

Abstract

Industrial participation in the HX fighter program

The report discusses the prerequisites for industrial participation in replacing the operational capability of the Air Force F/A-18 aircraft (hereinafter the “HX program”). The aim was to examine current offset (industrial participation) practices and their viability and to produce information that can contribute to a more transparent debate and decision-making process as Finland is seeking a replacement for its Hornet fighter jets. The issues discussed in the report are also relevant to the Squadron 2020 program, which is also in planning.

The aim of the HX program is to replace the Hornet fleet from 2025 onwards. According to the European Commission, industrial participation distorts the free market. The Act on Public Contracts in Defence and Security (1531/2011) was introduced in 2012, as required under the Defence and Security Contracts Directive (2009/81/EC) of the EU. A Member State can deviate from the directive under Article 346 of the Treaties (Article 346 TFEU) if essential security interests so require. Under Article 346 “no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security” (1a) and “any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes” (1b). Finland can deviate from the provisions laid down in the Act on Public Contracts in Defence and Security if its national security so requires. The report shows that the legislative changes have been taken into account in the preparation of the HX program but the processes concerning the practicalities of industrial participation should be reviewed.

Notwithstanding the directive, defence equipment that is essential to national security can thus be purchased on the basis of national procedures and industrial participation is still permitted under these procedures. However, industrial participation may not distort the market for non-military products. Ensuring adequate defence capability should be the only basis for industrial participation and it may no longer be aimed at promoting economic growth and employment. The main aim of the procurement has to be to purchase equipment with optimum performance. Industrial participation should only provide a framework for purchasing the best available equipment, and not be an end in itself.

Even though industrial participation increases the cost of the procurement, the needs of the defence capability must be considered as well

It is estimated that purchasing the new multi-role fighters for the Finnish Air Force will cost about 10 billion euros. According to experts, industrial participation (offsets) will increase the cost of the purchase 5 to 12 per cents. According to this investigation, a cost increase of about ten per cent seems to be a reliable estimate, even though there are no specific calculations to support any estimates. Such an increase could make the purchase up to one billion euros more expensive if 100 per cent industrial participation was required. From the perspective of state finances, such a cost impact would be justified if Finland received full

value for the money. This value can take the form of securing the defence capability. Using industrial participation to promote economic growth is not allowed under existing legislation. In Finland, the support for the core functions of the Defence Forces has partially been outsourced to companies. This means that strategic partner companies must be integrated into the system of security of supply as defined by the Defence Administration. Military security of supply ensures adequate operational capability in crisis situations.

Industrial participation (IP) related directly to supporting the procured system is called direct industrial participation. In the acquisition of the Hornet fleet, direct IP accounted for about 15 per cent of the total IP. Up to 85 per cent of the industrial participation requirement concerned indirect industrial participation, which was extensively applied to promote employment and exports prior to Directive 2009/81/EC.

In this example less than one fifth of the increased costs have concerned military security of supply, whereas at least four fifths of the increased procurement costs have concerned indirect industrial participation. This indirect IP may partly have been defence-related but it has also had economic aims. If the same were true in the HX program, up to 850 million euros would be spent on indirect IP which is very hard to measure. It is also very hard to show what kind of value for money has been gained in indirect IP.

In the HX program, the changes in the EU law have been acknowledged but, so far, no decisions have been made regarding the scope of the industrial participation requirement and how to ensure that the money will be well spent. Industrial participation will not come as a bonus as the supplier will calculate a price for the requirement and include it in the price of the offer. If 100 per cent industrial participation would be required (as was the case with the purchase of the Hornet fleet in the 1990s), indicators should be set for the whole requirement as well so that the results can be verified. Setting a 100 per cent industrial participation requirement may not be possible and the IP requirement should be based on ensuring defence capability in crisis situations, as laid down in Article 346 of the Treaty on the Functioning of the European Union (TFEU).

When assessing industrial participation from the perspective of state finances, consideration should, in addition to the cost impacts, be given to the fact that impacts the security of supply and is therefore an investment in the credibility of Finland's defence capability. From a national defence perspective, replacing the Hornet fleet is not only a matter of purchasing multi-role combat aircraft, as the procurement also has a security policy dimension. The model of military security of supply presented must be credible and Finnish companies play a crucial role in this. Industrial participation is linked to security of supply because IP ensures that Finland will also receive the necessary operating technology, licences and the expertise for the entire operating cycle.

This investigation finds that the preparation of industrial participation in the HX program, which is the responsibility of the Ministry of Defence, is competent. The arguments for industrial participation are credible and have been presented in a logical manner.

