DEFENCE TRADE CONTROL BILL

Submission to the Senate Standing Committees on Foreign Affairs, Defence and Trade

U.S. Trade and Export Control Services

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INTRODUCTION

It is worth making five introductory points.

Firstly, Defence suggests that the *Defence Trade Control Bill 2011* (the Bill) would be required to implement "best practice" intangible transfer and brokering controls regardless of the *Treaty Between The Government of The United States of America and the Government of Australia Concerning Defense Trade Cooperation* (the Treaty).

This is simply not sustainable in light of the evidence. The so-called "best practice" guidelines for intangible transfers and brokering were adopted by the Wassenaar multilateral export control group years ago, in 2006 and 2003 respectively, years before the Treaty was even conceived. But no action was taken to implement the guidelines until the Treaty had been finalised.

In fact, action was only taken now because the State Department *required* Australia to control intangible transfers and brokering as a condition of implementing the Treaty. The U.S. Senate Committee on Foreign Relations Report 111-5, 24 September 2010, page 37, states that intangible transfer and brokering controls are a condition of the Treaty entering force.

Secondly, Defence has assiduously avoided providing a Regulation Impact Statement for the Treaty, or in any way exposing the Treaty's costs and benefits to public examination. The Bill's Explanatory Memorandum continues to do so with its statement that "It is important to understand that a Treaty post Implementation Revise (sic) has been requested within 24 months since the commencement of its implementation. Therefore, a RIS is not required for the Treaty provisions in this Bill. This RIS focuses more on examining proposals to implement a strengthening (sic) the existing export controls."

In other words, the Treaty has not been publicly scrutinized (save for a cursory hearing by the Joint Standing Committee on Treaties, at which questionable evidence was provided), and on the face of it, it appears to be once again escaping review.

Thirdly, the two preceding points would not be as important were it not for the fact that the Treaty is fundamentally deficient and flawed from an Australian perspective. The Treaty was forced through a highly truncated negotiation and review process to permit it to be signed by then Prime Minister Howard and President Bush in September 2007 – that is, in time for the 2007 Federal election – and its provisions reflect too many concessions on the Australian side.

Fourthly, Defence's promise of a "post implementation revise" (review?) after two years of Treaty operation is glib and disingenuous. Defence fully understands that by then it will be too late and too difficult to rectify the existing deficiencies in the Treaty (which, via the Bill, will have flowed through to Australian legislation).

Finally, notwithstanding suggestions and claims to the contrary, Australian industry was not briefed on the Treaty until *after* it had been finalised and *could not be changed*; and subsequent Defence briefings were focused largely on telling industry (rather than consulting) about the Treaty and about procedural matters associated with moving it and its implementing legislation through government processes.

In light of the above facts, the Treaty should be the subject of at least as much Committee scrutiny as the technical details in the Bill under consideration. The following discussion is offered as background for this examination.

TREATY BENEFITS

The Treaty purports to provide a "comprehensive framework" for licence-free exports and transfers of controlled unclassified and classified defence articles (including technical data and services) between and within Australian and U.S. Approved Communities – but only "to the extent" that such activities are identified in, or limited by, Article 3 the Treaty.

The Treaty's scope limitations in Article 3 were codified and expanded in a highly prescriptive *Implementing Arrangement Pursuant to the Treaty Between the Government of the United States of America and the Government of Australia Concerning Defence Trade Cooperation* signed on 14 March 2008, (the Implementing Arrangement), and were

further buttressed by a lengthy and complex United States (U.S.) *List of Defense Articles Exempted from Treaty Coverage*.

When taken together, these scope limitations and exemptions result in a Treaty that will apply:

- **only to programs agreed by the U.S. Government**;

- **minus** activities involving third countries (like *Navantia* on the AWD Project);

- **minus** a long list of U.S. technologies – not all of which are "particularly sensitive" *contrary to evidence provided by Defence* (JSCOT Hansard, Monday 16 June 2008, page TR10). For example, U.S. defence articles, defence services and technical data are excluded from Treaty coverage if they have not "previously been subject to a US export licence"; also excluded are "All classified US-origin Defense Articles not being released pursuant to a US Department of Defense written request, directive or contract that provides for the export of the Defense Article";

