FOUNDATIONS OF INTERNATIONAL DEFENCE INDUSTRIAL CO-OPERATION BETWEEN WESTERN STATES AND EMERGING POWERS

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This paper examines the challenges, risk and opportunities associated with international defence industrial co-operation between Western states and emerging powers. It argues that as inherently dynamic, non-linear and risk-intensive endeavours such partnerships must embrace principles of effective governance and risk management – particularly in the day-to-day delivery of joint-ventures. It further stresses that viable government-to-government defence industrial partnerships are clearly dependent on healthy government–industry relationships and must be unpacked by governments in close dialogue with all relevant stakeholders.

Introduction

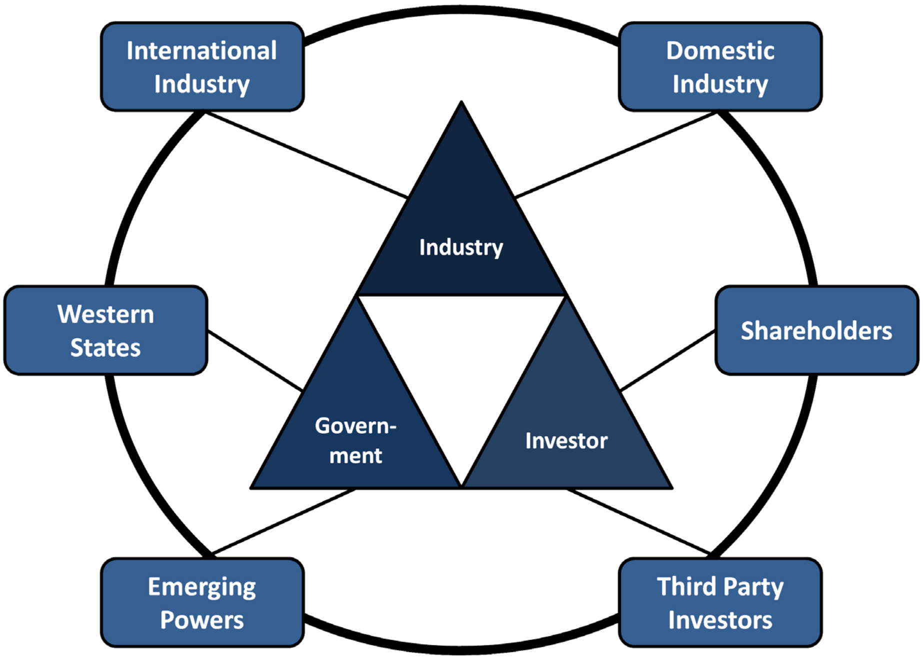
The bilateral relationships between Western states and emerging powers encompass multiple policy areas of varying complexity.[1] A particular example of this is the domain of defence industrial co-operation, as it not only ties countries to each other commercially, but also more fundamentally links their respective defence postures.[2]

Defence industrial co-operation among states, of course, follows the different rationales of the stakeholders involved (see Figure 1). These need to be assessed before examining how to successfully establish and effectively manage a reliable defence industrial relationship, as they can be sources of disruption to it. This paper examines recent developments in the UK–UAE and UK–Saudi relationships as practical illustrations of the challenges associated with international defence industrial co-operation.

Stakeholder Rationales

For Western states, defence industrial partnerships with emerging powers are an opportunity to sustain their access to a healthy and capable defence industrial base that delivers high-quality products and services in time, on budget and at an acceptable unit cost. Pressured by shrinking defence equipment budgets in their traditional home markets, Western defence companies have, over the last decade, substantially increased their outreach to emerging sales markets around the world to ensure the sustained commercial viability of their defence activities.[3]

Figure 1: International Defence Industrial Co-operation Stakeholders



Of course, given the sensitive nature of defence exports, and in particular of technology transfer, Western governments impose highly regulated export control systems on defence businesses registered within their area of jurisdiction.[4] A proven defence industrial partnership agreement with effective and transparent governance and accountability structures can be of significant benefit to ensure compliance with such control systems.

Beyond the regulatory and fiscal rationale, Western governments may also have an intrinsic interest in expanding defence industrial relationships with emerging powers as part of their broader foreign and security policies.[5] Commercial relationships in the defence field are of particular sensitivity, given their relevance in terms of strategic positioning with partner countries – making them rather different to most non-defence commercial government-to-government relationships.

