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AN END TO OFFSETS IN EUROPEAN DEFENSE TRADE?

Governments inside and outside Europe routinely require industrial compensation or "offsets" as a condition of granting contracts for their defense and security supplies. But the days of widespread use of offsets in European defense trade appear limited. As a part of its program to promote greater international competition and transparency in defense procurement, the European Commission has signaled a willingness to challenge the imposition of offset obligations which violate the principle of non-discrimination under EU competition law. Suppliers now have a sound legal basis to challenge offset commitments that are not directly related to the performance of the supply contract and are necessary for the protection of an essential national security interest.

Offsets in Defense Trade

Offsets come in a variety of forms. They may be direct or indirect, or a combination of both. Direct offsets are related to the performance of the contract and may take the form of local subcontracting, technology transfer, co-production or training requirements. Indirect offsets are unrelated to the subject matter of the contract and may require a foreign bidder to invest in the customer's local economy or to procure a counter-trade in exports of goods or services having a specified value (often 100% of the contract price).

In its 2012 annual report to the U.S. Congress on offsets in defense trade, the U.S. Commerce Department stated that during 2010, American contractors reported entering into offset arrangements for defense items valued at US$3.21 billion with an aggregate offset commitment equal to 64% of the value of sales. The individual offset requirements ranged from 3% to 100% of the relevant contract value.

The use of offsets within European Union has been widespread. In some member states such as Poland and Lithuania, the provision of offset commitments is mandated by local statute for defense procurements. In many other member states, offset commitments are an award criterion assessed as a part of the tender evaluation process.

A study commissioned by the European Defence Agency (EDA) found that the average offset obligation among EU member states between 2000 and 2006 was 135% of contract value, and that direct offsets account for only 40% of total offsets. The EDA has since issued a Code of Conduct on Offsets for its 26 participating members which, among other matters, established a cap of 100% of the contract value for offsets. The EDA Code of Conduct is, however, a non-binding voluntary code of practice with no legal enforcement mechanisms.

The New EU Defense Procurement Regime

In an effort to reduce the institutional 'national preference' that prevails in defense and security programs in Europe, the 27 EU member states have adopted a package of legislative initiatives to promote greater transparency and international competition. These measures include:

- The Directive on Defence and Sensitive Security Procurement extends features of the existing EU-wide public procurement code to certain types of defense and security contract. The measure requires national contracting authorities to adopt transparent and

non-discriminatory tender procedures and to establish bid-protest procedures to enable aggrieved bidders to seek redress in cases where contracts have been unfairly awarded.

- The Directive on Intra-EU Transfers of Defense Products designed to simplify the current national licensing systems for cross-border transfers of military equipment and technology transfers within the European Union.
- An official Communication regarding the legal interpretation of Article 346 of the EU Treaty which reserves the right of individual EU member states to take such measures as they consider necessary for the protection of their essential national security interests. National governments have relied on the Article 346 exemption extensively to avoid competitive tendering rules that would otherwise have been mandated by EU law for defense and security equipment programs, and as to avoid the operation of the principles of non-discrimination under EU competition law which would otherwise have rendered offset requirements illegal.

EU Competition Rules

The elimination of barriers to cross-border trade is a fundamental element of economic integration within the European Union. The principles of equal treatment, non-discrimination and transparency in the award of public contracts are enshrined in the EU treaty. The European Commission diligently polices and vigorously enforces these rules. An agreement or arrangement that has the object or effect of distorting competition between the member states (including restrictions on imports) is both illegal and may be set-aside by the national courts at the request of an aggrieved party.

These basic principles of EU competition law are restated in the new Directive on Defence and Sensitive Security Procurement as follows:

> **Contracting authorities/entities shall treat economic operators equally and in a non-discriminatory manner and shall act in a transparent way.**

Offsets, whether direct or indirect, by their nature discriminate against importers of defense products from other EU member states and impede the free flow of goods and services. The European Commission has signaled a willingness to use EU competition law to challenge the imposition of offsets that can not be objectively justified by an exemption established under EU law.

Economic considerations such as the need to maintain the purchasing country's industrial base or provide local employment can not provide a basis for a derogation from EU competition rules. As a practical matter, offset requirements unrelated to the subject matter of the contract can never be justified and may be challenged by a prospective bidder as an illegal restraint of trade under EU law.

In the context of direct offsets, in its published guidance, the European Commission has made it clear that contracting authorities are likely to violate competition rules in the context of offset requirements if they require either:

- the purchase of goods or services from suppliers located in a specific member state;
- the award of sub-contracts to suppliers located in a specific member state; or
- investments in a specific member state

and such offset requirement can not be objectively justified under the Article 346 "essential security interests" derogation from EU law.

The National Security Exemption

Article 346 of the EU Treaty expressly reserves to each EU member state the right to "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."

