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SESSION 2 - I

INTERNATIONAL PROCUREMENT DEVELOPMENTS IN 2017—PART II: EU DEFENCE PROCUREMENT BETWEEN COORDINATION AND PROTECTIONISM

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While the current rise of protectionism on the European continent was already visible at the time of last year's conference, the emerging trend intensified significantly over the course of 2017. Nowhere has this become more apparent than in the field of defence and security procurements, on which the following will focus. While it is too soon to presume a concerted EU-wide effort to obstruct or even exclude U.S. defence contractors from EU government procurement procedures, two emerging trends are evident. On the one hand, there is the systematic cooperation on procurement projects on an EU-level, paired with benefits for EU-based companies. On the other hand, there has been a notable increase in national preferences of EU bidders through selective procurement requirements.

I. PESCO AND EDF: THE NEW MECHANISMS OF EU DEFENCE PROCUREMENT

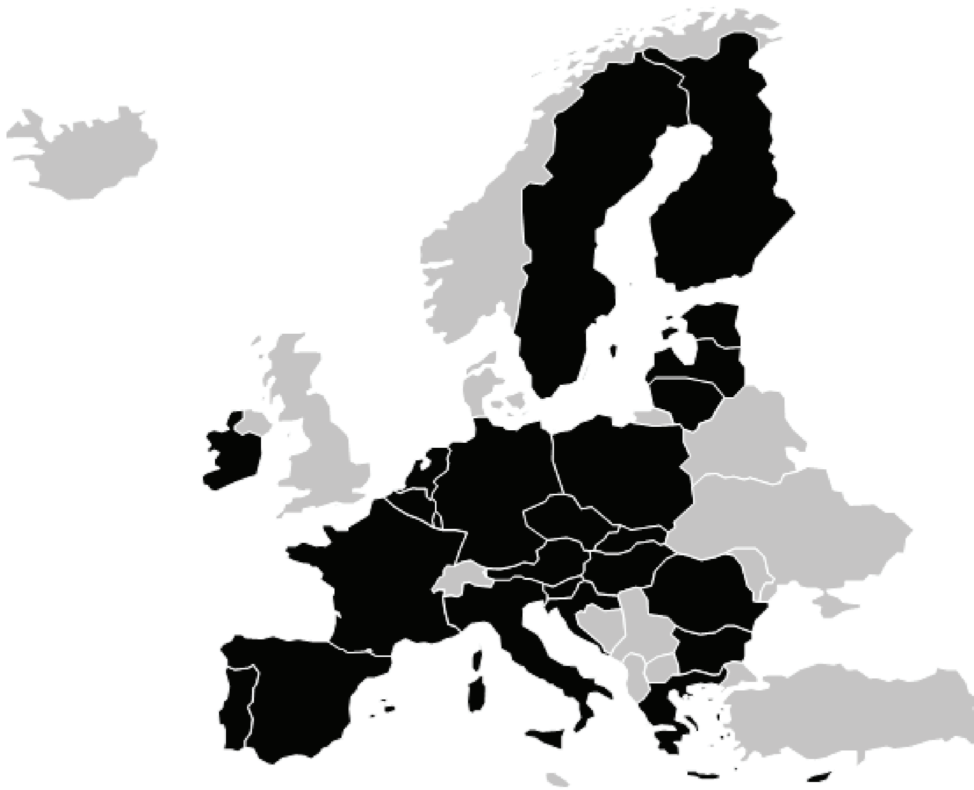
Increased pan-European cooperation on defence matters has been on the EU's agenda for a long time. In fact, Article 46 of the Treaty on European Union (TEU), which provides the legal basis for a Permanent Structured Cooperation (PESCO) in defence matters, had already been established through the Lisbon Treaty that had entered into force in 2009. However, it took several years of discussion and deliberation at various political levels for PESCO to be finally established. Several political obstacles to military integration in the EU can explain the sluggish pace of the process, especially the varying foreign and defence policies of 28 Member States. In particular, France and Germany disagreed over the scope and ambitions of PESCO: while France favoured an ambitious scope and binding commitments over a great number of participants, Germany aimed at including as many of the 27 states of the post-Brexit era as possible.

The eventual achievement of this milestone in European defence collaboration was certainly supported by two far-reaching events in 2016: the victory of Donald Trump in the U.S. presidential election and the British vote in favour of Brexit. Many European leaders were shocked when President Trump referred to NATO as "obsolete" in the course of his presidential election campaign. Similarly, the prospect of Britain's impending EU-withdrawal raised the awareness of an increasing need for defence and security cooperation among the remaining EU Member States (see for a U.S. perspective: Christopher R. Yukins, *Brexit and Procurement: A U.S. Perspective on the Way Ahead*, 2017 Pub. Proc. L. Rev. 71, accessible on Westlaw). Matters were further accelerated by the fact that London was no longer in a position to block or delay the further integration of the EU's common defence policy.

