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Comment to Proposed Rule on Spacecraft Systems and Related Items

I. Introduction

On May 24, 2013, the U.S. Departments of State and Commerce published proposed rules describing how certain articles the President determines no longer warrant control under the U.S. Munitions List ("USML") Category XV (Spacecraft Systems and Related Articles) would be controlled on the Commerce Control List ("CCL"). *See Amendment to the International Traffic in Arms Regulations: Revision of U.S. Munitions List Category XV and Definition of ''Defense Service,''* 78 Fed. Reg. 31,444 [hereinafter "DDTC Rule"]; *Export Administration Regulations (EAR): Control of Spacecraft Systems and Related Items the President Determines No Longer Warrant Control Under the United States Munitions List (USML),* 78 Fed. Reg. 31,431 [hereinafter "BIS Rule"].

We hereby offer comments on the BIS Rule. Specifically, we recommend modifying the proposed amendment to Subsection 734.4(a) of the Export Administration Regulations ("EAR") set forth in the BIS Rule. That proposed amendment, adding a new Paragraph 6 to Subsection 734.4(a), precludes use of the EAR's standard 25% *de minimis* rule for foreign-made items that incorporate U.S-origin "500 series" or "600 series" items when destined to China and other arms-embargo countries listed in the new Country Group D:5. *See* BIS Rule at 31,438; *see also Revisions to the Export Administration Regulations: Initial Implementation of Export Control Reform*, 78 Fed. Reg. 22,660, 22,720, 22,721 (April 16, 2013) (final rule creating the new Country Group D:5).

The modification that we offer for consideration is to apply the EAR's standard 25% *de minimis* rule to foreign-made commercial satellites or components incorporating certain U.S-origin "500 series" items when destined to China. Broadly speaking, our proposed change would provide that foreign-made commercial satellites or components are not subject to the EAR for reexport to China when they incorporate certain U.S.-origin parts and components that fall under the new "500 series," if that U.S.-origin content constitutes 25% or less of the total value of the foreign-made item.

It is important to note at the outset that the modification we propose would not seek to change the current restrictions on exports or reexports to certain end-users or end-uses in China of items subject to the EAR, including U.S.-origin satellites and non-*de minimis* parts or components. The current end-user and end-use restrictions would continue to apply, including those found in Part 744 of the EAR related to sanctioned entities, military end-uses in China and weapons of mass destruction end-uses, among others.

The change that we propose is based on the existing authority of BIS to release from control certain foreign-made satellites and components destined to China. We believe that BIS continues to enjoy that authority under the National Defense Authorization Act ("NDAA") for Fiscal Year 2013, which imposed legislative restrictions on certain exports of satellites and related items to China. Public L. No. 112-239 (January 2, 2013) [hereinafter "NDAA"].

In effect, what we are proposing is that the EAR should not group China together with other countries subject to U.S. arms embargoes when it comes to reexports of foreign-made commercial satellites. The basic reason is that China, in the global market place, is a desired provider of satellite launch services. Therefore, continuing to restrict the reexportation of foreign-made commercial satellites to China will lead foreign manufacturers to design-out all U.S.-origin content. This will continue to adversely affect and "hollow out" the U.S. parts and components industry. In deciding which approach to adopt, it is important to consider carefully the policy imperative of maintaining a healthy and competitive U.S. space industrial base, which is important for our economic strength, commercial technology base, and military capabilities.

The drawback of the BIS Rule as it is written is that it will lead non-U.S. commercial satellite and component manufacturers to continue to design-out U.S.-origin parts and components. By restricting the reexport of these foreign products to China, even when they incorporate only a single U.S.-origin item of minimal value, the BIS Rule is compelling foreign satellite manufacturers to choose between Chinese launch services and U.S. parts and components suppliers – companies that already face stiff competition from abroad. The reality is that foreign manufacturers can sacrifice their U.S. supply chains in favor of Chinese launch providers. We believe that Congress did not intend to require such a choice when a *de minimis* amount of U.S. content is incorporated into a foreign product. Therefore, we submit for BIS to consider in the exercise of its discretionary authority whether allowing reexports to China in these circumstances would strengthen our country's industrial base without any corresponding adverse impact on national security.

