

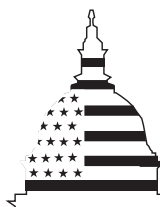
GAO

Report to the Chairman and Ranking
Minority Member, Subcommittee on
Readiness and Management Support,
Committee on Armed Services,
U.S. Senate

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DEFENSE TRADE

Contractors Engage in Varied International Alliances



G A O

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The Honorable James M. Inhofe
Chairman
The Honorable Charles S. Robb
Ranking Minority Member
Subcommittee on Readiness and Management Support
Committee on Armed Services
United States Senate

Together, the United States and Europe saw defense spending decline over 20 percent after the end of the Cold War. As the Department and Ministries of Defense purchased fewer weapon systems, defense companies on both continents looked increasingly to each other's market for additional sales. To gain political advantage when competing in the other's market, U.S. and European contractors began forming transatlantic business alliances. To better understand these alliances, we surveyed four large U.S. contractors, reviewed four weapon system programs being executed by two of these contractors, and studied three foreign-owned U.S. companies. We used the results of our review to address your questions regarding (1) the types of alliances companies are establishing and their reasons for forming alliances; (2) why companies prefer certain types of alliances over others; and (3) whether U.S. laws, regulations, policies, and practices influence a company's decision to form an alliance or its choice of a type of alliance.

Results in Brief

U.S. and European defense companies create teams, joint ventures, and subsidiaries and sometimes merge with or acquire one another in order to compete worldwide for the sale of military weapon systems. Generally, two or more companies form a team by negotiating an agreement to work together to pursue a particular government procurement, with one company acting as the primary contractor and others as subcontractors. In contrast, a joint venture is typically a separate legal entity, either a partnership or a corporation, that two or more companies form to pursue a discrete market. A subsidiary is different from both a team and a joint venture because it is wholly owned by one company and is physically located in another country so that it may pursue that country's defense business. Defense companies form these alliances and subsidiaries to access and increase their competitiveness in other markets.

Large U.S. companies prefer to engage in flexible alliances whenever possible. U.S. defense contractors said they prefer teams to other alliances because teaming allows companies to choose new partners in each market in which they wish to compete, increase company capabilities without forming permanent relationships, and access unique technology needed to meet military requirements. However, European governments are not always receptive to teams because they perceive them as alliances led by U.S. companies using U.S. technology that consign European participants to a subsidiary role. Companies that want to satisfy European governments' desire for greater industrial participation form joint ventures in which companies share risk, decision-making, work, and, to the extent their governments will allow, technology. However, U.S. companies see significant disadvantages with joint ventures because the U.S. government often abandons multilateral programs before completion and all governments supporting the joint venture make decisions that adversely affect its operational efficiency, such as directing the companies to divide work according to each country's investment rather than according to each company's skills.¹ Subsidiaries are not a favored approach because in the fragmented European market a subsidiary in one country has no impact on market access in another country. Neither have large U.S. defense companies favored merging with or acquiring major European defense companies.² One company said that it has not pursued such combinations because they would be unlikely to reduce operating costs since large non-recurring costs would be incurred in moving sizable manufacturing facilities and there would likely be political opposition to such a move. However, European acquisitions of small and medium U.S. defense companies are common because they provide access to the U.S. defense market, which is the world's largest. As of April 2000, 26 of the largest foreign defense companies own 197 U.S. subsidiaries engaged in the U.S. defense market, according to Department of Defense records.³

Companies we reviewed do not consider the U.S. legal and regulatory environment to be a major impediment to forming an alliance or a principal

¹Governments take these actions when the joint venture is formed to execute a government-to-government cooperative program.

²Little data is available on the number of European companies that U.S. companies have merged with or acquired.

³According to an official in the Office of the Secretary of Defense, the office estimated the largest foreign defense companies based on each company's reported sales dollars.

determinant of the type of alliance chosen. However, U.S. companies are concerned with the effect a slow technology transfer process can have on the operation of an alliance and with the effect that a regulation that requires foreign governments to seek U.S. consent before transferring purchased alliance products to third parties may have on future alliance sales.