[The objectives for industrial participation and their assessment processes should be improved](#)

The industrial participation obligation refers to the terms and conditions that the supplier has agreed to follow. The Finnish Committee on

Industrial Participation operating under the Ministry of Economic Affairs and Employment decides on the approval of the industrial participation obligations of the companies that have concluded industrial participation agreements. The obligations are approved based on applications submitted by the suppliers. Even though there have been substantial changes in the IP environment since 2012, the investigation finds that there have been few practical changes. The future of the Finnish Committee on Industrial Participation should be critically reviewed regarding the transparency and effectiveness of the process and the knowledge base under which it operates.

This investigation finds that the structure and the operating practices of the committee should be reviewed. The Ministry of Economic Affairs and Employment has monitored that the suppliers meet their IP obligation but this supervision has only targeted individual contracts, not IP obligations as a whole. The Finnish Committee on Industrial Participation also doesn't report any other information but the obligation fulfilment figures. The Finnish Defence Forces Logistics Command has monitored the content of the direct industrial participation. The content and focus of all forms of industrial participation should be systematically monitored and subjected to a critical review, both inside and outside the Finnish Committee on Industrial Participation.

Existing industrial participation agreements will remain in effect at least until the year 2021. How the suppliers have met their IP obligations, is the only information that has been made public. The Ministry of Economic Affairs and Employment argue that they can't release more information due to trade secrets. However, as the process involves supporting industries with an instrument paid for by the taxpayers, it should be examined whether the names of the beneficiaries could be made public and whether more information on the industrial sectors could be disclosed. More information about the impacts of industrial participation should be provided to improve government transparency. Particular attention should be paid to active provision of information because practices cannot be expected to change automatically as the operating environment changes.

Attitudes towards industrial participation in the administration have been positive and no consideration has been given to whether IP might have negative impacts on the markets. However, when decisions are made in public administration, the impacts of industrial participation on the markets as a whole should be recognised as industrial participation has an impact on the business solutions of the participating companies and the competitive position of the companies left outside the process.

In any industrial participation agreements concluded under the current legislation, the aim must be to strengthen national defence capability and not to promote economic growth. In the new operating environment, it should be examined whether the role of the Finnish Committee on Industrial Participation should be changed so that industrial participation could be managed more effectively in the future. It can be assumed that if the industrial participation process is complicated for the suppliers, the extra effort required will be included in the price of the IP. For companies, negotiating an industrial participation agreements is an additional transaction cost, which will be taken into account in pricing.

It is clear that industrial participation can be justified with military security of supply. In most cases, this means direct industrial participation and also indirect industrial participation in the defence sector. Under existing EU law, indirect industrial participation, too, must

be limited to ensuring military security of supply. Under current legislation, it is not possible to use economic policy as a justification for industrial participation without a clear defence dimension. This also applies to industrial participation based on ensuring security of supply.

The impacts of industrial participation on the market need to be acknowledged

In addition to the Defence Administration, industrial participation also benefits Finnish companies that are accepted as partners in contracts eligible for industrial participation. Here it should be noted that industrial participation may impact the market as it will have a negative effect on the competitive position of those companies that are not involved in the contracts eligible for industrial participation. According to this investigation, the Ministry of Economic Affairs and Employment has also viewed the market impacts as either positive or neutral. No negative impacts have been identified and no independent reports on the impacts of IP on the market have been prepared.

If industrial participation becomes a tool for improving the overall operational prerequisites of specific companies without making any clear contribution to the Finnish Defence Forces' security of supply needs, the risks of market impacts should be critically assessed. Under the current legislation, it is not possible to have a parallel aim of supporting domestic defence industries in addition to the primary aim of ensuring the Finnish Defence Forces' security of supply. It should be openly assessed, how the operating subsidies of up to one billion euros are divided between the beneficiaries, whether there are any alternative ways of achieving the objectives and how industrial participation impacts the market as a whole.

Recommendations

Based on this investigation, the National Audit Office presents the following recommendations for consideration in the future preparation of the HX preindustrial participation:

1. In the preparation of the HX program,, particular consideration should be given to ensuring that any requirement for industrial participation is explicitly based on defence needs. For this reason, the industrial participation obligation should not go beyond what is required as part of Finland's defence capability. This limitation also impacts the additional price paid for industrial participation.
2. Industrial participation is one way of providing Finnish Defence Forces with optimum capability. Under the existing EU law, industrial participation can't be an end in itself.
3. The industrial participation processes (compensation system) should be reviewed so that the effectiveness of the system can be ensured in the existing regulatory environment.
4. The results of industrial participation should be monitored more systematically and they should be more actively communicated. An up-to-date overall picture of the content of indirect industrial participation should also be produced.
5. To ensure equal treatment of all operators, any neutral or negative market impacts of industrial participation should be considered in decision-making.