For emerging powers, access to high-quality, cutting-edge equipment and to through-life support services (including training) is an obvious reason to engage in defence industrial co-operation with Western states. More fundamentally, these countries also seek to build strategic relationships with Western states as part of their overall defence postures. A defence industrial partnering agreement, much like the commercial contracts themselves, should therefore be regarded as a crucial element of a bilateral relationship.

Furthermore, in the medium-to-long term, emerging powers may seek to build up their own defence industrial bases. Accordingly, international military sales today not only encompass the export of equipment and through-life support services, but often also involve the transfer of technology to, and build-up of production capacities in, the customer state. To this end, joint ventures between international and domestic defence businesses are regularly created; these allow Western companies easier access to emerging markets while, at the same time, ensuring that industrial expertise can be acquired by importer states, which often hold direct ownership of domestic defence businesses.[6]

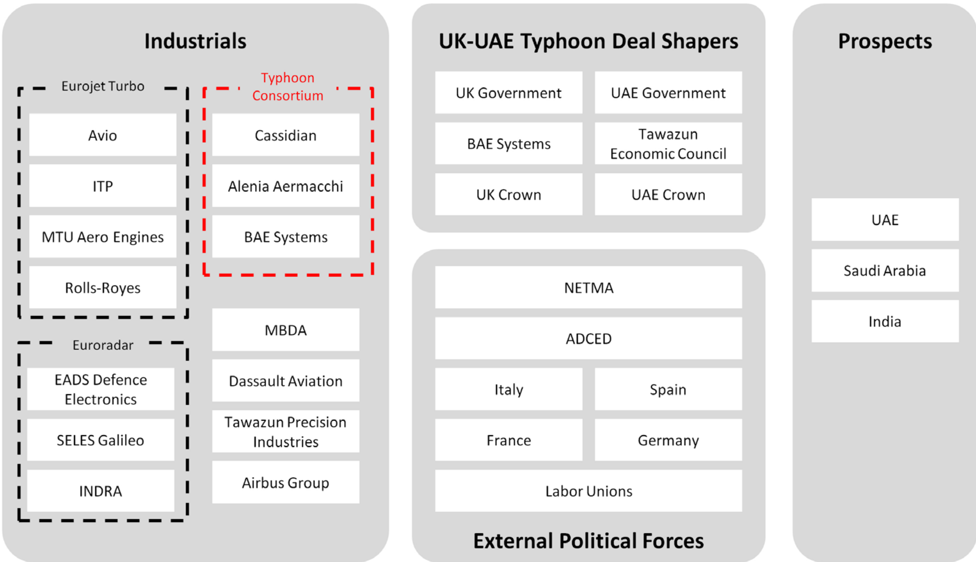
Investors are another important category of stakeholder. As shareholders of both Western and emerging-market defence companies, they exercise significant influence over corporate decisions. Their interests, however, may not always be aligned with governments establishing a defence industrial partnership. Although investors certainly appreciate the potential cash flows and revenues that derive from such partnership arrangements in their quest for return, they may judge the financial risks associated with such deals to be too high, or the time horizon for the realisation of upfront investments to be too long. This is particularly problematic when private-finance institutions – so called third-party investors – act as creditors for contracts placed within the scope of the defence industrial partnership agreement.

The multitude of stakeholders involved in international defence industrial co-operation sheds light on the complexity involved in successfully establishing and effectively managing such bilateral relationships. Their often diverging interests, emerging from different cultural and organisational backgrounds, make this an inherently dynamic, non-linear and risk-intensive endeavour – not least because the policy decisions and interventions of various stakeholders can have unpredictable and unintended consequences.[7]

The UK–UAE Relationship

In November 2012, Britain and the United Arab Emirates (UAE) announced a defence industrial partnership and close collaboration in relation to defence technology.[8] Within the conceptual framework of this partnership agreement, BAE Systems – as the lead negotiator for the Typhoon consortium – formally submitted a bid to build sixty Typhoon fighter jets for the UAE in September 2013.[9] This deal, potentially worth £6 billion, was considered by many to be a cornerstone of the future UK–UAE defence industrial relationship. Figure 2 identifies the key stakeholders of the Typhoon deal.