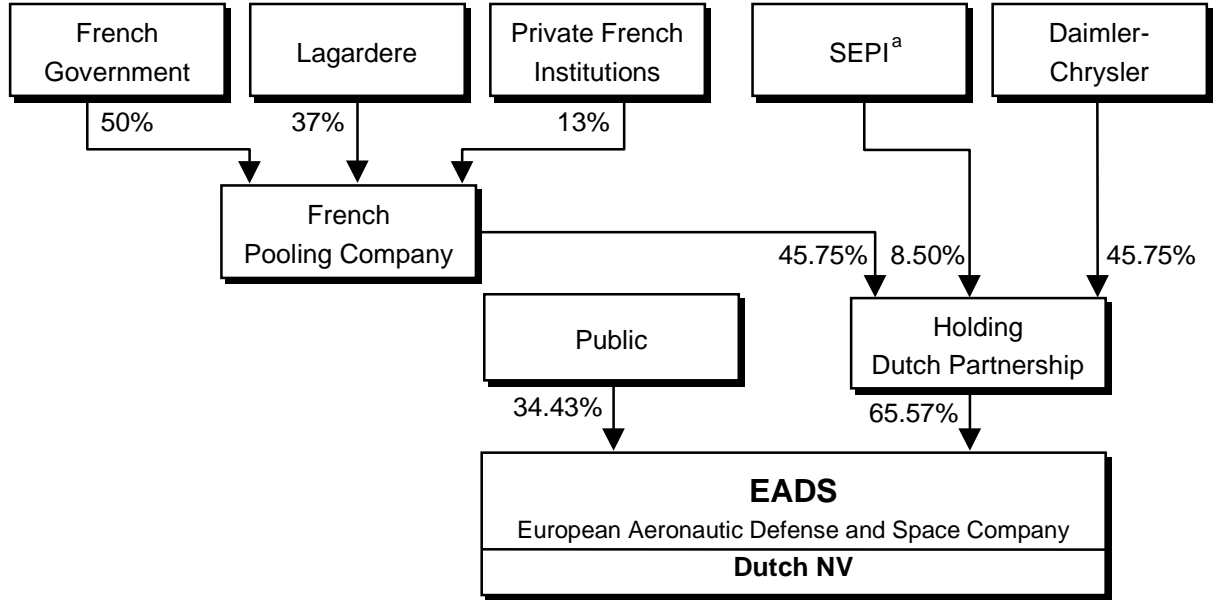
In written comments on a draft of this report, the Department of Defense agreed with our findings.

Background

Between the end of the Cold War and fiscal year 2000, the U.S. government reduced the Department of Defense research and development and procurement annual budgets by about \$60 billion. In response to decreased demand in the U.S. defense market, U.S. defense companies consolidated, merged with other companies, and sold off less profitable divisions and business segments unrelated to the company's core competency. For example, today in the United States there are 5 large defense companies that in 1990 were 33 separate businesses. In addition to consolidating, companies are placing greater emphasis on international sales to make up lost revenues.

European companies, also faced with their governments' declining defense spending, began forming alliances within Europe, in part, to gain access to other countries' defense markets. As companies merge and establish long-term joint ventures for product development, it becomes increasingly difficult to keep track of the multiplicity of relationships. Figure 1 provides a snapshot of one European company's complex shareholder structure.

Figure 1: Shareholder Structure of the European Aeronautic Defense and Space Company



^aSEPI is a Spanish state-owned industrial holding company.

Source: French Armament Procurement Agency, Ministry of Defense.

To access defense markets in Europe, U.S. companies have learned that they have to involve European countries' defense companies in the production of items being sold. This involvement allows European governments to build public support for the purchases. Governments leverage their weapon acquisitions to preserve defense jobs and make their defense companies more competitive in the global market by structuring competitions so that work sharing and technology transfer are competitive discriminators.

Initially, European governments required offsets that created or preserved jobs in return for purchasing weapon systems produced outside of their home country.⁴ An offset could be directly related to the weapon system

⁴Offsets are commercial or industrial benefits that a company offers a foreign government as an inducement or condition for the purchase of military goods or services. See *Defense Trade: European Initiatives to Integrate the Defense Market* (GAO/NSIAD-98-6, Oct. 29, 1997).

being purchased, for example, buying parts for the weapon system from companies in the purchasing government's country. But offsets could also be assisting the country's commercial businesses with marketing their products or helping the country develop its infrastructure. Offsets are still common today and, in some cases, have resulted in European companies becoming long-term suppliers to U.S. contractors.

European countries spend far less than the United States on research and development. For example, in 1997, the United States spent \$32.2 billion on defense research and development compared with the combined spending of France, Germany, Italy, and the United Kingdom of \$7.1 billion. Therefore, larger European countries have come to want more from U.S.-European business alliances than workshare. They also want technology that will make their defense companies more competitive in the global marketplace. Technology transfer is widely used to fulfill offset obligations and may be a key factor in a country's acquisition decisions. It provides European governments with a technology infusion that enables their companies to produce more advanced weapon systems for the export market, which is responsible for a significant portion of some countries' defense industry sales.

Many governments on both continents are increasingly showing support for transatlantic alliances. On February 5, 2000, the U.S. Department of Defense and the United Kingdom Ministry of Defense signed a Declaration of Principles in support of defense industry integration, and the Department of Defense is in discussion with other European countries on this subject. Because the United States expects to fight jointly with its North Atlantic Treaty Organization allies in future conflicts, it wants to ensure that each country's military forces bring compatible equipment to the battle. The Department of Defense believes that the best way to ensure that U.S. and allied equipment can work together is to have U.S. and European defense companies jointly develop weapon systems. If U.S. and European governments also jointly fund development programs, each country's weapon system costs should also decline because each would be responsible for only a portion of total development costs. In addition, Department officials believe that close ties between U.S. and European defense companies ensure companies access to each other's defense market.