- **minus** projects undertaken by U.S. companies that decide not to use the Treaty. Given their potential exposure to "export control risk" some U.S. companies may decide not to use Treaty even when they are permitted to do so – and the State Department will not demand that Treaty processes be used. *General Accounting Office (GAO) report-02-63: DEFENSE TRADE: Lessons to Be Learned from the Country Export Exemption* commented (at page 5 *et al*) that that U.S. companies were still applying for U.S. export licences for defence articles that were eligible for licence-free export under a Canadian ITAR exemption. In response, the State Department advised (page 28) that "Although an item may be exempt from the State (licensing) review and approval, it is still subject to U.S. export control law"; in other words, the burden for reviewing the legitimacy of the transaction does not disappear, it merely shifts from State entirely to the U.S. exporter. This exposes exporters to greater levels of risk, which some may not be prepared to accept.

To date, Defence has either ignored or at best ambiguously qualified these limitations on Treaty coverage, and this has misled both Australian industry and many defence media commentators.

Even now, the Bill's Explanatory Memorandum continues to claim that the Treaty will offer licence-free trade that will "significantly reduce the administrative delays" associated with export controls, and provide "reduced delivery times for new defence projects". Or that it will also provide "improved business opportunities for Australian companies to participate in US contracts". Do these claims stand serious scrutiny?

Reducing delivery time for new defence projects

Schedule delays have been a long-standing U.S. export licensing issue. Although almost all Australian licences and other authorisations are eventually approved by the State Department, about a third of licence applications and all agreements (for the export of technical data or defence services) are circulated for review by U.S. government agencies before State Department approval is granted. This can take up to three months or longer.

While regulatory delays such as these are bothersome, but generally predictable, they are often not accommodated adequately in DMO project schedules.

In any case, it is worth noting that timing issues could have been resolved in 2005-2009 under a State Department program known as the Technology Transfer Process Improvement Initiative. Under this program, and following negotiations with Defence, the State Department agreed that if defence articles to be exported to Australia met the ITAR exemption criteria for Canada, then the relevant Australian export licence application would be reviewed only by the State Department (and not other U.S. agencies) with the aim of approval within 10 days. For exports that did not meet the Canadian criteria, the State Department agreed to aim for a 30 day licence turn-around. Australian companies were advised of this arrangement (known as "Expedited Licence Review") by Defence's Head of Industry Division (HID) on 15 May 2007.

Inexplicably, in May 2009, HID advised that the DMO had agreed to the suspension of expedited licensing. This decision was based on a fundamental misunderstanding within the DMO of both the original State Department agreement and State Department's export control metrics. For example, HID not only confused the specifics of the State Department's agreement, but also claimed that the State Department's licence processing times had improved – and that the average processing time had "been reduced to 15 working days". In fact, there had been no change at all: the average processing time in April 2008 (*a year* before the DMO's decision) was 15 days; it was 17 days in April 2011; it was 22 days in mid-2011; and was 18 days in December 2011.

It is revealing that Australian industry was not consulted on its experience of U.S. licensing approval times before the DMO agreed to the suspension of expedited licensing.

Setting aside the mishandling of U.S. export control arrangements in the recent past, the best that can be said of the Treaty is that it will eliminate an as yet unquantified number of licences for an unidentified number of projects. Whether this will have a material impact on Defence project schedules is doubtful, as the following example illustrates.

If it was starting today, one might expect that the DMO's Air Warfare Destroyer (AWD) project – a major project with perhaps hundreds of U.S. licences and agreements – would pass through the first filter of Treaty eligibility, the basic Treaty scope limitation. However, of its hundreds of licences and agreements, many will *not* be eligible for Treaty coverage because they involve Spanish company, *Navantia*; as noted above, exports involving third countries are excluded. Other licences may not be ineligible because they involve "excluded technologies". And, still others may be excluded because U.S. exporters do not wish to use the Treaty (as discussed above).

The obvious question is what benefit would be achieved on a particular AWD project activity involving, say, 20 licences and four technical data agreements, if the Treaty permits 10 or 12 licences and one or two agreements to be eliminated? The answer is probably that very little overall benefit would be gained because the currently complained of schedule pressure would simply move to the non-exempt agreements or licences.

Facilitating business by permitting sharing of technical data

Defence claims that by facilitating Australian and U.S. companies sharing technical data the Treaty will improve opportunities for Australian companies to participate in U.S. defence programs – in other words, to gain access to the U.S. defence market.

