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Government-to-Government Contracts and Offsets

1 Introduction

The preceding chapters have broadly focused on access and treatment of foreign contractors seeking direct participation in contract award procedures of the host country. This final chapter focuses more specifically on two particular and related aspects of procurement, namely government-to-government or "foreign military sales" contracts and "offsets". Government-to-government contracts concern a request by a foreign government to another to procure items on its behalf from the latter's domestic market which are then sold to the requesting government. Offsets concern compensations provided by a foreign contractor to a foreign government in return for the award of a contract. Such contracts are of considerable political and economic importance in the context of transatlantic and international trade.

Comprehensive legal analyses of their legal regulation and reform would necessitate books in their own right. This chapter merely aims to provide a comparative frame of reference for debate on these practices by exploring just some of the areas of legal uncertainty arising under US and EU law. The chapter seeks, for the first time, to identify whether the USA's experience in legal and policy terms offers any useful insights into the potential issues facing the development of EU law and policy in this area and, similarly, whether the EU's legal experience in light of the Defence Directive may necessitate at least some reconsideration of the operation of the US legal and policy framework.

This chapter begins by setting government-to-government contracts and offsets within the broader economic and political context of transatlantic defence trade (Section 2). The chapter then critically examines government-to-government contracts (Section 3) and offsets (Section 4) under EU and US law before offering concluding observations (Section 5).

2 Government-to-Government Sales and Offsets in Transatlantic Defence Trade

In order to understand legal approaches to government-to-government contracts and offsets, it is first necessary to outline their basic characteristics and purported significance for transatlantic defence trade.

2.1 Government-to-Government Contracts

A state may not have the technological or industrial capacity, finances or time to field its requirements domestically and may, therefore, seek to obtain certain of its requirements from a foreign government. Government-to-government sales typically involve the sale of equipment that is surplus to the selling government's requirements but may also include new equipment. Where necessary, the selling government sources the requested item from its own stocks. Where there is no retained stock, the selling government may award a contract for the equipment to a domestic vendor. Under a separate sales contract, the selling government then sells the procured item to the requesting government.

Government-to-government sales offer certain advantages and disadvantages to both the selling and purchasing governments, only certain of which are illustrated in this chapter. Concerning advantages, from the selling government's perspective, where it seeks to purchase the same items for its own needs, the selling government may be able to negotiate a reduced price from the domestic vendor.[1] Further, such sales can sustain a high value export market. The significance of FMS from the perspective of US trade is reflected in the formal designated of an FMS program under US law and which is discussed in Sections 3.1–3.3. By contrast, EU Member States have not developed equivalent foreign military sales programmes, although it is understood that certain European countries are increasingly considering programmes based on the US model.[2] This already provides an indication, therefore, that if major defence trading European countries develop similar models for exports, the more a coherent regulatory response will need to be formulated both at the Member level and EU

[1] Government Accountability Office, *Defense Contracting – Actions Needed to Increase Competition* GAO-13–325 (Washington, DC, March 2013), 1, 15.

[2] The UK has consulted on the adoption of a US-style FMS programme. See A. Chuter, 'UK Considers Adapting FMS Framework for its Exports', 18 November 2013, *RP Defense Blog*. Available at: http://rpdefense.over-blog.com/2013/11/uk-considers-adapting-fms-framework-for-its-exports.html. Last accessed 20 September 2015.

level and which is likely to draw on US experience. This requires a clearer understanding as to how foreign military sales processes legally operate in different jurisdictions.

From the purchasing government's perspective, a purchasing government may wish to rely on foreign military sales programmes such as that in the USA even when it is able to purchase products directly from a contractor in the state of the selling government. It has been observed that purchasing governments can take advantage of economies of scale by adding their purchase to an order for the same products that the US Government places, for example.[3] Further, the purchasing government can rely on the regulations and procedures that the selling government's own department of defence uses for its own procurement albeit with certain adaptations.[4] Consequently, the foreign government may receive certain of the same benefits not least in terms of expertise, protections and quality assurance standards which might not otherwise be afforded.[5] In addition, programmes such as the US FMS programme relieve most obligations placed on the defence contractor to obtain export licences that would otherwise be required, in turn, reducing costs, timing and uncertainty for the purchasing government.[6]

From the perspectives of both the selling and purchasing governments, foreign sales may also contribute to ensuring that allies use interoperable equipment. For example, the US Arms Export Control Act gives the US President discretion to designate which military end items must be sold exclusively through FMS channels for reasons which include interoperability for US forces.[7]

Concerning disadvantages, a number will be outlined in subsequent sections of this chapter. Generally, it has been identified that there may be a risk of abuse by the selling government where foreign military sales are used as a means to avoid competitive contract awards.[8] The purchasing government's ability to rely on the expertise and responsibility of the

[3] A. B. Green, *International Government Contract Law*, 1st edn (New York: WEST-Thomson Reuters, 2011), §3:2. The author is grateful to Major Daniel E. Schoeni (US Air Force JAG Corps) for bringing this source material to the author's attention when reviewing an earlier version of this chapter.