Defense companies must consider various statutes, regulations, and other legal requirements when considering transatlantic alliances. Among other things, these laws, regulations, and other legal requirements are meant to

ensure fair competition, establish a preference for or require use of a domestic source, regulate imports and exports, and protect national security. Table 1 lists important U.S. statutes, regulations, and other legal requirements and briefly explains the purpose of each.

Table 1: Statutes, Regulations, and Other Legal Requirements Affecting Transatlantic Alliances

Laws and implementing documents	Primary purpose
Antitrust Laws <ul style="list-style-type: none"> • Clayton Act • Hart-Scott-Rodino Act • Sherman Act 	These laws: <ul style="list-style-type: none"> • Require parties to large mergers to report their plans to the Federal Trade Commission and the Antitrust Division of the Department of Justice; • Prohibit acquisitions that substantially lessen competition or tend to create a monopoly; and • Prohibit acquisitions, mergers, and joint ventures that cause unreasonable restraints of trade or monopolize a market.
Domestic Source Laws <ul style="list-style-type: none"> • Buy American Act • Berry Amendment • Other statutory restrictions 	These acts either establish a preference or a requirement for acquiring domestic articles, supplies, and materials for public use.
Import/Export Laws and Regulations <ul style="list-style-type: none"> • Arms Export Control Act • International Traffic in Arms Regulations • Export Administration Act • Export Administration Regulations 	These acts and regulations control the import and export of military goods and services and goods that may have both commercial and defense uses. <ul style="list-style-type: none"> • The Arms Export Control Act establishes U.S. policy that allows international programs and projects for cooperative exchange of data, research, development, production, procurement, and logistics support to achieve specific national defense requirements and objectives of mutual concern. The act also established the need for export regulations that reduce the international trade in weapons and lessen the danger of regional conflicts. • The International Traffic in Arms Regulations define the type of defense articles and services that require the Department of State's approval for export, the entities that may request such approval, the general policies and procedures related to exports, and the criminal penalties for failing to comply with the regulation. • The Export Administration Act implements the U.S. government's export control licensing and enforcement system for goods that may be used for both commercial and defense purposes. Although the Export Administration Act expired in 1994, the export control process under that act continues under the authority of an executive order. • The Export Administration Regulations implement the Export Administration Act.

(Continued From Previous Page)

Laws and implementing documents	Primary purpose
National Security Legal Restrictions on Acquisitions and Mergers <ul style="list-style-type: none"> • Executive Order 11858 • Exon-Florio Amendment • National Industrial Security Program Operating Manual 	<ul style="list-style-type: none"> • Together the Executive Order and Amendment establish the interagency Committee on Foreign Investment in the United States and give the President the power to act upon the Committee's recommendations. The Committee is responsible for reviewing the voluntary notices of foreign companies that intend to merge with, acquire, or take over U.S. companies and submitting to the President any recommendations that a foreign company suspend or abandon its purchase of a U.S. firm. The President is empowered to act upon Committee recommendations and may also order the divestiture of a foreign company's ownership in a U.S. company. • The Manual prescribes requirements, restrictions, and other safeguards necessary to prevent unauthorized disclosure of classified information released by U.S. government Executive Branch departments and agencies to their contractors. It provides that before a foreign-owned company may access classified information, measures must be taken as necessary to remove the possibility of unauthorized access or adverse effect on classified contract performance by a foreign owner. The level of access granted without restrictions depends on the type of mitigation employed to offset foreign ownership, control, or influence. Foreign-owned U.S. firms operating under a trust or proxy agreement do not have any access limitations, while firms operating under a special security agreement can access information above the secret level only if the government contracting activity prior to the award of a classified contract determines that it is in the national interest to allow the firm access to such information.

Source: GAO analysis of U.S. statutes, regulations, and other legal requirements affecting transatlantic alliances.

U.S.-European Company Alliances Are Varied

Our survey and case studies show that defense companies are engaging in various types of alliances to gain transatlantic market access and become more globally competitive. Six of the seven companies in our study are part of project-based teams, joint ventures, subsidiaries, or mergers and acquisitions, while a representative of the seventh said that the company recently signed an agreement with a European company that provides for teaming when opportunities arise. Large U.S. contractors said that when they compete for business in foreign markets, they form the type alliance that is most likely to result in market access and yield the greatest return on their investment. Officials from European-owned U.S. companies told us that European companies purchase U.S. defense companies to acquire new product lines, capabilities, and advanced technology that enhance access to the U.S. defense market. Table 2 displays the number of teams, joint ventures, and subsidiaries in which the three large U.S. contractors included in our review that established alliances and subsidiaries are engaged.