Figure 2: Key UK–UAE Typhoon Deal Stakeholders



After lengthy negotiations, the deal eventually collapsed in December 2013.[10] A number of the factors impacting upon the cancellation of negotiations were highlighted, such as disagreements over the jet's actual operational capability profile and uncertainties over its financing base and commercial structure, notably regarding buy-back of the UAE's Mirage 2000 fighter aircraft and offset components.[11] Though these elements may have indeed been relevant, two further aspects seem to have been of particular relevance at the strategic level.

First, as with the joint defence partnership with the UK in general, the UAE government had considered the Typhoon deal as part of a strategic alignment with the UK, and one to be relied upon in its national defence effort. Such a notion was grounded in an established sense of trust in the British government's willingness to intervene as a strategic partner of the UAE in a potential high-intensity regional conflict.[12] Yet commentators suggest that the House of Commons's rejection of UK military action against Syrian President Bashar Al-Assad to deter the use of chemical weapons on 30 April 2013 raised substantial doubts as to the reliability of a UK–UAE strategic defence partnership.[13]

Second, throughout the negotiations there seems to have been a dominant focus on the commercial side of the deal while not enough attention was paid to the broader strategic reasoning of the top political UAE leadership. According to press reports, industry executives involved in the negotiations felt that the UAE has never been in any rush to seal a deal for a new aircraft.[14] Discussions by RUSI researchers with Western government officials and analysts working in the region suggest that the UAE may not have wanted to risk a possible worsening of its relationship with Iran over a large order of strike-capable jets. Both government and industry seemed to have focused their efforts on making the financial numbers work. This, however, came at the expense of hands-on management of top-level decision-makers acknowledging their broader strategic reasoning.

Taken together, these points clearly stress that a healthy government-to-government defence industrial relationship is fundamentally dependent not only on the general state of the overall bilateral relationships, but also on an in-depth understanding of top-level decision-making processes, which are often rooted in highly complex cultural and societal dynamics. Furthermore, it might be argued that extensive commercial relationships in non-defence sectors do not necessarily translate into a similar defence industrial relationship.

The Salam Deal

Despite being equally turbulent and subject to protracted negotiations, the terms of the Salam Deal determining the price of the seventy-two Typhoon fighters to be sold by the UK to Saudi Arabia were successfully agreed on 19 February 2014.[15] Diplomatic talks regarding the Saudi purchase began quietly with the signing of an 'understanding' between the two governments in December 2005, while the contract itself was not signed until September 2007.

Even with a successful history of co-operation between the two governments under the Saudi British Defence Co-operation Programme, the eight years and three months of negotiations from December 2005 were far from smooth.[16] Nevertheless, the willingness to compromise and persist with the talks ensured the successful conclusion of the deal.

Prior to this, the allegations of corruption against BAE Systems (the UK's prime contractor) during the 1980s Al-Yamamah Deal for the Saudi Arabian purchase of forty-eight Tornado fighters had put a strain on the relationship between the two countries. The Saudi government's distaste was such that rumours began to circulate that it was looking into buying a fleet of French Rafale fighters instead. However, although a controversial decision, taken to prevent damage to the UK's national and international security and protect the lives of UK citizens and service personnel, the UK government had the Serious Fraud Office's investigation into the corruption allegations closed down.

Having overcome this controversy, in late 2007 negotiations stalled once more and the media began reporting on the Saudi government's second 'disillusionment'. Although terms had been agreed between the two governments, the addition of contractors and other stakeholders to the negotiations brought new issues into play. BAE Systems refused to accept the previously agreed price tag of £4.5 billion, asserting that this would not cover the escalating programme costs – an issue which has only recently been resolved. In addition, while the two governments had agreed that only the first twenty-four of the seventy-two Typhoon fighters would be assembled in the UK – while the rest would be assembled in Saudi Arabia – Boeing, the main stakeholder in the only potential production facility in Saudi Arabia and competitor to the Eurofighter consortium, created obstacles to the domestic manufacturing component. Much to the Saudi government's frustration, this left it with no option but to agree to all fighters being assembled in the UK.[17]

Finally, as late as December 2013, negotiations foundered as a price still could not be agreed upon. At this point, BAE reported that 'the Group's earnings per share guidance for 2013 would be impacted by approximately 6 to 7 pence as a result of these discussions not being concluded in the near term'.[18]

Although a stilted process, however, the importance of the deal to all parties involved led to consistent and persistent negotiations taking place, and to the development of a trusting relationship. For the UK, particularly after losing the deal with the UAE, the conclusion of the contract is significant in that it offers assurance of an ongoing relationship with one of the key markets in the region. Moreover, in the face of budget cuts, such a large contract ensures the maintenance of the UK's core defence capabilities, including long-term production and the protection of skills essential to the defence industry, which might otherwise be lost.