A. The scope of PESCO

On 11 December 2017, a Council Decision (14866/17, available at http://www.statewatch.org/news/2017/dec/eu-council-pesco-decision-14866-17.pdf; hereinafter, "Council Decision") finally established PESCO. Ultimately, 25 Member States approved the Council Decision, whereas initially only 23 Member States had signalled their intention to participate. The participating EU Member States are Austria, Belgium, Bulgaria, Czech Republic, Croatia, Cyprus, Estonia, Ireland, Finland, France, Germany, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden. Denmark, Malta and the UK will not take part in PESCO, although they could potentially opt in at a later stage.

MEMBER STATES PARTICIPATING IN PESCO



The participants of PESCO assure that their "military capabilities fulfil higher criteria" and that they will make "more binding commitments with a view to the most demanding missions and operations" in accordance with Article 42(6) TEU. This pledge involves a commitment to increase the participants' respective defence investment expenditure to 20% of their total defence spending. It should be noted that PESCO will neither be a defence alliance in the traditional sense nor contain an entirely new procurement regime for EU defence projects. However, PESCO offers a mechanism for enhanced coordination within the existing legal framework for procurement. As before, projects regarding the development of capabilities will remain the sole responsibility of Member States.

The purpose of the program is twofold: a significant reduction of fragmentation and inefficiencies in Member State defence spending as well as an increase in overall EU defence and security expenditure. It aims to ensure binding com-

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mitments and to establish common principles for Member States in order to enhance cooperation in defence planning and the procurement of joint defence capabilities. In order to reach these ambitious goals, the PESCO framework contains principles for the coordination, funding and governance of joint defence procurement projects as provided for in the TEU. It will rely on already established mechanisms for identifying, analysing and prioritising current and future defence-related capability needs, such as the Coordinated Annual Review on Defence (CARD) and the Capability Development Plan (CDP). It will also make use of institutions previously created, in particular the European Defence Agency (EDA) and the recent European Defence Fund (EDF, see below).

Along with the Council Decision establishing PESCO, the participating Member States also presented an initial list of collaborative PESCO projects. Among them are research, procurement and upgrade projects regarding a variety of sectors, including prototypes for infantry vehicles, autonomous maritime surveillance systems and mine countermeasures, cyber security, radio and indirect fire support solutions, logistic hubs, operational support, military mobility measures and the establishment of a European Medical HQ as well as training centres (a list of the initial 17 PESCO projects released by the Member States is available at http://www.consilium.europa.eu/media/32020/draft-pesco-declaration-clean-10122017.pdf). The participating Member States estimate that a successful cooperation will save them between EUR 25 billion and EUR 100 billion per year.

B. The protectionist nature of PESCO and the EDF

However, PESCO carries a significant risk of discrimination against non-EU contractors. While PESCO's aims are primarily to achieve economies of scale, the harmonisation of processes, assets and infrastructure as well as the pooling of resources, the mechanism has also a pronounced protectionist nature. This is due to the intended involvement of the European Defence Fund (EDF). The EDF consists of two separate strands, designated as research and capability window. Combined, they will have an initial budget of EUR 590 million at its disposal, which is set to gradually rise to EUR 5,5 billion from 2020 on.

From a procurement perspective, the funding support provided by the EDF will be one of the central pillars of PESCO. The EDF will assume an active role in the funding of joint and collaborative projects regarding the research, development and acquisition of defence products and services. Its exclusionary nature stems from the fact that the EDF will focus its support on projects with "EU added value", this means projects involving EU-based contractors. Contractors with non-EU majority-owners are excluded from funding. Only projects with at least three participants from at least two Member States are eligible for support. Moreover, grants will only be available to undertakings established in the EU and effectively controlled by Member States or their nationals. In addition, beneficiaries of EDF support must use EU-based infrastructure, facilities, assets and resources.

In addition, PESCO and the EDF potentially also involve significant legal risks and uncertainties. Multinational projects regularly raise questions regarding the applicable national law and jurisdiction. Furthermore, an increase in contract volume may lead to a rise in challenges by competitors under public procurement law. PESCO may even allow Member States to avoid public procurement regulation entirely. Currently, EU procurement law offers exceptions from the general obligation to tender for joint defence procurements relating to fundamental and applied research or experimental development. Member

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States might make use of this exception by collaborating on research projects in order to avoid national tendering requirements altogether.