Table 2: Reported U.S.-European Alliances of Three Large U.S. Defense Contractors

	Teams	Joint ventures	Subsidiaries
Number of reviewed companies engaged in this type alliance	3	3	2
Aggregate number of alliances formed by these companies	115 ^a	26	3 ^b

^aThis number is an estimate rather than a precise count because one contractor said that his company does not maintain a centralized database that includes all teams of which the company is a part.

^bIncorporated marketing offices are not included as subsidiaries.

Source: GAO analysis of contractor data.

Contractors Value Flexibility

Large U.S. contractors said that they prefer to engage in alliances that give them maximum flexibility. However, the companies said that to access certain markets or compete for certain procurements they must sometimes engage in less flexible linkages.

Contractors Find Teaming Most Advantageous

Teaming offers more flexibility than other types of alliances. Because teaming agreements are negotiated, they may contain any provisions to which the parties can agree. Prime contractors said they often try to limit the life of the team to an individual procurement because if a contractor wants to sell its product in more than one market, it gains an acquisition advantage by choosing different subcontractors in each of the markets. Teaming is also a way of temporarily adding capabilities that make a company more competitive. One large U.S. contractor said that teaming with a European company with product expertise different from its own allows it to compete for sales in parts of the U.S. market in which it is not a leader without making an investment to acquire that capability. Another said that governments sometimes require capabilities in their weapon systems that only one company can deliver. For example, the U.S. Army requires that the computer system being developed for a reconnaissance vehicle that it and the United Kingdom are jointly funding be able to communicate with computer systems of command vehicles. Only one company possesses this technology; as a result, the joint venture initiated a nonexclusive teaming arrangement with the company.⁵

⁵Teaming agreements may be exclusive or nonexclusive. An exclusive agreement precludes the teaming partners from joining with other contractors to pursue the same procurement.

However, according to the Department of Defense, teaming arrangements are not always acceptable to European governments and companies. At a time when European governments are insisting on performing a larger portion of a program's work and sharing more U.S. technology, a Department official said European governments and their contractors are less receptive to alliances in which U.S. companies lead programs, thereby retaining most U.S. technology, and relegate European participants to subcontractor status.

U.S. Defense Companies Find Joint Ventures Less Attractive

U.S. and European companies may form joint ventures when their governments are jointly procuring a weapon system and want their countries' contractors to work together as partners to develop and/or produce the system. U.S. companies also engage in transatlantic joint ventures to gain an advantage when competing for European acquisitions. Joint ventures are advantageous because governments see them as a way that companies can work together as equals, sharing jobs and technology. However, contractors said government actions sometimes make joint ventures less attractive alliances.

Unlike a team, a joint venture typically does not place one company in a leadership position. Instead, the companies share risks and assets in joint pursuit of a discrete market, often a specific weapon system program. We studied two joint ventures that companies formed because their governments wanted one to cooperatively develop and produce an air and missile defense system and another to develop a reconnaissance vehicle. U.S. and European governments are jointly funding both systems. In these joint ventures, the participants share decision-making, program risks, technology (to the extent allowed by individual governments), and program work. Representatives of one U.S. company that is located in the United Kingdom said that United Kingdom joint ventures are likely to be more common in the future because the government is moving toward having one contractor support a system from cradle to grave. The representatives said that this concept requires a contractor to make a large, long-term capital investment in facilities, equipment, and personnel, and companies will likely want to form joint ventures to share these risks.

Contractors said joint ventures are not the most advantageous transatlantic linkage because the U.S. government often abandons programs that the ventures support before completion and U.S. and European governments often decide which companies should form a joint venture, as well as requiring that their companies' work share equal their country's program

investment. Of the two programs in our study executed by joint ventures, the Department of Defense has decided not to provide future funding for one and did not plan long-term funding for the second until the program had been in place for 3 years. Joint venture contractors also told us that companies work together best if they are allowed to decide who will compose an alliance because they look for partners that complement their capabilities. Companies also want to decide what percentage of work each participant will perform so that work may be allocated efficiently. One contractor representative said that, when a joint venture must ensure that each country receives work share equal to its investment, work cannot always be assigned to the company best able to perform the tasks.

U.S. Companies Establish Few European Subsidiaries

Of the four large U.S. defense companies in our sample, two have subsidiaries in Europe. We reviewed one subsidiary established in the United Kingdom by each company. Representatives of these subsidiaries said that because of their permanent presence and the number of local citizens they employ, they are better able to compete with the United Kingdom's large contractors. However, being located in the United Kingdom does not guarantee that a subsidiary will be treated more favorably in all respects than other foreign sellers. In addition, contractors said that because the European defense market is fragmented, establishing subsidiaries is not always an efficient use of capital.

