageous) European competitors.

A number of bilateral or multilateral agreements and initiatives aiming at simplifying transfers of defence related products have been developed on an inter-governmental basis. Even the most prominent of these, namely the Letter of Intent and the subsequent Farnborough Framework Agreement signed by the six main arms producing Member States (FR, DE, UK, ES, IT, SE), have achieved rather limited results to date. As far as the EDA is concerned, it has no mandate for dealing with transfers.

4. OBJECTIVES

The Commission's overarching objective is to establish an open and competitive European Defence Equipment Market (EDEM) in the EU. A well functioning EDEM requires a coherent regulatory framework in the various policy areas, such as procurement and transfers. In order to protect Member States' security interests, this framework needs to take into account the specific nature of defence equipment (strategic importance, security of supply and security of information requirements).

Such overarching objective also fits into the broader pictures of the Lisbon agenda given its contribution to the development of a competitive European Defence Technological and Industrial Base (EDTIB), which may in turn foster the Common Foreign Security Policy (CFSP).

The specific objective pursued by the Commission is the facilitation of intra-community transfers of defence-related products to reduce the complexity - and the related administrative burden - associated with the existing web of diverging national licensing schemes. To that extent, reaching such specific objective will complement the forthcoming directive on defence procurement. Thanks to the transfers' facilitation of defence related products delivered to EU armed forces, procuring governments will enjoy more predictability and consequently greater security of supply, which will reduce current reluctance to cross-border purchases. It will make it easier for cross-border suppliers to "demonstrate" their ability to timely deliver defence related products.

5. POLICY OPTIONS

Five main options have been considered:

<u>Option 1</u>	No action (business-as-usual scenario)
<u>Option 2</u>	Non-legislative measures, taking the form of an interpretative Communication on Article 296 or confidence building measures
<u>Option 3</u>	Complete liberalisation of all defence-related products transfers
<u>Option 4</u>	Management of intra-community transfers at EU level via an Agency
<u>Option 5</u>	Simplification and approximation of national licensing schemes. These

	<p>simplification elements pertain to:</p> <ul style="list-style-type: none"> – the type of licence issued (3 sub-options: A1 = general licences only, A2 = global licences only, A3 = combination of general and global licences), – the guarantees provided concerning the reliability of the recipients (3 sub-options: B1 = no EU certification for companies, B2= mandatory certification, B3 = certification for receiving transfers under a general licence), – the guarantees provided concerning the management of re-exportation to third countries (2 sub-options: C1 = regulatory information requirements and sanctions, C2 = traceability system based on a centralized database) .
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In line with the principle of proportionate analysis, options 2, 3 and 4 have been examined but not retained for further detailed impact analysis, given either their unlikelihood to effectively meet the identified objectives, or their unrealistic nature from a political acceptability perspective. A thorough impact analysis has been performed for the business-as-usual scenario, as well as for each sub-option of the legislative simplification scenario.

In the course of the stakeholders’ consultation, the Council's Common Military List (CML) emerged as a shared reference for all Member States in the framework of the EU Code of Conduct on Arms Exports. This already agreed list consequently represented a natural candidate for defining the scope of any legislative action.

6. ASSESSMENT OF IMPACTS

Option 1: no EU action

The absence of action at Community level to address intra-Community transfers of defence related products does not necessarily imply a frozen *status quo*. A certain number of Member States are likely to continue reviewing their national licensing regimes with a view to simplifying them, and (ongoing or future) initiatives developed in an intergovernmental context could continue to endeavour some facilitation of transfers between participating countries.

Given the observed difficulty in extending such arrangements to additional participating members, the potential discrimination between participating and non participating Member States would at best be maintained, or be even amplified. Such situation would hinder the exploitation of all European competencies and niche expertise (in particular those located in new Member States). Excluded Member States will continue to see little complementary incentive to buy European defence related products given that (a) their defence industry companies (mostly SME) will be less integrated in major defence programmes, and (b) the absence of any greater security of supply compared to alternative third country suppliers.

