

E.U. Opens Up For Competition In Defense Contracting

Tuesday, August 01, 2006 --- On July 1, 2006, the European Defense Agency (EDA) officially launched the new European Defence Equipment Market (EDEM), designed to bring open competition to E.U. defense procurement.

Undergirding the new market and critical to its success are the following voluntary initiatives:

- Code of Conduct on Defense Procurement (“Code of Conduct”), and
- Code of Best Practice in the Supply Chain (“Code of Best Practice”).

Responding to a May 19, 2006 deadline, 22 of the E.U.’s 25 member states have now formally subscribed to these programs. Hungary and Spain exercised their option not to subscribe, and Denmark previously opted out of the European Council’s collective defense policy and does not participate in the EDA. The centerpiece of the Code of Conduct, the Electronic Bulletin Board (EBB), became operational on June 30, 2006, with Sweden, Germany, France, Finland, the United Kingdom and the Netherlands already posting calls for tender.

EDEM is designed to open Europe’s €30 billion defense equipment market to substantial cross-border competition. The result could be increased opportunities for any company, whether or not owned in Europe, that has “a technological and/or industrial base” in a subscribing EDA member state.

The Code of Conduct, adopted by the Steering Board of the EDA on Nov. 21, 2005 and now formally ratified by the subscribing member states, is a nonbinding guideline intended to foster open markets in the E.U. defense-equipment sector.

The defense-equipment sector has traditionally been exempted from open market principles by Article 296 of the E.C. Treaty. Founded on a national security rationale, Article 296 permits member countries to reserve defense contracts for domestic manufacturers where “specifically military purposes” are implicated. The meaning of this term is often hotly debated between the E.U. institutions, the member states and contractors. The European Commission plans to issue an interpretive communication clarifying and narrowing the kinds of procurements that fall within the scope of Article 296. The Code of Conduct and Code of Best Practice are a parallel development, opening up another front in Europe’s attempt to bring integration and cross-border efficiencies to its defense market.

The Code of Conduct and Code of Best Practice will apply to procurements where “specifically military purposes” are squarely implicated. Application of

the Codes will be limited to the list of procurement possibilities referred to in Article 296. This list, which was devised by the Council of Ministers in 1958, consists largely of military hardware. The Codes are thus designed to establish a voluntary norm of open-market procurement in the military hardware sector. General E.U. defense procurement rules will not be affected by the new voluntary regime, and most defense procurement within the E.U. will still be bound by the normal public procurement directives.

1. Code of Conduct

By adopting the Code of Conduct, the 22 participating countries have agreed to open their Article 96 defense procurements to bids from all suppliers “having a technological and/or industrial base” within the territory of any subscribing member state. These defense contracts should be open to non-E.U. and EU companies alike on a cross-border level playing field, provided that they have the requisite commercial presence within the territory of a subscribing member state.

The centralized EBB, accessible via the Internet, is intended as the key operational feature of the Code. Through it, subscribing member states will advertise procurement opportunities. All procurement opportunities of €1 million or more falling within the scope of Article 296 will be subject to the Code, although certain enumerated categories will be exempted (e.g., nuclear systems; chemical, bacteriological and radiological goods and services; and cryptographic equipment).

The Code of Conduct could provide significant new opportunities for defense equipment manufacturers in Europe positioned to compete effectively in an open market. While the Code of Conduct is nonbinding, and longstanding defense procurement practices under NATO and under Article 296 may persist, a substantial redistribution of market share in Europe’s €30 billion defense equipment sector is possible.

At this stage, it is not clear that contracts won through the EDA are required to be performed through the contractor’s base of operations in Europe or whether the work may be allocated to divisions or subcontractors outside the territory of the subscribing member states. Under E.U. procurement provisions the place of performance of the contract is normally a matter of negotiation between the competent authority and the successful tenderer. The competent authority could, in principle, impose an obligation on the successful contractor to perform the contract within E.U. territory. In regard to subcontracting, the new Code of Best Practice does impose a duty upon prime contractors to select from among bidders that themselves have a “technological and/or industrial basis” in a subscribing member state.

2. The Code of Best Practice

Approved by E.U. Defense Ministers on May 15, 2006, the Code of Best Practice is a nonbinding guideline intended to extend the benefits of competition down the supply chain to subcontractors. The Code of Best

Practice augments the Code of Conduct and is designed to be read and implemented as part of that instrument. However, the Code of Best Practice would impose duties beyond those that apply to the contracting agencies of the member states. Under the Code of Best Practice, the open-bid practices that subscribing member states have agreed to apply in awarding defense contracts will be imposed down the chain of supply.

The Code of Best Practice thus aims to encourage a voluntary commitment by prime contractors to select subcontractors on a free and open basis from among suppliers “having a technological and/or industrial basis in a subscribing member state.” Wherever it is “efficient and practical,” prime contractors, and other buyers in the supply chain, are required to evaluate their own suppliers, to ensure that fair opportunities and the benefits of increased competition are extended to all capable enterprises with the requisite territorial presence in Europe, including those not economically positioned to compete for prime contracts.

The responsibilities that the Code of Best Practice would impose upon prime contractors and other buyers within the chain of supply are quite limited. The Code provides that the process of evaluating and awarding subcontracting opportunities should be transparent. Subcontracting opportunities would be published either through the relevant administrative agency of a subscribing member state, through the EBB, or through the contractor’s own Web site. Buyers are asked to evaluate bids objectively and notify all bidders of the outcome on the same day.

Likewise, buyers would, when requested and without breaching commercial confidentiality, provide losing bidders with a statement explaining the reasons for the decision. As is the case for the Code of Conduct, a monitoring system will be introduced to assess the operation of the Code of Best Practice. Monitoring will rely on information furnished by the prime contractor.

In general the Code of Best Practice will be a voluntary undertaking by which buyers agree to subject their requisitions to open competition when it is “efficient, practical, or technologically appropriate” to do so. The Code of Best Practice thus appears to affirm the discretionary business judgment of management, and the prime contractor remains wholly responsible for the selection of subcontractors. The Code expressly accommodates the possibility of strategically preferred suppliers within a contractor’s line of business and that such relationships should be honored but “test[ed] where appropriate.”

For component manufacturers in Europe serving the defense equipment sector, the Code of Best Practice is expected to have a market opening effect. Companies that are looking for cross-border opportunities may be able to benefit significantly. Note, however, that the rate of participation under the Code of Best Practice is difficult to predict. While the administrative agencies of subscribing member states have agreed to participate in the Code of Conduct, participation by private parties in the Code of Best Practice will likely depend on the efficiency with which the process unlocks demand

and supply, enabling buyers to find sellers who can bring economies to their operations, without additional transactional costs. If the process frees buyers from restricted pools of sellers, then significant new opportunities for component makers could ensue. Presumably prime contractors will also conform to the Code of Best Practice to the extent that adherence positions them more favorably to win additional business through the EDA.

The Code of Conduct in conjunction with the Code of Best Practice constitutes EDEM's voluntary open-market platform. While entailing no legal commitment, this voluntary regime signals an overriding commitment by the E.U. to open competition in defense procurement and is expected to significantly ameliorate the protectionist application of Article 296. The European Commission is contemplating the possibility of a binding directive, imposing enforceable procurement guidelines, but those developments are procedurally more complex and will take time. While the voluntary regime provides a clear platform for adherence, EDA initiatives have generated domestic political opposition in the United Kingdom and in Poland. Ultimately, participation will depend on EDEM's capacity to deliver efficient economic results that are politically acceptable.

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