In some regards, subsidiaries are treated no differently than other foreign companies. For example, the United Kingdom treats foreign-owned subsidiaries as it does all other foreign sellers in regard to offsets. The United Kingdom's policy is that any company selling defense goods to the United Kingdom must provide an offset if the goods being sold include components valued at more than about \$15 million that are not produced in the United Kingdom. Therefore, if a subsidiary does not plan local production of a substantial portion of a weapon system that the United Kingdom is purchasing, it must subcontract work to United Kingdom defense companies, transfer technology, or perform some other defense activity that benefits the government.

Contractors said that it is sometimes difficult to make a good business case for establishing a subsidiary. Because Europe is made up of many different countries, each with its own defense budget and acquisition process, a subsidiary in one country does not ensure access to the defense markets of other countries. The contractors told us that if a country's defense budget is small and potential profits from likely sales are limited, or if product

pricing is dependent upon large infrastructures, as in the aircraft industry, a subsidiary is likely not feasible.

Transatlantic Mergers and Acquisitions

A complete picture of the status of U.S. and European mergers and acquisitions cannot be drawn because little data is available on the number of European defense companies that U.S. companies have acquired as subsidiaries.⁶ But available data shows that no large U.S. and European defense contractors have merged or acquired one another⁷ and foreign acquisitions of smaller U.S. contractors are common.

Large U.S. companies in our sample cited several obstacles to mergers and acquisitions among large U.S. and European defense contractors. One contractor said that despite over-capacity on both sides of the Atlantic consolidation of manufacturing operations does not appear practical because of the large nonrecurring cost of moving work and the political opposition such a move would create. This contractor also said that the complex interlocking ownership structure of European companies makes it difficult for a U.S. company to reduce costs through consolidation because the European companies have negotiated and contracted work share and established long-term supplier relationships for most products. Other contractors pointed out that U.S. antitrust laws would likely prevent consolidations of large U.S. and European contractors because the size of consolidated companies would give them a competitive advantage. Finally, a representative of one contractor said that his company is not financially able to acquire European companies and is not interested in being acquired.

Acquisitions Enable Entry Into World's Largest Defense Market

Records maintained by the Office of the Secretary of Defense show that, as of April 2000, 26 of the largest foreign defense companies own 197 U.S. subsidiaries engaged in the U.S. defense market. Purchasing U.S. companies is advantageous because it increases the European owners'

⁶A Department of Defense representative said the Department could use its contract database to develop a partial list of U.S. subsidiaries in Europe. However, the list would be limited to subsidiaries to whom the Department awarded contracts with a value of \$25,000 or more over the last 5 years.

⁷Although no mergers or acquisitions have occurred between large U.S. and European defense companies, at least one large U.S. company is considering selling one of its divisions to a European buyer.

access to the largest defense market in the world by providing them with new and profitable product lines and increased capability. Access to U.S. funded technology and acquisition programs are also powerful incentives driving this trend of foreign acquisitions. But purchases can be expensive and, in some cases, market access is limited.

Our case studies show that European companies often enter or expand sales in the U.S. market by acquiring a U.S. defense company. A foreign company principally involved in food processing and real estate investments acquired a U.S. company that is a diversified manufacturer of commercial and defense products and a leader in certain niche markets. The acquisition provided the European buyer with an entirely new endeavor and new market. In another case study, a foreign company acquired a U.S. electronics company that complemented its systems integration capabilities, expanded its market, and provided more of a presence in the United States. The acquirer expects that the synergies between the companies will allow it to obtain a leadership position in the aerospace and defense industry.

Our study also shows that a European company may access U.S. technology and eliminate competitors in the global market through the acquisition of U.S. companies. For example, through one case study we found a European company that acquired two U.S. companies manufacturing a product that is critical to U.S. national security, closed their operations, and moved specialized hardware and software to the European company's facilities. According to Department officials, these actions allowed the European company to narrow the U.S. technological lead in this product, which reduced its competition in the world market. Industry experts also said the foreign company obtained unique technology from one of the acquired companies that enabled it to win a recent U.S. military contract over its remaining U.S. competitor. In addition, the foreign company later acquired another U.S. company manufacturing a similar product and moved that company's operation to Europe.⁸ These actions, according to Department officials, allowed the European company to narrow the technological lead that the United States held in this product.

⁸The European company acquired this U.S. company after the Congress enacted the Exon-Florio Amendment to the Defense Production Act in 1988. The European buyer voluntarily notified the Committee on Foreign Investment in the United States of its intended acquisition of the U.S. company and stated in the notification that the business might be moved to Europe. The Committee did not recommend to the President that this acquisition be suspended.

Even though foreign acquisitions of smaller U.S. companies are common, our sample shows that such consolidations can be expensive because foreign companies pay large sums of money to acquire U.S. companies and incur additional legal fees to transfer company ownership and comply with U.S. laws. Table 3 shows the approximate cost in then-year dollars of the foreign acquisitions of U.S. companies in our review.

