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New EU Legal Framework For The Defense Industry

The so-called Defense Package is about to be agreed upon by the European Parliament and the Council of Europe. As a consequence, the defense industry will face a completely revised legal framework. The proposal aims to open the European internal market for defense equipment and implement EU-wide transparency and competitive rules for the trade and procurement of arms. The package consists of

- a communication outlining the European Commission's vision for the European defense equipment market (COM 2007 (764) final),
- a directive on intra-EU transfers of defense products (COM 2007 (765) final) and
- a directive on defense procurement (COM 2007 (766) final).

The package will enhance competition in the European defense markets. At the same time, companies will benefit from less bureaucracy and—possibly—the prevention of offsets (demands for countertrade in order to obtain a contract). Finally, the proposal not only concerns European suppliers, but will materially affect the business of companies from third countries such as the U.S. because it might lead to a “Buy European” policy.

Background—Today, the European defense market is characterized by clear divisions between individual member states. As a result, the market is still fragmented.

EU internal market rules do not apply to defense product exports to other member states. Applications for export and reimport licenses are subject to a complicated, time-consuming and expensive legal framework. Currently, there is no distinction between licenses for exports to member states and to third countries. Hence, companies face lengthy administrative proceedings if

they want to export defense goods within the EU or even for temporary transfer to other member states of arms in need of repair.

Moreover, defense contracts are not subject to EU procurement rules and may be awarded largely at the discretion of a member state's authorities. Thus, it is hardly surprising that member states spend almost 85 percent of their equipment budget domestically. Countries want not only to promote their own national defense industries, but also to ensure their independence from foreign suppliers and the security of sensitive information.

The EC Treaty established a separate legal scheme for the transfer and procurement of defense products. According to Article 296, “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.” Member states use Article 296 extensively to award defense contracts to their own defense industries. From a legal perspective, a member state need only consider the measures to be necessary. Therefore, the European Commission has few means of control.

European Initiatives—In implementing a European security and defense policy, member states began to coordinate their military capabilities, improving the efficiency of defense spending and enhancing the defense industry's competitiveness at the European level. The European Defense Agency in Brussels was founded in 2004 for this purpose.

The same year, the European Commission published a green paper on defense procurement. COM 2004 (608) final. The Commission stated that the strict separation of national markets, substantial structural differences between defense procurement and other public sectors, and the complex regulatory background create a serious challenge for a working internal defense product market.

As a response to the green paper's conclusions, the Commission presented the Defense Package in December 2007. The vote in the plenary session is scheduled for November, and member states must agree on the proposal in the Council. The French presidency seeks

to pass the Defense Package in 2008 to bring it into effect as soon as possible. After the Defense Package passes the European Parliament and the Council, the member states must implement the directives into national law.

The Directive on Intra-EU Transfers—The directive on intra-EU transfers is expected to facilitate cross-border transfers of military equipment by simplifying the framework of 27 different national licensing schemes. Producers established in one member state will be authorized to supply all member states without restrictions.

In the future, exports of defense products to member states will be distinguished from exports to third countries. Intra-EU transfers will involve little paperwork, which in turn will reduce the financial burden on companies. A study provided by the European Commission estimates that the current legal situation increases license application costs by more than € 3 billion per year.

The transfer directive's linchpin is the implementation of so-called general and global licenses to replace individual transfer licenses. Current licenses permit defense product suppliers to perform several transfers of defense-related products to another member state without individual authorizations. The new, simplified approach requires member states to have greater mutual confidence in the licensing bodies of other EU member states. Therefore, the directive standardizes the appropriate reliability criteria for companies. Recipients of defense-related goods must complete a certification process before they may receive military equipment.

The Directive on Defense Procurement—The directive on defense procurement aims to limit the use of Article 296 of the EC Treaty, according to which member states may exempt defense contracts from general EU procurement rules and award contracts directly to companies without competition. Therefore, the directive allows contracting parties to use the negotiation procedure, including prior publication of a contract notice, as the applicable procurement procedure.

The scope of the directive covers all public works and service contracts for the supply of arms, munitions and war materiel. The directive also applies to works, supplies and services that are needed for the security of the EU and its member states. Thus, the EU accounts for the new dangers arising from the threat of terrorism that might affect the procurement of certain sensitive, non-military goods.

The Commission further intends to minimize the use of countertrade, known as offsets, because of its market-distorting effects. Countries with a highly specialized defense industry and many exporters often face demands for offsets to obtain contracts. The proposal includes a recital according to which no conditions of a procurement decision “may pertain to requirements other than those relating to the performance of the contract itself.”

Impact of the Defense Package on the Defense Industry—The Defense Package will create for the first time an EU-wide, level playing field for an industry that has been dominated by the interests of the respective member states. It will foster new business opportunities for companies in other member states, but companies will have to compete to prevail in their home markets, which will also be opened to competition. In times of tight budgets, member states may not continue to award automatically to domestic companies.

Stakeholders in the U.S. should understand the regulatory changes in the European defense markets. After the U.S. Department of Defense decided to delay the \$35 billion air tanker procurement, a battle between European supplier EADS and the U.S. competitor Boeing, the European Parliament Foreign Affairs Committee voted in favor of a so-called “Buy European” and “reciprocity” clause. If the November plenary session confirms this clause, a company from outside the EU could be excluded from a supply contract if the EU considers the procurement rules in the company's home market to be adverse to the European defense industry. With this broad condition, member states will be legally entitled to discriminate against bidders from third countries. This particularly affects the U.S., which is the most important defense market.

However, if any European NATO country were to apply the clause to exclude a U.S. company, it would breach an interministerial agreement between the Pentagon and the defense ministry of the country concerned. Such memoranda of understanding require reciprocal equal treatment for defense products of each country in a defense procurement by either country. The U.S. could retaliate by closing its own market to European companies such as EADS. The directive's rapporteur therefore intends to amend the committee's proposal to comply with the U.S. agreements with EU member states before the final European Parliament vote.

Moreover, third countries, in particular NATO members outside the EU, will realize no transfer benefit

from the system of general and global licenses provided for by the directive. If not amended, the Defense Package will widen the gap between market conditions for European suppliers and their competitors from third countries.



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