II. Statutory and Regulatory Background

The NDAA authorized the President to transfer commercial broadcast satellites from the USML to the CCL, thereby moving export control of such satellites and related items from the Department of State, under the International Traffic in Arms Regulations ("ITAR"), to the Department of Commerce, under the EAR. However, Section 1261 of the NDAA sets forth conditions for the transfer of satellites and related items to the Commerce Department's export control jurisdiction. Specifically, Subsection 1261(c) sets forth the following prohibitions that relate to China (as well as a few other countries):

> "(1) IN GENERAL.—Subject to paragraph (3), no satellites or related items that are made subject to the Export Administration Regulations (15 CFR part 730 et seq.) as a result of the enactment of subsection (a) of this section, whether or not enumerated on the Commerce Control List—
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> (A) may be exported, re-exported, or transferred, directly or indirectly, to (i) any government of a country described in paragraph (2); or (ii) any entity or person in or acting for or on behalf of such government, entity, or person; or
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> (B) may be launched in a country described in paragraph (2) or as part of a launch vehicle owned, operated, or manufactured by the government of such country or any entity or person in or acting for or on behalf of such government, entity, or person.
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> (2) COUNTRIES DESCRIBED.—The countries referred to in paragraph (1) are the following: (A) The People's Republic of China. (B) North Korea. (C) Any country that is a state sponsor of terrorism.
>
> (3) WAIVER.—The President may waive the prohibition in paragraph (1) on a case-by-case basis if not later than 30 days before doing so the President— (A) determines that it is in the national interest of the United States to do so; and (B) notifies the appropriate congressional committees of such determination."

This language makes clear that commercial satellites and related items that are being made subject to the EAR cannot be exported or re-exported to the government of China or launched from China. Of course, military satellites and related items that remain on the USML continue to be subject to the ITAR and therefore cannot be exported or re-exported to China.

However, the NDAA does not mandate or specify whether the transfer of a foreign-manufactured commercial satellite that contains a *de minimis* proportion of U.S.-origin parts and components would be subject to the prohibitions of Subsection 1261(c). Nor does the statute specify whether components that are manufactured abroad and contain *de minimis* U.S.-origin content would be restricted for export or reexport to China.

Under the NDAA, the Department of Commerce retains the authority to determine whether a foreign-manufactured commercial satellite or component should be made subject to the EAR and therefore whether the prohibitions of subsection 1261(c) should apply to it. The statute restricts exports and reexports of "satellites or related items that are *made subject* to the Export Administration Regulations." NDAA § 1261(c)(1) (emphasis added). It does not modify

the authority of the Department of Commerce to decide whether a particular class of foreign-manufactured items is made subject to the EAR. If Commerce determines that an item is not subject to the EAR, subsection 1261(c) does not apply to exports or reexports of that item. Therefore, the Department of Commerce retains the discretion to set *de minimis* rules in this area, just as it has done in other areas of the EAR.

Congress did not appear to limit the President's existing authorities in this area. The Conference Report for the NDAA states explicitly that "nothing in this Act shall be construed as removing or limiting existing authorities of the President . . . to otherwise take such actions as are necessary to implement requirements for improving national security controls in the export licensing of satellites, launch vehicles, and related items." *Conference Report to Accompany H.R. 4310* at 911, 112th Cong. (Dec. 18, 2012). A clear concern was with export of U.S.-origin items. See the remarks of Congressman Rohrabacher calling for the prohibitions to apply to "U.S. satellites." Cong. Record at H3669 (May 25, 2011).

Currently, the BIS Rule provides that even foreign-made satellites with a single U.S.-origin part or component in the "500 series" would be subject to the EAR when destined to China, and therefore would also be subject to the prohibition on transfers to China in Subsection 1261(c). Specifically, the proposed regulations would add a new Paragraph 6 to Subsection 734.4(a) of the EAR. *See* BIS Rule at 31,438. Paragraph 6 would preclude use of the EAR's standard 25% *de minimis* rule for foreign-made items that incorporate U.S-origin "500 series" or "600 series" items when destined to China and other arms-embargo countries listed in the new Country Group D:5. *Id.* With the *de minimis* rule no longer available for reexports to China of foreign products incorporating "500 series" parts and components, the foreign products would become subject to the controls of the EAR and their reexportation to China would be prohibited absent a Presidential waiver.