Table 3: Reported Foreign Acquisition Costs of Selected U.S. Defense Companies

Dollars in millions		
Acquisition ^a	Purchase cost	Legal fees ^b
#1	\$5	\$0.085 ^c
#2	704	3.000
#3	1,100	2.000
#4	10,000	^d

^aOne company that we selected as a case study was acquired by a foreign company that was in turn acquired by another foreign company. Therefore, we reviewed two acquisitions for one of the case studies.

^bLegal fees include fees for filing with the antitrust review authorities and with the Committee on Foreign Investment in the United States, if applicable.

^cThis acquisition did not undergo an antitrust review or a review by the Committee on Foreign Investment in the United States.

^dAccording to a company executive, the company's records do not separate legal fees from other transfer costs. Total transfer costs were approximately \$158 million and included legal fees, investment banker fees, consultant fees, and other costs.

Source: GAO analysis of contractor data.

Although purchasing a U.S. defense company enhances market access, it does not ensure full access to the U.S. defense market. Department of Defense policy does not allow foreign-owned U.S. defense companies to execute contracts that require access to information above the secret level unless the government contracting authority determines that the release of such information advances U.S. national security interests and the owners of the information approve its release. This policy prevented a United Kingdom-owned U.S. company in our sample from bidding on Navy and Air Force contracts worth in excess of \$123 million.

U.S. Laws Are Not Determinants in Establishing Alliances

U.S. companies in our sample said U.S. laws and regulations are neither the principal determinant of whether they form an alliance nor the reason one type of alliance is chosen over another. Rather, the companies regard the legal and regulatory environment that the United States has designed to protect national security and foreign policy interests as a cost of doing business. However, companies said these laws, regulations, and policies may increase the complexity of establishing an alliance, increase start-up and operational costs, impact an alliance's ability to operate efficiently, and prevent the synergy expected from a business consolidation.

Compliance Increases Complexity and Costs

To meet the requirements of antitrust laws and to prevent future reviews or a directed divestiture for national security reasons, many alliances provide antitrust agencies and the Committee on Foreign Investment in the United States with substantial amounts of information regarding their intended alliances. Foreign-owned U.S. defense companies in our sample said gathering this information requires a significant amount of time and increases start-up costs. However, according to a Department of Justice official, antitrust laws have not stopped any foreign and U.S. companies from forming alliances and records show that the President at the recommendation of the Committee has only prohibited one foreign company from purchasing a U.S. defense company.⁹ Because companies combine all legal fees in their financial records, only one company in our study was able to approximate the cost of filing these antitrust and national security documents. It estimated that it expended about \$400,000 to prepare information for the consideration of the Committee on Foreign Investment in the United States and about \$100,000 to prepare information for antitrust agencies. Neither the antitrust agencies nor the Committee required the company to provide additional information that would have increased costs.

⁹A number of potential mergers or acquisitions have been withdrawn or restructured during the course of a review by the Committee on Foreign Investment in the United States. In addition, in one case a foreign company agreed to voluntarily divest a U.S. company already acquired.

Foreign-owned U.S. companies also said that preventing foreign owners from using their ownership to obtain unauthorized access to export-controlled and classified technology, as required by the National Industrial Security Program Operating Manual, is a continuing expense. Companies reported that costs for security personnel, record keeping, Board of Directors fees and meeting expenses, and legal fees necessary to protect U.S. technology from disclosure range from about \$31,000 to \$295,000 per year.¹⁰

Technology Transfer and Restrictions Slow Operations and Affect Sales

Most alliances in our sample view technology transfer laws, regulations, and policy as exacting a higher cost than other elements of the legal and regulatory environment on an alliance's operation. Joint ventures, subsidiaries, and teams, which execute programs that depend upon sharing U.S. technology, expressed concern with the time that it takes the U.S. government to approve the export of technical data to foreign companies that participate directly or indirectly in the alliance. Subsidiaries also expressed concern with the effect retransfer restrictions could have on future sales in the market they were established to access.

Before a U.S. company participating in an alliance can share with the alliance's foreign participants many technologies owned by the U.S. government or the company, it must, according to the International Traffic in Arms Regulations, obtain approval of a technical assistance agreement from the State Department. The agreement identifies the U.S. technology that the U.S. government is willing to allow the parties to the agreement to share. Because many programs being executed by transatlantic alliances are leveraging U.S. technology, work is slowed or cannot begin until the State Department approves the agreement. Table 4 displays data provided by contractors on the length of time that the State Department required before approving technical assistance agreements for programs included in our sample.

¹⁰All companies executing classified contracts incur continuing expenses for security personnel. However, foreign-owned U.S. companies may incur additional expenses because the National Industrial Security Program Operating Manual requires each company to establish a permanent committee of its Board of Directors, known as the Government Security Committee, to ensure that the company maintains policies and procedures to safeguard export controlled and classified information with which it is entrusted. The Manual further requires the appointment of a Technology Control Officer and the development and approval of a Technology Control Plan.