This is simply fanciful. U.S export controls are but one brick in comprehensive protective wall of U.S. domestic preference laws, policies and practices, all of which have the effect of impeding foreign access to the U.S. defence market. The other bricks in the wall include legislated barriers (eg, *Title 10 United States Code–Armed Forces*, the Buy America Act, and the Annual U.S. Defense Authorization and Appropriations Acts); set-asides for U.S. small businesses; specified U.S.-only acquisitions; and the inclusion of functional requirements that are specifically aimed at excluding foreign suppliers.

The negotiation of the Australia/U.S. Free Trade Agreement (FTA) provided the best opportunity to dismantle such barriers. But they remain as strong today as they were before the FTA was concluded.

It strains credibility almost to breaking point to believe that an export control treaty would be able to achieve what the FTA could not. Indeed, it is unsurprising to find that the Treaty's Implementing Arrangement is already armed to apply U.S. protective barriers to Australian access under the Treaty. The Implementing Arrangement requires *inter alia* that Australian companies will only be permitted to contribute to U.S. contracts that are "specifically open to foreign participation"; and *in addition*, that the U.S. solicitation must specifically state that "Australian Approved Community members are permitted to participate using Treaty procedures".

Clearly, the U.S. intends that Australian access the U.S. defence market will continue to be governed, as it is now, by U.S. domestic preference laws, policies and practices applied on a case-by-case basis by U.S. contracting officers.

Transfers without the need for U.S. approval

Defence expects that pre-approved transfers of U.S. defence articles within the Approved Community, permitted under the Treaty, will overcome current delays in the State Department's processing of transfer applications; and will facilitate *inter alia* the out-sourcing of Foreign Military Sales (FMS)-origin equipment to Australian companies.

A preconditions for access to U.S. defence technology is that a foreign recipient must agree not to transfer the technology by any means from the nominated end-user to another company or individual in Australia or overseas, unless State Department prior written approval has been obtained. While this is not generally a significant issue for U.S. equipment that has been acquired under direct commercial sales arrangements, there can be long delays in obtaining retransfer approval where U.S. defence technology has been acquired under (government-to-government) Foreign Military Sales (FMS) arrangements. The time to obtain retransfer approval can be more than 12 months in some cases.

Regardless of the acquisition method, retransfer approval is not always granted – and the State Department does not provide reasons for denial. Since approval will not be granted if the original U.S. exporter objects, the retransfer process and its opacity have been used by some U.S. exporters as a screen for their own opposition to proposed transfers.

Under the Treaty, there will be a number of retransfer processes at work, including processes associated with:

- U.S. equipment acquired under licence – ie, U.S. equipment that, for whatever reason, is not covered by the Treaty;
- FMS-origin equipment, which is excluded from Treaty coverage (in accordance with Article 3 of the Treaty);
- U.S. equipment that is covered by the Treaty, but which is to be transferred outside the Approved Community; and

- U.S. equipment covered by the Treaty, and "pre-approved for Transfer within the Approved Community".

Setting aside the added complexity associated with retransfers under the Treaty, the notion of a "pre-approved retransfer" in the last point above is likely to be illusory. Even under the Treaty, U.S. exporters will place their own restrictions on the transfer of their products within the Australian community. They will be concerned at the potential for their product (including technical data) to be cycled without apparent restraint through the Australian Community, with a real possibility that it could end up being transferred back to a potential competitor in the U.S. (noting that all U.S. defence companies are *de facto* members of the U.S. Approved Community).

Thus, in the absence of the current State Department review of retransfer applications – which provides U.S. companies with an opportunity to support or oppose a particular retransfer – U.S. exporters are likely to impose their own retransfer approval process on Treaty goods. Some U.S. exporters might even see a blanket denial on pre-approved retransfers as the safest and the easiest solution. (For FMS-origin defence articles, denial can be achieved merely by adding a note in the FMS Letter of Offer and Acceptance.)

TREATY COSTS

Cost information provided to date is guesswork

Normally, a Treaty which has significant impact on Australian industry would require a Regulation Impact Statement (RIS) to be developed and tested by the Productivity Commission. In this case, the Australian Treaty National Interest Analysis prepared by the Defence Export Control Office advised that "Due to the process by which the Treaty was negotiated and signed [discussed in the Introduction above], an RIS was not prepared in accordance with the best practice regulation requirements".