By making subject to the EAR foreign-made items with near-zero or *de minimis* U.S.-origin content when destined to China, the proposed rule goes beyond the statutory mandate in the NDAA. For the reasons set forth below, the Department of Commerce should consider revising the proposed rule to provide that foreign-made satellites and components incorporating a *de minimis* proportion of U.S.-origin EAR-controlled content are not subject to the EAR when destined for China.

III. Policy Considerations

The proposed rule as written will undermine the key policies underlying the move of commercial satellites and, in particular, their parts and components, to the CCL, by making foreign-manufactured items with minimal U.S. content subject to the EAR when destined to China and thereby restricting their reexportation to China. BIS states in the proposed rule that the objective of moving certain Category XV items to the CCL is to minimize the commercial burden imposed by the export control regulations, especially on small companies, by, among other things, eliminating some license requirements and making license exceptions more available. BIS Rule at 31,437. The proposed rule states that it would relax licensing requirements generally for Category XV items moving to the CCL, but "particularly 'parts' and 'components'". *Id.*

This proposed rule from the Department of Commerce arose out of a well-studied and informed effort to streamline the export control laws in such a way that would serve both economic and national security objectives. Particularly in areas like spacecraft, the idea was to narrow the restrictions in order to allow more focused enforcement and promote greater export activity. Increased exports would serve national security goals by strengthening the U.S. technological and industrial base.

The President announced his vision of export control reform as an effort to "enhance national security by focusing on the enforcement of strict controls around the export of the most critical technologies and products, while strengthening the competitiveness of key manufacturing industries in the U.S. by streamlining the regulations that apply to their exports." *President Obama Details Administration Efforts to Support Two Million New Jobs by Promoting New Exports*, White House Office of the Press Secretary (March 11, 2010). Shortly thereafter, the Administration issued the National Space Policy, which sets out a goal to "actively promote the export of U.S. commercially developed and available space goods and services, including those developed by small- and medium-sized enterprises, for use in foreign markets, consistent with U.S. technology transfer and nonproliferation objectives." *National Space Policy of the United States of America* at 11, The White House (June 28, 2010).

This policy focus on export promotion arose in part out of concern over the decline of the U.S. space industry. Lack of access to foreign markets caused by export restrictions has cost the U.S. space industry an average of $600 million per year and, accordingly, has also helped foreign competitors. *National Security and the Commercial Space Sector* at 13, Center for Strategic & International Studies (July 2010) [hereinafter "CSIS Report"]; *see also Hearing on National Defense Authorization Act for Fiscal Year 2013 and Oversight of Previously Authorized Programs*, Before the H. Comm. on Armed Services, 112th Cong. (March 8, 2012) (statement of Rep. Loretta Sanchez) (". . . the U.S. satellite industry, the industrial base continues to struggle to keep pace with the global competition in what is intensely really an international market. … Prudent changes to overly restrictive export control regulations could have a significant impact on the health and the sustainability of our United States satellite industry."); *see generally Beyond "Fortress America,"* National Research Council, National Academy of Sciences (2009).

The Administration has been forward-leaning in treating the strength of the U.S. industrial base as a national security issue. The National Security Strategy ("NSS") itself promises to "promote a unified effort to strengthen our space industrial base." *National Security Strategy* at 31, The White House (May 2010). The NSS also clearly ties these economic and security issues to the export control reform effort: as part of the goal of doubling U.S. exports by 2014, the NSS affirms that "we are reforming our export controls consistent with our national security imperatives." *Id.* at 32.

Congress too has made clear that the NDAA and related export control reform laws were intended to bolster the U.S. industrial base as a national security issue. Congressman Berman, one of the key sponsors of this legislation, focused on the "unintended consequences" of overly restrictive controls on the exportation of satellite components, in particular that European manufacturers are increasingly seeking to design-out U.S. components, with "serious implications" for the health of the defense industrial base. *Export Controls, Arms Sales and Reform: Balancing U.S. Interests, Part II*, Hearing Before the H. Comm. on Foreign Affairs at 4, 112th Cong. (Feb. 7, 2012) (statement of Rep. Berman).