Table 4: Average Days Required for State Department Approval of Technical Assistance Agreements as Reported by Contractors

	Average approval time for basic agreement	Average approval time required to change a basic agreement ^a
Program 1	107	70
Program 2	95	Not reported
Program 3	74	58

Note: Only three of the programs that we reviewed required technical assistance agreements. The fourth program required a manufacturing license that the State Department approved in 95 days.

^aChanges may include adding or deleting parties with whom data may be exchanged or changing the scope of the data that may be shared.

Source: GAO analysis of contractor data.

The time the United States requires to export technology is even greater if an alliance needs access to government-owned rather than company-owned technology. Department of Defense Directive 5230.11, which implements U.S. policy for the disclosure of classified military information to foreign governments and international organizations, and Directive 2040.2, which regulates the international transfer of technology, goods, services, and munitions, require the Department of Defense to review government-owned classified and export-controlled unclassified information and approve its release to foreign parties.¹¹ A joint venture in our sample reported that during the 27 months after the State Department approved its request for a technical assistance agreement, the Department of Defense required an average of 131 days per document to make a disclosure decision.¹² Department of Defense foreign disclosure officials said the decision process was lengthy because (1) the joint venture requested a large number of documents, many of which were sensitive;

¹¹The National Security Decision Memorandum formulates U.S. national policy governing decisions on the disclosure of classified military information to foreign governments and international organizations. The Memorandum is implemented by National Disclosure Policy-1, an interagency document, that is implemented within the Department of Defense by Directive 5230.11. However, the National Disclosure Policy does not regulate the disclosure of six classes of information. Other national disclosure policies determine the release of national intelligence data, counterintelligence operational information, communications security information, nuclear information, sensitive compartmented information, and strategic planning and guidance. Other national committees or U.S. government officials make disclosure decisions on these classes of information.

¹²The average release time does not include consideration of documents for which decisions were pending or documents whose release the Department denied.

(2) the joint venture failed to provide all required information when requesting data; (3) reviews of requested information by its owners were sometimes lengthy; and (4) the Department did not provide officials with a Technology Assessment/Control Plan¹³ that it requires be used as the basis for foreign disclosure decisions.

Subsidiaries also expressed concern that retransfer restrictions that the U.S. government places on weapon systems sold to foreign governments may reduce the subsidiary's ability to compete for future business in the European market. The U.S. International Traffic in Arms Regulations require recipients receiving U.S. exports of all defense articles and services to obtain the written approval of the U.S. Department of State before transferring those articles and services to third parties. Representatives of subsidiaries said that this regulation sometimes prevents them from successfully competing with European firms. For example, one large U.S. company with a subsidiary in the United Kingdom that competed to develop and produce an air-to-air missile for the United Kingdom believed that it could not be competitive with European companies unless it received relief from this regulation. Because the United Kingdom plans to sell the selected missile as the munition on an aircraft that it is manufacturing and will export to other countries, a retransfer restriction would require the United Kingdom to seek U.S. permission each time it wants to sell the aircraft. In cases such as this, the Department of Defense sometimes agrees in writing to allow the resale of the item in question, in this case the missile, to a select group of countries. However, because exports are under the control of the State Department, the Department of Defense can only provide firm assurance that it will not oppose disclosure of the incorporated technology to the named countries, not that the State Department will agree to allow the missile to be resold to the countries.

Synergy Not Always Attainable

Companies in our sample said technology policy has the potential to prevent or diminish the synergy that alliances expect from business combinations. A foreign-owned company in our sample and its parent that produce similar military items want to share their knowledge and expertise. However, because it is Department of Defense policy to prevent

¹³A Technology Assessment/Control Plan itemizes all sensitive U.S. classified and unclassified articles, commodities, or technical data that may be transferred under a proposed international agreement, assesses the risk to U.S. national security of such transfers, and identifies the foreign technologies that the United States is likely to acquire as a result of a proposed agreement.

foreign owners from using their ownership to obtain unauthorized access to export-controlled and classified technology, the two companies find it difficult to learn from one another and often find themselves in competition. Similarly, representatives of a joint venture that is leveraging U.S. government-owned technology said that some of the technology the United States released to the joint venture is restricted to U.S. access only. The representatives said that because this restriction prevents the free flow of information it undermines the functioning of the joint venture's U.S.-European contract teams. However, another company in our sample realizes synergy without sharing export-controlled or classified data. A representative of a United Kingdom company said that its purchase of a U.S. company will boost operating performance and competitiveness through the synergies and opportunities available to the combined companies. The combination builds on the U.S. company's cost management and financial control skills and the United Kingdom company's large-scale project management and systems integration skills.