Equally, budget cuts in the UK, the US and Europe have affected BAE Systems' profits.[19] Thus, the Salam Deal is a lifeline to which it has shown commitment by continuing to supply Typhoons to Saudi Arabia (twenty-eight as of August 2013) without any injection of cash from the Saudi government.

For its part, the latter, apart from gaining a new fleet of fighters, has secured its position as a strategic partner of the West, gained access to technology through provisions for transfer, and ensured the establishment of domestic production and support capabilities for its growing defence industry. This has been achieved by compromising on the location of production, by recognising the bounds of the agreement in terms of the country's level of influence over UK policy in the absence of the contract, and, most importantly, by continuing to negotiate with BAE Systems over the price tag.

Risks to an Effective Partnership

In light of both the failed UK–UAE Typhoon deal and BAE Systems's Salam Deal, policy-makers and industrialists alike should reflect seriously on the potential risks likely to affect future international defence industrial partnership agreements.

Such risks do not reside solely within individual projects. Defence industrial partnerships between Western states and emerging powers are usually not limited to a single large-scale multi-billion contract. Instead, a portfolio of contractual commitments that regularly include a multitude of smaller contracts drives them. Though less financially significant, these contracts – often as challenging as the multi-billion contracts from a political and risk management perspective – can indeed be considered the building blocks of defence industrial partnerships.

Therefore, governments and industry alike must apply a comprehensive understanding and management of risk, at both the individual project level and the portfolio level in order to build viable long-term defence industrial relationships. The list of eight common causes of project failure produced by the National Audit Office and former Office of Government Commerce in 2008-09 is a useful starting point in this regard:[20]

- The lack of a clear link between the project and the organisation's key strategic priorities, including agreed measures of success
- A lack of clear senior-management and ministerial ownership and leadership
- A lack of effective engagement with stakeholders
- A lack of skills and a proven approach to project management and risk management
- A lack of attention to breaking development and implementation into manageable steps
- The evaluation of proposals according to initial price rather than to long-term value for money (especially in terms of securing the delivery of business benefits)
- A lack of understanding of, and contact with, the supply industry at senior levels of the organisation
- A lack of effective project-team integration between clients, the supplier team and the supply chain.

These points are essential to any project, especially one that involves the co-operation of multiple different stakeholders and which aims to deliver value to all parties (not only in terms of revenue).

Set Principles of Effective Governance to Ensure Successful Partnership

In order to avoid such failures it is recommended to ensure both strong governance and the close co-ordination of operational activities through the implementation of four general principles of effective governance.

First, all parties involved should have a specific strategic intention when signing up to an agreement, as well as clearly stated expectations in terms of the outcomes it will generate. Therefore the implicit needs to be made explicit, and a fair and shared for a trusting relationship needs to be built in order to ensure that strategic objectives are met. Though this may sometimes be difficult due to political sensitivities, it is a necessary precondition for an effective governance system.

Second, any deviation from the initial intent must be controlled effectively and if, for any reason, the targets set at the outset do need to be revised, the process must be managed sensitively in order to maintain an appropriate balance between the partners, and to avoid generating frustration.

Third, a sufficient level of transparency and the involvement of all relevant stakeholders in the decision-making process must be guaranteed. An interested party should never feel that some actions may be managed at their expense, or that a counter-party may take control to the extent that they feel their interests are no longer protected.

Fourth, as trust is the key for partnership efficiency, each actor must build the necessary elements of credibility and reliability through open collaboration. Stakeholders can thereby ensure the right balance of investment between each party in terms of mutual respect.

Though the day-to-day handling of defence industrial relationships is a task for industry and government first and foremost, there is also an important legislative oversight function that needs to be addressed. Defence, foreign affairs and public accounts committees all have an intrinsic interest in assessing compliance with the aforementioned principles of effective governance and, more broadly, in analysing whether defence industrial relationships with emerging powers fit with parliamentary views of the country's desired overall strategic international footprint. It is important that parliaments continue to ensure that select committees are funded appropriately if these oversight responsibilities are to be undertaken effectively.