In the medium to long run, if deprived from the benefits of deeper cooperation and integration, European industry will lose competitiveness and its role could be reduced to that of niche players and suppliers to mostly non-European prime contractors, thereby jeopardising its capacity to autonomously develop the capabilities needed for the European

security and defence policy. Any such exclusion from the highest value-added market segments would also have a negative impact on returns available from European defence companies, creating difficulties in attracting investment. The progressive erosion of EU industry's competitive edge would ineluctably negatively influence both the level and the quality of employment in the sector.

Option 5: Simplification and approximation of national licensing schemes

It clearly emerged during the consultation phase that the overall prevailing level of security interests' protection should be maintained. Concretely, this implies that any simplification / facilitation of intra-community transfers needs to be complemented by measures fostering a climate of mutual confidence, notably as regards possible re-exportations to third countries. The cost efficiency of the various above-mentioned sub-options as regards the facilitation means (type of licence) and the guarantees (certification and re-exportation control) have been screened in detail.

The analysis concludes that an EU scheme based on both global and general licences would constitute the most adequate compromise between the efficiency objectives of the measure (i.e. genuinely facilitating intra-community transfers of defence related products) and the required flexibility for Member States to fine-tune possible re-exportation or end-use restrictions on the most sensitive products.

EU certification of recipient companies appears to constitute a powerful means of raising mutual confidence at minimum marginal cost. Given however the potential disproportionate impact of making certification mandatory (notably for SMEs), the sub-option linking certification to the benefit of reception under a general licence appeared to represent an efficient confidence-building incentive for Member States to make the widest possible use of the least burdensome licences. Reliability associated to EU governments buying products for their own armed forces (i.e. products to be end-used by EU governments) also allows to open general licensing to EU procuring governments.

Finally, as regards re-exportation control, a double control IT traceability system would manifestly generate significant burdensome new obligations for both companies and administrations. The more conventional regulatory technique based on ex post information requirements and effective enforcement policies are therefore deemed as more cost-efficient.

Combining the estimates of the corresponding sub-scenarios leads to an estimated net benefit in administrative burden comprised in a range from **€ 190 mio** to **€ 405 mio /year**. But even more significantly, the expected indirect benefits of simplified transfers as a contribution to a well functioning EDEM and an efficient EDTIB are deemed to considerably exceed these direct net benefits.

Direct social impacts are expected to be minimal, whilst by contrast, indirect impacts are likely to be much more significant. The strengthening of a pan-European Defence and Technological Industrial Base could in the short term lead to rationalisation of structures, and hence, job cuts in redundant programmes and in poorly-competitive companies. Such restructuring is however a prerequisite for keeping the EU defence industry abreast of technological developments, a necessary condition both for being able to face the competition of new entrants and to avoid any further widening of the technological gap with its most advanced competitors. This scenario thereby offers the best guarantee to maintain or develop both in qualitative and quantitative terms, employment in the medium to long run.

Finally, this framework should entail no perceptible environmental impact.

7. MONITORING AND EVALUATION

Any Community instrument established to facilitate intraEU transfers of defence related products will need to be applied and enforced by Member States. The latter will need to adapt their regulatory framework, for instance in order to provide for appropriate provisions on certification and global / general licences. These national application measures will need proper monitoring by Commission services, first to check compliance with Community rules, and secondly to organise transparent confidence-building information exchanges amongst Member States.

In the mid term, the Commission should assess the functioning of the new EU simplified regime, with special attention on administrative costs.

Given the rather long life cycle of defence equipments, changes of government procurement practices and reorganisation of industrial supply chains should not be expected to immediately take place. The yield of greater security supply remains a rather subjective feeling, and time is therefore an essential parameter for forging mutual confidence. The indirect benefits pursued by the facilitation of intraEU transfers of defence products can therefore only be harvested over the long run. Evaluation of these broader macroeconomic impacts should thus be conducted over the same time horizon, probably not sooner than 5 years after entry into application of the Community instrument.