Similarly, Congressman Manzullo, the principal Republican co-sponsor of the House bill underlying the satellite provision, elaborated by explaining that ITAR restrictions on commercial satellites and their parts and components have caused the market share of U.S. manufacturers to drop from 75% to 44% on average over the past thirteen years, leading to a loss of $21 billion in revenue from 1999 to 2009 and 9,000 direct jobs per year. Cong. Record at H3006 (May 17, 2012). Congressman Manzullo affirmed that this "harmed our national security because it hurt our U.S. space industrial base, particularly component manufacturers." *Id.* He pinpointed as the cause the "perverse incentive" brought about by overly strict export controls for "foreign satellite makers to design out U.S. parts." *Id.* This problem is causing "U.S. component makers [to] struggle to sell their product in the commercial marketplace," and leading them to "become less able to meet the national security needs of the U.S. government." *Id.* He cited a 2011 finding by the Tauri Group that, "out of 135 U.S. space hardware manufacturers, 28 technology areas are at some risk of disappearing from our shores because of limited suppliers." *Id.* Congressmen Smith and Rohrabacher echoed many of these same concerns. *See* Cong. Record at H3668-69 (May 25, 2011). Representative Rohrabacher focused on the fact that foreign satellite manufacturers are pursuing "ITAR-free sources," especially for components, and that overly-restrictive controls "are not slowing foreign space capabilities, but encouraging them." *Id.*

Emerging from this policy context, the proposed rule from the Department of Commerce states that one of its objectives is to reduce the effect that the current regulations have of discouraging foreign companies from buying U.S.-origin parts and components. BIS Rule at 31,437. The current regulations discourage foreign companies from incorporating U.S.-origin content into their products by applying strict ITAR controls even to relatively minor items that are incorporated into foreign-made goods. The new rules seek to reduce this effect on items moving to the CCL by applying the *de minimis* provisions of the EAR, which generally free from the controls of the EAR foreign-origin items with U.S.-origin content constituting 25% or less of the total value. BIS states that, under the new rules, "foreign manufacturers would have less incentive to avoid such U.S.-origin 'parts' and 'components,' a development that potentially would mean greater sales for U.S. suppliers, including small entities." BIS Rule at 31,437. It is clear that BIS was attempting to respond to concerns about the U.S. industrial base by promulgating this proposed rule.

However, the proposed rule can and should do more in order to strengthen the U.S. space industry and allow it to meet national security requirements. Specifically, the proposed rule does not apply the *de minimis* provision of the EAR to foreign-made satellites and foreign-made components destined to China, even though the NDAA does not compel such a limited approach. The continued restriction on exports of foreign-made items with U.S. content to China will have a profoundly negative impact on U.S. parts and components manufacturers and, accordingly, will make these regulatory changes less successful in achieving their policy objectives.

An array of U.S. policies and laws has put the U.S. space industry in a vice: on the one hand, the U.S. Government has been driving commercial satellite companies to use foreign launch providers, while, on the other hand, it has restricted access to those foreign launch providers if the equipment has any U.S.-origin content. CSIS Report at 21. The net result has been to force many commercial satellite and component manufacturers to stop using U.S.-origin parts and components altogether in order to avoid these launch restrictions, which of course is leading to a hollowing-out of U.S. capacity in this area and feeding the growth of foreign

competitors. *Id.* One senior U.S. official described the competitive position of U.S. industry as being at a "tipping point" vis-à-vis its foreign peers. *Id.* at 21-22.

U.S. export control laws have been serving as a "catalyst" for the development of foreign capabilities, including by China. *Id.* at 24. Even the European Space Agency (ESA) is funding the development of component technologies in Europe in order to work around U.S. export control restrictions. *Id.* U.S. companies are struggling with these regulatory limitations at a time when the industry is becoming increasingly competitive and globalized, due to the spread of advanced space technology around the world. *Id.* at 11.

Export control laws that provide disincentives for foreign satellite and component manufactures to buy American parts will continue to hurt U.S. industry, along with its workers and its innovative capacity. Once those human and technological assets are lost, they take years to recover. Moreover, financial weakness among second- and third-tier suppliers in the U.S. has created an ever-looming risk of supply chain disruption for manufacturers. *Id.* at 28. These documented weaknesses in the U.S. industrial base, combined with the associated growth of foreign competitors, presents a national security challenge to the United States.