Conclusions

The U.S. and European defense companies that we reviewed are trying to maintain flexibility so as to increase their sales in a market that has seen little to no growth globally. Their goal is to seek alliances that best increase their ability to sell products to other governments. In this dynamic environment, the U.S. companies have preferred alliances, such as teams, that they can easily abandon should the alliance be unsuccessful in competing for new business or should an alliance with other companies offer greater potential for increased sales and revenues. Foreign companies included in our review, seeking to increase their share of the largest defense market in the world—the U.S. market—have been willing to establish a more permanent presence. As these U.S. and European companies focus on quickly gaining market share, they are more willing to test different types of alliances. While the companies we reviewed do not consider the U.S. legal and regulatory environment to be the driver in their choice of an alliance, they do find that some laws and regulations, particularly those related to technology transfer, affect an alliance's operation. However, in this rapidly changing environment, it is difficult to determine the full effect U.S. laws, regulations, policies, and practices may have on future linkages.

Agency Comments and Our Evaluation

The Department of Defense agreed with a draft of this report and provided technical comments. The Department's written comments are reprinted in appendix I. The Department's technical comments have been incorporated as appropriate.

Scope and Methodology

We examined the integration of the U.S. and European defense industries by surveying four large U.S. defense contractors, examining four programs two of these companies are executing, and studying three foreign-owned U.S. companies. We cannot statistically state that the conditions we found in our review apply to all U.S. and European industry alliances. However, our aim was not to project our findings to the universe of transatlantic alliances, but to illuminate trends in today's changing business environment. To further ensure that these trends are representative, we discussed them with Department of Defense officials tracking transatlantic linkages and an industry expert familiar with today's business landscape.

We judgmentally selected contractors that are included among the largest diversified U.S. defense companies and programs that are executed by various types of transatlantic alliances, including joint ventures, teams, and subsidiaries. The three foreign-owned U.S. companies were judgmentally selected to include different technologies and various European countries. We did not audit financial or licensing data provided by companies or programs and cannot attest to its accuracy.

To determine the types of alliances formed between U.S. and European defense companies, the impetus for forming these alliances, companies' reasons for choosing certain types of alliances over others, and the influence that the U.S. legal and regulatory environment has on decisions to form alliances, we analyzed survey responses and information collected from defense companies included in our review. We also analyzed U.S. laws, regulations, and policies to determine how they might affect transatlantic linkages and compared our results to the companies' responses and documentation.

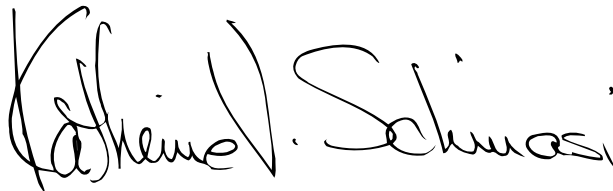
To accomplish our analysis, we held discussions with and collected information from the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics, Washington, D.C.; Office of the Under Secretary of Defense for Policy, Washington, D.C.; Office of the Assistant Secretary of Defense for Command, Control, Communications, and Intelligence, Washington, D.C.; Defense Security Service, Alexandria,

Virginia; Defense Threat Reduction Agency, Arlington, Virginia; Defense Intelligence Agency, Washington, D.C.; National Ground Intelligence Center, Charlottesville, Virginia; Army Counterintelligence Center, Fort Meade, Maryland; Department of Defense General Counsel, Washington, D.C.; U.S. Department of Justice, Washington, D.C.; Defence Export Services Organisation, Ministry of Defence, London, England; and the U.S. Embassy, London, England. We also collected documents from and held discussions with U.S.- and European-owned U.S. defense companies included in our review.

We conducted our work from October 1999 through June 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this report to other interested congressional committees; the Honorable William Cohen, Secretary of Defense; the Honorable Louis Caldera, Secretary of the Army; the Honorable Richard Danzig, Secretary of the Navy; and the Honorable F. Whitten Peters, Secretary of the Air Force. We will make copies available to others upon request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are Barbara Haynes and Erin Baker.

A handwritten signature in black ink that reads "Katherine V. Schinasi". The signature is written in a cursive style with a large initial "K" and a distinct "V" and "S".

Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues

Comments From the Department of Defense



ACQUISITION AND
TECHNOLOGY

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

AUG 11 2001

Ms. Katherine V. Schinasi
Associate Director
Defense Acquisitions Issues
National Security and International Affairs Division
U.S. General Accounting Office
Washington, DC 20548

Dear Ms. Schinasi:

This is the Department of Defense (DoD) response to the GAO draft report, 'DEFENSE TRADE: Contractors Engage in Varied International Alliances,' dated July 27, 2000 (GAO Code 707453/OSD Case 2059). We concur with the draft report. Our suggested technical changes for clarification and accuracy have been provided separately and are attached for your reference.

Sincerely,

Jeffery P. Bialos
Deputy Under Secretary of Defense
(Industrial Affairs)

Attachment: DoD Technical Comments



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