In publishing its official Communication on the interpretation of Article 346, the European Commission has signaled its intention to scrutinize the future reliance on the national security exemption by national procurement authorities. This guidance document, which reflects existing EU case law, provides that application of Article 346 to defense procurement is subject to the following conditions:

- use of the exemption must be necessary for the protection of member states' essential security interests;
- only the protection of essential security interests justifies an exemption (other interests such as economic and industrial interests are by themselves not sufficient); and
- the security interests at stake must be "essential," which implies that the exemption is only available for defense procurement contracts which are of highest importance for member state's military capabilities.

In the context of offsets, it will be for the contracting authority to make an assessment of whether the Article 346 exemption is available for a particular form of offset requirement on a case-by-case basis. If a contracting authority elects to rely on Article 346 to avoid a competitive tendering procedure or to impose a discriminatory offset obligation under the provisions of the new Directive on Defence and Sensitive Security Procurement, the European Commission may require the relevant member state to furnish evidence to justify its use. It can also challenge that use in the European Court of Justice if it considers that a member state is making improper use of Article 346.

Settled EU case law has established that the derogation under Article 346 is limited to exceptional cases. The contracting authority must be prepared to specify the essential security interest that makes an offset requirement necessary and to demonstrate that it can not achieve the same objective by less restrictive means.

Security of Supply

Security of supply is recognized in both the Directive on Defence and Sensitive Security Procurement an in EU case law as an example of an essential security interest that may justify a derogation from EU law under the Article 346 exemption. Security of supply, for these purposes, means a sufficient guarantee of supply of goods and services to enable a member state to discharge its defense and security commitments in accordance with its foreign and security policy requirements. This includes securing the ability to deploy its armed forces without third party constraints or control.

Contracting authorities may, for instance, properly require suppliers to provide commitments to establish and maintain a local facility to carry out maintenance, modernization or adaptation of the supplies covered by the contract. Similarly, a condition to provide all necessary intellectual property licenses and information to enable the customer to produce spare parts, components, assemblies and testing equipment in the event that the supplier is no longer able to provide these supplies may be justifiable under the Article 346 exemption.

But any security of supply requirement must satisfy the conditions of the Article 346 exemption in that it must be necessary to protect an essential security interest (and not merely desirable). The contracting authority must also be able to demonstrate that the same degree of security can not be achieved by a less restrictive means.

The European Court of Justice has repeatedly stated that, in public procurement, the principle of equal treatment of tenderers is intended to afford equality of opportunity to all suppliers when formulating their tenders, regardless of their nationality. The nationality of a supplier or the country of its establishment can not by itself be a security of supply consideration.

Recent Enforcement Activity

The European Commission has recently shown its willingness to challenge contracts with discriminatory provisions imposed by procurement authorities without proper justification on grounds of essential national security interests. In 2009, the Greek Ministry of Defence launched an open tendering procedure for the supply of six submarine battery kits with a total value of €22 million (US$29 million). The call for tenders included a requirement that 35% of the material used for the batteries should be produced in Greece.

The Greek government sought to justify this requirement on the basis of its essential national security interests. The European Commission challenged the tender process on the basis that it was discriminatory without justification and has required the Greek government to re-open the tender process and amend the contract award procedures. The case remains open and the European Commission may still take the matter to the European Court of Justice where the amended award procedures continue to breach the procurement rules.

Bilateral Agreements

The Directive on Defence and Sensitive Security Procurement contains no "Buy-European" requirement equivalent to the domestic preference in the U.S. Buy American Act. Individual member states are free to select which suppliers they invite to compete in a restricted negotiated procedure under the Directive provided that no preference is given to a particular EU member state. Procurement authorities will remain, however, subject to their obligations under any bilateral trade agreements to which they may be a party such as any Reciprocal Defense Procurement Memorandum of Understanding (RPDMOU) with the United States.

Fourteen member states have signed RPDMOUs with the U.S. These remove the American preference for U.S. Government procurements in return for reciprocal access to their domestic market for government contracts. These bilateral agreements neither limit nor extend the obligations of the EU member states with regard to the procurement practices under either EU competition law or the Directive. Their effective will mean, as between the U.S. and the participating EU member state, that a prospective bidder from the U.S. must be treated no less favorably than a domestic contractor.

Impact

The days of indirect offsets in government contracting appear limited. It is difficult to envisage how offset requirements unrelated to the subject matter of the contract can ever be justified on grounds that they are required for the protection of essential security interests and are not motivated by national economic interests. Only offset requirements related to preserving security of supply or otherwise directly linked to the performance of the contract are likely to conform to EU law, and even those must be imposed without regard to the nationality of the supplier.

A bidder faced with an offset requirement that is not directly related to the essential security interests of the customer but which has been imposed to promote ancillary political or economic interests may now challenge the requirement on the basis that it is contrary to EU law. As illustrated by the Greek submarine battery case, the European Commission has the power to investigate and, if necessary, bring an infringement action against the offending member state in the European Court of Justice.

The threat of such action may, in itself, be sufficient to cause the procurement authority to reconsider and retender. Alternatively, the aggrieved bidder may have private rights of action in the national courts of the relevant member state invoking general principles of EU competition law.

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