In the absence of an RIS, or *any other* contestable cost-benefit analysis, Defence has relied on "guesstimates" such as that provided by the then Head of Defence Materiel

Organisation's Industry Division in evidence to the Joint Standing Committee on Treaties hearing in 2008:

> "Our estimates are that initially it will cost industry around about $50 million to do that. We base that on the fact that many of the companies who would be involved in the approved community already have approval … for the security levels that are needed to do this. That does not mean that they do not have to set up separate record-keeping arrangements. They will have to do that. There is a compliance cost in that. For newer companies to become members of the approved communities who are not already DSB approved, of course there would be a cost for compliance."
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> (JSOT, op. cit., page TR13)

There is simply no published or tested basis for this assessment; and no work has been conducted in the three years since then to provide one.

Industry concerns have been ignored

In this regard, when the Treaty was first exposed to companies in 2008, most companies expressed serious concern about the costs associated with a requirement that U.S. Defence Articles exported to Australia under the Treaty must be classified at least to the RESTRICTED level (most current licensed exports are U.S. "controlled unclassified"[1]).

Most viewed this requirement as a *major* Treaty cost-driver; some went so far as to suggest that it would not be feasible. This fundamental concern has been brushed aside.

This is a matter of particular unease for Small-to-Medium Enterprises (SMEs) who can ill-afford added costs that contribute nothing to the bottom line. As Mr Greg Evans, Director Economic and Industrial Policy at the Australian Chamber of Commerce and Industry, said in evidence to the Senate Select Committee on New Taxes: "SMEs are thinly capitalised and are unable to cope with even marginal cost increases. Additional costs diminish their already narrow profit margins and diminished profits will reduce their return on labour and capital." (Hansard 10 August 2011, page 69)

[1] Controlled Unclassified is a unique U.S. classification defined as "technology or technical information to which access or distribution limitations have been applied in accordance with applicable U.S. national laws or regulations". Some estimates suggest that well over 95% of U.S. defence exports to Australia are Controlled Unclassified.

OTHER MATTERS

Treaty obligations are inequitable

Even a cursory reading of the Treaty and its Implementing Arrangement reveals that Australian companies face obligations that far exceed those of their U.S. counterparts. The inequity is illustrated in the following examples:

- **Approved Community.** Australian Companies must satisfy a detailed and extensive list of requirements to be eligible for membership of the Approved Community. Australian companies will not be approved for entry to the Approved Community *unless the U.S. Government has agreed in writing*. On the other hand, U.S. companies do not face a "qualification process" similar to that proposed for Australian companies: all U.S. defence exporters are *already members* of the U.S. Community based on their current registration with the State Department (which itself is based on the submission of an application form and payment of a fee).

- **Exports of Defence Articles.** U.S. defence articles exported to Australia under the Treaty must not be re-transferred or re-exported outside the Australian Approved Community member without prior U.S. Government approval. On the other hand, since *all* U.S. defence companies are already members of the U.S. Approved Community, the question of re-transfers outside the U.S. Approved Community does not arise. An Australian defence product can circulate without restraint through the *entire* U.S. defence industry community (and, in this light, it is worth keeping in mind one of the mandatory agreement ITAR clauses that "No liability will be incurred by or attributed to the US Government in connection with any possible infringement of privately owned patent or proprietary rights, either domestic or foreign"). U.S Community members are also permitted to re-export Australian defence articles outside the U.S. in accordance with the *U.S. Government*'s existing export procedures. Unlike the requirements for U.S. products in the Australia, Australian Government approval does not need to be sought for re-exports of Australian products from the U.S., although the U.S. Government has agreed to "consult" with the Australia Government on a list of countries with which the

Government of Australia has *significant* national security and foreign policy concerns.

- **Suspension.** The U.S. Government can suspend Australian companies from the Approved Community at very short notice if U.S. Defence Articles are believed to be at risk of diversion. On the other hand, no such authority is offered to the Australian Government in respect of Australian defence articles at risk in the U.S.

Notwithstanding this clear evidence of inequality between Australian and U.S. obligations, the then Head of Defence Strategic Policy, the Division responsible for implementing the Treaty and the current Bill, advised the Joint Standing Committee on Treaties on 16 June 2008 that the "obligations on the companies at either end are equal and reciprocal". (JSCOT Hansard, Monday 16 June 2008, page TR13)

Treaty risks have not been acknowledged

The Treaty attracts risks which have not been adequately addressed by Defence. The principal long-term risk is that Australian products will be "captured" by U.S export controls.