In light of the above, the impending implementation of PESCO should be monitored closely. Following the decision to establish PESCO on 11 December 2017, the final adoption of the initial list of PESCO projects should be expected for early 2018. In addition, the publication of conditions for the involvement of contractors from non-EU states in PESCO projects is still pending. It remains to be seen whether the mechanisms of PESCO will ultimately be challenged under EU or international law.

II. NATIONAL PREFERENCES BY MEMBER STATES

Apart from the rise of EU-level *de jure* protectionist measures such as PESCO and the EDF, there is also a notable trend of debatable national action by individual Member States. Recently, there have been several attempts by government agencies of Member States to establish *de facto* barriers to international trade in procurement through the use of extensive procurement requirements. Two German cases will be used to illustrate these developments.

A. Exclusion of products with U.S. approval requirement

On 31 May 2017, in a case (Higher Regional Court of Düsseldorf, Decision of 31 May 2017, VII-Verg 36/16) concerning the procurement of Unmanned Aerial Systems (hereinafter, "drone") by the Inspector General of the German Armed Forces with a volume of around EUR 500 million, the Higher Regional Court of Düsseldorf held that the choice of a negotiation procedure without prior publication of a call for competition was in accordance with German procurement law. The court ruled that the contract awarded by the Ministry of Defence to a European defence contractor (Airbus) was valid. The U.S. manufacturer General Atomics had filed a complaint after the German government had previously awarded the contract. The drones were to be supplied and manufactured by the Israeli company Israel Aerospace Industries, which is a subcontractor to Airbus. The Inspector General had justified the preference of an Israeli drone over a competing product by General Atomics with the need to address a capability gap in the German Armed Forces, which was to be resolved as quickly as possible. Whereas the U.S. product was subject to government approvals, no comparable foreign restrictions applied to the Israeli drone.

According to the court, obtaining approval from the U.S. government for the purchase, leasing and export would not have been an issue, as the U.S. State Department had already clearly indicated its willingness to grant an approval. However, each future modification of the drone's area of operation from the approved operational purpose would have required additional approval. As the court found, this would have constituted a considerable risk of delay for the German Armed Forces. The risk was aggravated by the uncertainty as to whether such an approval would actually be granted in a timely manner. Any approval decision would have depended on political majorities within the U.S. Congress. The court further considered that due to the increasingly complex international security landscape, the German Armed Forces might in future be forced to consider deployment scenarios or tactical decisions that would deviate from U.S. interests. Whether the U.S. Congress would approve a modification of the drone's area of operation in such a case within a reasonable time was uncertain. In addition, there was no enforceable right to obtain such an approval. Any approval would thus be solely dependent on discretionary decisions by the U.S. government. This was not the case for the competing Israeli drone.

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Consequently, the court held that the Ministry of Defence acted lawfully when it took the disadvantages caused by the required U.S. approval into account in its decision in favour of the Israeli drone. It further stated that the earlier availability of a system which required no foreign approval may constitute an objective and order-related reason for favouring it over competing products. As in the case at hand, it may justify conducting a negotiated procedure without a prior call for tenders. According to the court, this reasoning may even apply to cases in which obtaining the required approvals could be expected within a reasonable time, provided that there was no legal claim to the approval and future approval depended on political majorities in the U.S.

To conclude, the court effectively granted contracting authorities the right to exclude from competitive bidding processes any defence procurements products that are subject to the approval of foreign governments. In light of the ongoing integration of the EU defence market and the large number of export restrictions for defence articles under U.S. foreign trade legislation, this ruling will likely affect U.S. contractors in particular.

B. Exclusion of products with ITAR restrictions

Another case involving a preference for European companies through extensive procurement requirements in the defence sector is that of the ongoing bidding procedure for a new standard assault rifle for the German Armed Forces. The new rifle is supposed to replace the current standard weapon, the G36 rifle produced by the German based manufacturer Heckler & Koch. To achieve this aim, the Federal Office for Equipment, Information Technology and Use of the German Armed Forces (BAAINBw) issued a Europe-wide call for tenders for a successor rifle on 21 April 2017. The contract has an estimated net value of approximately EUR 250 million and initially includes the acquisition of 120,000 firearms as well as "accessories in different quantities". Contracts between the contracting authority and the successful tenderer are scheduled to be concluded in 2019. The new rifles shall be delivered from the third quarter of 2020 onwards.