Transferring commercial satellites and related parts and components to the CCL will be a positive step toward reviving the U.S. space sector by providing U.S. companies with an even playing field and an opportunity to compete again in order to regain their leadership position in the increasingly globalized space industry. However, these goals may not be realized if foreign satellite and component manufacturers are driven to design-out all U.S.-origin components, due to continued restrictions on their own, foreign-made items being sent to China, even if only for launch purposes as opposed to end-use (although both are important considerations to these non-U.S. manufacturers). It is therefore worth questioning whether the presence of minimal U.S. content in foreign-made items presents such a grave risk to U.S. national security as to be worth the heavy cost that these controls impose.

The commercial reality of the satellite industry makes this tradeoff inescapable: the U.S. Government cannot restrict exports of foreign-made items with some minimal U.S.-origin content to China without jeopardizing the strength of its own domestic suppliers. If a prospective buyer of a satellite subject to U.S. export controls faces the prospect of being precluded from accessing key providers of launch services (such as in China), the buyer will frequently opt instead for a product with no U.S. content that will not be subject to the same restrictions. That choice is driven by the key position that Chinese launch service providers hold in the market. End-users of satellites, when deciding to purchase a commercial satellite system, weigh heavily the cost, availability and reliability of launch services in deciding what satellite and components to procure. Satellite manufacturers do not sell their goods in a vacuum, but rather as part of an integrated package of equipment and services. In part, that is because the launch may constitute as much as 25% of the total cost. Putting into operation a typical communications satellite can run as reported between $200-500 million, of which approximately $50 million on average can be associated with the launch service. Apart from cost, the reliability and availability of the launch service is critical, since a delayed or unsuccessful launch can have dramatic repercussions for the business plan, service commitments, and revenue of the satellite service provider. For these reasons, satellite end-users view these purchases as a package, involving both hardware and service elements.

In light of the interconnectedness of the hardware and services, the availability of Chinese launch services is a very important factor to a non-U.S. manufacturer's ability to market its equipment. In other words, if a satellite made outside the United States cannot be launched by Chinese entities, that satellite will be less marketable. Thus, to maximize the marketability of their products, manufacturers of satellites and components will seek to eliminate launch service restrictions. That is where the proposed rule from BIS puts U.S. manufacturers of satellite parts and components at a severe disadvantage.

By restricting the exportation to China of foreign-made satellites with *any* U.S. content, even a *de minimis* amount, the proposed rule in effect forces foreign satellite and component manufacturers to choose between U.S. parts and components, on the one hand, and Chinese launch services, on the other. Because manufacturing technology has spread around the world, while launch services remain more restricted, satellite buyers often have no choice but to focus on the latter and seek products that have been stripped of any U.S. content. If this trend continues, U.S. industry will continue to decline, possibly to the point of posing a dramatic risk to national security.

IV. Conclusion

The proposed rule from the Department of Commerce does not go far enough to remedy the core problem that spawned the export control reform effort with regard to satellites and related items. By declining to apply the *de minimis* provision of the EAR to foreign-made items destined to China incorporating "500 series" parts and components, it will continue to encourage foreign manufacturers to design-out U.S.-origin content. This will cause the current hollowing-out of the U.S. space industry to continue, jeopardizing the competitive position of U.S. industry, depressing employment, reducing domestic investment, stifling research and development, and putting the United States at a disadvantage in commercial space as well as in defense technology and capacity.

Recognizing that the NDAA sets out certain clear mandates, the Department of Commerce nonetheless has the authority to modify the proposed rule in ways that would alleviate the impact on the U.S. parts and components industry. A solution for BIS is to institute a specific *de minimis* rule for foreign-made satellites and components that use "500 series" parts and components that would allow their reexportation to China. BIS could issue such a rule while still abiding by the legislative mandate of the NDAA. As it appears to have the legal authority to issue that type of modification to the proposed rule, the Commerce Department should consider the policy implications of such a change. In weighing the advantages and disadvantages of allowing the reexportation to China of foreign-made satellites and components containing *de minimis* U.S. content, the Department should carefully assess the impact of the final rule on the U.S. industrial base and national security.

Applying the *de minimis* rule to foreign-made items destined for China is not inconsistent with the NDAA. Indeed, applying *de minimis* treatment would do more to achieve the stated goals of the proposed rule with respect to U.S. industry and national security and would support job growth, innovation, and manufacturing in this critical sector of the U.S. economy.

If you have any questions regarding these comments, please contact me at 202.429.8083 or ekrauland@steptoe.com.

Sincerely,

Edward J. Krauland