Currently, before the State Department will approve an Australian company's access to U.S. defence technology, the company must agree that any Australian product which is manufactured, incorporates, uses, is changed by, or derived from, *any* US defence article or technical data, will not be transferred by any means to another company or individual in Australia or overseas, *unless the State Department has provided prior, written approval*.

This obligation remains extant under the Treaty (but as another example of inequality, it does not apply to U.S. companies in relation to Australian products in the U.S.). Effectively, this means that an Australian product will become hostage to U.S. export controls if it is *in any way* affected by U.S. technology (there is no minimum level of U.S. content required).

In the past, Australian SMEs (and even some Defence agencies) have been discouraged from engaging with U.S. companies under any form of U.S. export licence or agreement,

unless there is exceptional justification for doing so that outweighs the risk of having their products compromised (eg, the certainty of a lucrative sale in the U.S.).

To the extent that the Treaty is successful in freeing information exchange between the U.S. and Australia, it will be far more difficult to control and manage the "tainting" of Australian products than is presently the case under discrete licences and agreements. This suggests that Australia's defence exports could be put at much greater risk, without the compensating certainty of market access to the U.S. (given the discussion above on U.S. domestic preference laws, policies and practices.)

Notwithstanding this risk, Defence has offered no protections for Australian companies or Australian products under the Treaty.

The Treaty is voluntary in name only

The Bill's Explanatory Memorandum states that "Industry participation in the Australian Community will be voluntary".

This is consistent with Defence evidence during the Joint Standing Committee on Treaties hearings (referred to above); it was repeated during the December 2010 Industry Briefings; and it has been raised in the DECO Treaty flyer for industry.

But the undeniable fact is that Defence's clear preference for U.S. technology means that even large Australian Defence companies will have *no real choice* but to join the Treaty community if they want to continue working in the Defence sector. (Interestingly, at one of the industry workshop's on the Treaty, a Defence representative, responding to this very concern, suggested that the decision to continue to work in the Defence sector was itself voluntary!)

U.S. officials will have an open door to Australian companies

Under the Treaty, and as provided for in the Bill, U.S. officials will be permitted to accompany an authorised Australian Defence official to conduct an examination of the

company's compliance with Approved Community conditions. It is almost certain that similar, largely unfettered access will not be provided to Australian officials in the U.S.

Once implemented, the Treaty will endure

As noted above, and notwithstanding the intention to conduct a post-implementation review, the obligations laid down in the Treaty will endure regardless of the outcome of the review.

More than that however, they will endure whether or not an individual Australian company decide to "opt out" of the Approved Community. Companies that decide to abandon the Treaty at some future time can expect to face the same or more onerous licence conditions as those presently captured in the Treaty obligations.

A FINAL WORD

The Defence Trade Cooperation Treaty, which the draft Defence Trade Control Bill 2011 will implement, has enormous implications for Australian industry. Despite this, its benefits and costs have not be analysed or exposed to public scrutiny, let alone to the scrutiny expected of a Treaty under normal government processes.

Its risks, while significant, have simply been ignored.

This Treaty was defective when it was negotiated some years ago, but developments on the U.S. export control front threaten to make it increasingly inadequate.

Under economic and industrial pressure to address problems with its own export control arrangements, the U.S. has embarked on a program of export control reforms which was announced in the 2010. The key elements of this program involve the harmonisation of the USML and its commercial equivalent into a single tiered, more positively focused, control list; the setting up of a single licensing agency using a single information technology system; and, the establishment of a single enforcement coordination agency.

Some elements of the program have already been started. But pressure on the Administration continues to grow as economic stress and uncertainty begins to flow down to the U.S. defence manufacturing sector (which in some respects, has been largely immunised by the equipment demands for Afghanistan and Iraq). Economic pressure on the U.S. defence manufacturing sector will translate into continuing pressure for U.S. export control improvements and new initiatives.

In such an environment of change, and unless the current Treaty is revised, Australian industry could find itself impaled on an "old" Treaty negotiated at what in hindsight might be seen as the high water mark of U.S. export control obligations, while everyone else is benefiting from more recent, and (if the new ITAR nationality rules are any guide) more liberal, U.S. export control requirements.

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