SIG Sauer, a German-American bidding consortium, initially took part in the preceding competition with their MCX rifle. Besides SIG Sauer and the incumbent Heckler & Koch, the German Rheinmetall group participated in the competition together with Austrian manufacturer Steyr Mannlicher. However, SIG Sauer eventually dropped out of the procurement, citing an alleged deliberate discrimination of U.S. contractors in comparison to their competitors.

According to press releases, the new rifle must meet a comprehensive catalogue of performance requirements. The call for tenders by the BAAINBw purportedly stipulated that a proposed rifle design may not contain technology subject to the International Traffic in Arms Regulations (ITAR). ITAR is a U.S. regulatory framework for state control of trade in arms, armaments and defence equipment. An ITAR-listing effectively means that the U.S. authorities may control the export and whereabouts of weapons. As it stands, Canada is the only country that has been granted an ITAR exception in the past under the 1963 Defense Development Sharing Arrangement with the U.S. Government. EU Member States have attempted to obtain exceptions in the past.

In the case of the German rifle procurement, the ITAR-free exclusion criterion apparently applied even to supplies and weapons produced in Germany. SIG Sauer, which had offered a purely Germany-based production and

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a product without U.S. patent reservations in order to accommodate German authorities, eventually dropped out of the competition, as their proposed design was subject to ITAR restrictions. The company cited "blanket discrimination against U.S. products and bidders" and a disadvantageous wording of the invitation to tender as the main reasons for withdrawing their offer. SIG Sauer alleged that had it stayed in the competition, it would not have had a realistic chance of winning the tender, as the technical requirements were clearly and unambiguously tailored to the incumbent competitor Heckler & Koch. Furthermore, the company accuses the German Department of Defence of discriminating against U.S. bidders through excessive procurement requirements. The company criticises that the exclusion of ITAR controlled products constitutes a preliminary decision in favour of its EU-based competitors, as the criterion *de facto* renders most products by manufacturers with minor links to the U.S. ineligible.

C. Analysis

Both exclusionary requirements signal a new trend, as the BAAINBw and the German Army had in the past regularly accepted U.S. reservations and ITAR restrictions for equipment and armaments projects. While the delays resulting from U.S. approval and extensive disclosure requirements have been subject to criticism before, the timing and context of both depicted cases suggest an intention to ask for "ITAR-free" products in future. ITAR-free clauses are thus becoming increasingly common as exclusion criteria in invitations to tender.

This practice is not just a German development, but indicative of a Europe-wide trend. A widespread, albeit not concerted, effort to avoid the purchase of products subject to ITAR regulation, whenever possible, is observable throughout the entire landscape of European defence procurement. For instance, the French arms industry tends to avoid using or sourcing ITAR-regulated items, as long as an adequate substitute is available. Many manufacturers attempt to circumvent ITAR restrictions too. Products are regularly marketed as being "ITAR-free". French manufacturer Dassault Aviation, for example, avoids using key U.S. technologies in order to strategically advertise and commercialise its fighter aircrafts as being exempted from ITAR restrictions.

The increased use of ITAR-free clauses in EU procurements is certainly not exclusively attributable to protectionist intent. ITAR restrictions do in fact tend to complicate and delay multiple international procurements. In addition, the U.S. has shown a tendency to apply them strictly in the past. For instance, in 2014 a French contract for the sale of reconnaissance satellites to the United Arab Emirates worth EUR 700 million was stalled for more than a year, as the satellites in question included ITAR-regulated items. The recent paradigm shift toward ITAR-free clauses may in part be explained by these and similar past negative experiences with ITAR-regulated items. However, the recent German cases clearly demonstrate how ITAR-free clauses might be employed in the future to *de facto* entirely exclude U.S. competitors and products from European procurements.

III. CONCLUSION AND OUTLOOK

These developments in the European market mirror those in the U.S. under the Trump administration: rising defence budgets, paired with an increased tendency to "buy local" and to restrict transatlantic competition. Both PESCO and the EDF, as well as the *de facto* exclusion of products under ITAR

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restrictions from European defence procurements, indicate a shift towards favouring European producers. In the long term, both developments might even end up playing into the hands of President Trump's "America First"-policy, as they provide a justification for implementing reciprocal protectionist measures against EU-based companies.

However, legal challenges to these practices under European Procurement Law and International Trade Law are likely. It remains to be seen if the trend of protectionism from within the European defence sector continues and if the EU or individual Member States adopt similar strategies towards other markets. While neither PESCO nor the above-mentioned protectionist measures implemented by individual Member States constitute, as of yet, a "Buy European Act" (as called for by French president Emmanuel Macron during his election campaign) for defence procurement, they are representative of a general move away from a NATO-centric procurement policy towards an EU-centric one.

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