Making Joint Ventures Work

Given that joint ventures are a regular element of the commercial component of government-to-government defence industrial partnership agreements, their efficient day-to-day management is essential to the overall success of international defence industrial co-operation. Companies can achieve real value from joint ventures by focusing on six fundamental processes:[21]

- Developing clear, common objectives and definitions of success
- Ensuring comprehensive, frequent and consistent communications
- Determining an appropriate governance model, with clear decision-

making, work-sharing, and associated roles and responsibilities
- Assigning an alliance relationship manager to help anticipate the most likely conflicts
- Planning for evolution and keeping key project team-members on board until the joint venture or alliance is operational
- Establishing clear financial and operational reporting metrics to track and measure successful transition.

Many efforts and barriers may be encountered during the set-up phase, during which the elements of governance, organisation and performance management that will drive the operational phase are defined. This is also the period during which all stakeholders begin to collaborate, and learn to communicate by defining the elements of language which are a prerequisite for building a trusting relationship. It is also the right time and a necessary evil to anticipate, as far as possible, potential future problems through open legal and risk management discussions – a process which will help the future partnership thrive.

It must be mentioned here that the effective management of joint ventures is of crucial relevance not only to the successful delivery of the main military contract, but also to the efficient performance of the offset contracts attached to them. With offset obligations regularly equivalent to more than 50 per cent (in some cases even to more than 100 per cent) of the military contract value, and with substantially increasing penalties for non-performance, they certainly pose both a commercial and a reputational risk to global defence businesses.

In the past, Western defence companies have struggled on more than one occasion to match their offset obligations. They have encountered difficulties particularly when contracts have been placed outside their traditional comfort zone – as in the case of US radar-system and missile manufacturer Raytheon failing to run a shrimp farm in Saudi Arabia in 2006 – or when target economies have proven incapable of absorbing the investment demanded, leaving substantial offset obligations oustanding.[22]

As such, sound governance arrangements in line with the factors identified above must be in place at the corporate and programmatic levels. At the same time, emerging powers face the challenge of ensuring that their domestic skills base and infrastructure are sufficiently developed to be able to absorb the economic and technological benefits generated by offset programmes. Meanwhile, in close co-operation with industry and Western governments, they must address potential corruption threats – particularly with regard to the role of brokers and intermediaries in the domestic awarding of offset contracts.

Managing Government–Industry Relationships

All of this suggests that a viable government-to-government defence industrial partnership is clearly dependent on a healthy government–industry relationship. The foundation for such a relationship is arguably Western governments' acknowledgement that corporate strategy is, in essence, business development writ large. In other words, despite a comprehensive understanding of their professional environment, companies' responses to the complex demands of government-to-government defence industrial partnerships are manifested at the operational level in business-development activities.23

The impact and role of investors in publicly listed defence businesses seems to be little understood by most Western governments. The boards of defence companies are under clear pressure to align their activities with those of their sponsoring and client governments in terms of state-to-state defence industrial partnerships, but there is widespread recognition that the specific interests of individual and especially institutional share-holders might differ, and can have an impact on company strategy. As such, the management of, and engagement with, investors constitutes an increasingly pivotal strategic focus in the establishment and management of government-to-government defence industrial partnerships.

More fundamentally, the multinational structure of large international defence companies engaged in government-to-government defence industrial partnerships requires co-operating states to assume a sensible regulatory role in their relationship with industry.24 The control of classified information within strategic partnerships is a particular challenge in this regard. Though a partnership agreement may provide governments with greater leverage, it usually does not diminish their interest in the protection of intellectual property rights over cutting-edge technology. While firm regulation of corporate agents' behaviour through rigorous and comprehensive contracting is therefore essential, over-regulation – regulations that protect companies from competition, prevent them from growing and exploiting new markets, generate excessively high compliance costs for both companies and governmental actors and contribute to companies becoming less capable of adapting to technological change or customer needs – can nonetheless have a detrimental impact on government-to-government defence industrial partnerships. Not only could this, in turn, potentially reduce the capacity of the partnership agreement to generate required cutting-edge military capabilities, if not communicated properly it could also affect the level of trust among co-operating states.25 The regulation of corporate agents' behaviour must therefore be aligned with the principles of effective governance outlined above.

Taken together, the multinational structure of large defence businesses and the long-term strategic nature of government-to-government defence industrial partnership agreements appear to highlight the impelling need for more elaborate, long-term co-operative relationships between governments and defence prime contractors, with contracts being a significant, albeit not the only, element in these relationships.26 The time horizon of both the government–industry (currently short- to mid-term) relationship and the government-to-government (long-term) relationship must be aligned for the former to become a building block of the latter. The commercial certainties of such a long-term relationship would not only balance a company's risk portfolio – something appreciated by investors and boards alike – but also contribute significantly to the overall stability of bilateral defence industrial partnership agreements.

Unpacking the Debate

The above suggests that international defence industrial co-operation between Western states and emerging powers should be perceived as a multilayered complex that needs to be addressed by governments in close dialogue with all relevant stakeholders. As a highly complex matter, international defence industrial co-operation features various dimensions – government-to-government, government-to-industry, industry-to-industry, industry-to-investor and government-to-investor relationships – with multiple stakeholders and power relationships at play.

To complicate matters further, the defence industrial debate takes place against the backdrop of multiple other dynamics – in the non-defence commercial, cultural, geopolitical, legal and labour spheres – which can be profoundly different in nature, and can involve different stakeholders, locations, power relationships and – not to be underestimated – timeframes. Tough, interdependent defence industrial stakeholders may not always be fully, if at all, aware of such dynamics due to a lack of adequate information resources and a self-constructed inability to look beyond the environment to which they are accustomed.

As noted, the delivery of such partnerships is therefore an inherently dynamic, non-linear and risk-intensive endeavour. In order to master it, Western governments require significant cultural, technological, organisational, operational and financial expertise, a reflective acknowledgement of the complexities surrounding and affecting them, and a well-established network of inter-personnel relationships in the governmental, corporate and investor domains on which to rely throughout the process of establishing and developing defence industrial partnerships.

This is, arguably, a hands-on task that forces Western governments to regularly assess their own conceptual and structural pre-positioning towards such defence industrial partnership discourses. More fundamentally, however, they must integrate their roles as customers, sponsors and regulators of the defence industry – while dealing with businesses that are no longer national in ownership or strategic direction, and while engaging with governments of emerging powers that not only want to buy a military capability, but are also seeking to develop long-term strategic ties and to build up their own national defence industrial capacities.

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Appendix: Required Foundations for International Defence Industrial Co-operation

Set Principles of Effective Governance to Ensure Successful Partnership

- Embrace specific strategic intentions when signing up to an agreement, and clearly state expectations in terms of the outcomes it will generate
- Effectively control any deviation from the initial intent
- Guarantee sufficient levels of transparency and involvement of all relevant stakeholders in decision-making processes
- Build necessary elements of credibility and reliability through open collaboration
- Exercise continued legislative oversight to ensure compliance with these principles and the partnership's fit with a parliament's view of a country's desired overall strategic international footprint.

Effective Management of Joint-Ventures

- Develop clear, common objectives and definitions of success
- Ensure comprehensive, frequent and consistent communications
- Determine an appropriate governance model, with clear decision-making, work-sharing, and associated roles and responsibilities
- Assign an alliance relationship manager to help anticipate the most likely conflicts
- Plan for evolution and keeping key project team-members on board until the joint venture or alliance is operational
- Establish clear financial and operational reporting metrics to track and measure successful transition
- Ensure a sufficiently developed domestic skills base and infrastructure able to absorb the economic and technological benefits generated by offset programmes
- Address potential corruption threats – particularly with regard to the role of brokers and intermediaries in the domestic awarding of offset contracts.

Effective Management of Government–Industry Relationships

- Acknowledge that company responses to the complex demands of government-to-government defence industrial partnerships are manifested at the operational level in business-development activities
- Engage with individual and institutional investors, which have specific interests and exercise significant influence on company

strategy

- Apply sensible regulatory frameworks, which impose firm regulation of corporate agents' behaviour through rigorous and comprehensive contracting while at the same time avoid over-regulation
- Align the time horizon of government–industry and government-to-government relationship to balance company risk portfolios and increase the stability of bilateral defence industrial partnership agreements
- Strengthen Western governments' cultural, technological, organisational, operational and financial expertise and developing their networks of inter-personnel relationships in the governmental, corporate and investor domains.

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1. Notwithstanding that Western states have a significant portfolio of defence industrial partnership among themselves – like the UK-France co-operation as part of the Lancaster House treatment – this paper focuses on such relationships with emerging powers. The latter, though similar to the former in many ways, feature distinct characteristics with regard to the driving rationales of stakeholders involved and specific challenges with regard to their governance and risk management.

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