[4] Defense Security Cooperation Agency, Security Assistance Management Manual, DSCA 5105.38-M ("SAMM") C.6.3.1. The importance of the SAMM is indicated in Section 3.1.

[5] Ibid. [6] Green, *International Government Contract Law.*

[7] SAMM, C.4.3.5. and C.4.3.5.2.

[8] Comp. Gen. Report No.B-165731 (PSAD-78–147) *Defense Department is Not Doing Enough to Maximize Competition when Awarding Contracts for Foreign Military Sales Programmes*, 17 October 1978, 8–9.

selling government has, historically, been identified as one reason for the procurement of non-military commercial items that could have been purchased on a commercial, and potentially more competitive, basis in the open market.[9]

2.2 Offsets

Whilst government-to-government contracts are a systemic feature of international defence contracting, offsets are often portrayed as an endemic feature. There is no uniform consensus on the concept or definition of an offset.[10] However, an offset can be broadly understood in one form as the receipt of additional compensations from a foreign contractor to "offset" the fact that public funds are expended on foreign, as opposed to domestic, purchases.[11] Offsets may take many forms. Examples include, among many others: requiring production of defence or civil items in the purchasing country; requirements on a foreign contractor to use subcontractors from the purchasing country; and investment in national industries and infrastructure. Offsets can be required in a range of procurement scenarios. In the simplest scenario, a contracting authority may require a foreign contractor to provide offsets as a condition for, or in addition to, the award of the main contract. A more complex scenario concerns the use of "*juste retour*" or fair return practices in multinational cooperative programmes for the procurement of major systems. It is recalled from Chapter 3 that states may seek a division of work proportional to their respective national investment in the programme according to a defined calculation.[12]

[9] Ibid., 8.

[10] For a discussion of the difficulties of definition, see D. Schoeni, 'Second-Best Markets: On the Hidden Efficiency of Defense Offsets' (2015) 44(3) *Public Contract Law Journal* 369, 374–8 and citations therein.

[11] Article XVI fn. 7 GPA defines offsets as: "measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements". Concerning an EU concept of "offsets" the Commission in its Communication, 'Towards a more competitive and efficient defence and security sector' COM(2013) 542 final 1, 6 simply refers to: "economic compensations required for defence purchases from non-national suppliers". The US Defense Offsets Disclosure Act of 1999 Pub L 106–113 §1243(3) defines the term "offset" as: "the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase military goods or services, including benefits such as co-production, licensed production, subcontracting, technology transfer, in-country procurement, marketing and financial assistance, and joint ventures".

[12] Section 5.5.2. For a useful discussion of the general complexity of fair return mechanisms albeit in the related field of space procurement under the European Space Agency, see

Offsets can be divided into a number of categories.[13] 'Direct' military offsets require the compensation to be directly related to the defence items or services provided under the main procurement contract.[14] By contrast, indirect offsets concern items unrelated to the main contract[15] and which can be further subdivided into "defence related indirect offsets"[16] and "non-defence related indirect offsets".[17]

As will be discussed in Section 4.1.1, US and EU legal approaches to offsets are formally dictated by the argument that offsets are economically inefficient and trade distorting.[18] The economic case against offsets includes, *inter alia*, the argument that offsets distort trade flows because offsets lead to industrial hyper-specialisation in certain areas, shift production away from non-defence sectors and force arms manufacturers to handle risky investments outside their competencies and which may lead to resource misallocation.[19] More generally, anecdotal evidence suggests that the purported goals of job creation, technology transfer and cost reduction are not achieved in practice or succeed at too great a cost for them to be a useful policy tool.[20]

S. Hobe, M. Hofmannova and J. Wouters (eds), *A Coherent European Procurement Law and Policy for the Space Sector: Towards a Third Way* (Münster: Lit Verlag, 2011), pp. 70–6.

[13] For a useful taxonomy, see A. Eriksson, M. Axelson, K. Hartley, M. Mason, A.-S. Stenérus and M. Trybus, *Study on the Effects of Offsets on the Development of a European Defence Industry and Market*, SCS Henley on Thames, UK and FOI Stockholm, Sweden, Final Report of 06-DIM-022 (EDA Commissioned), Brussels 2007, pp. 14–18.

[14] According to the *Study on the Effects of Offsets*, p. 4, direct military offsets accounted for 40 per cent of offsets received by participating EDA Member States. According to US Department of Commerce, Bureau of Industry and Security (BIS), *Offsets in Defense Trade*, Nineteenth Study, Conducted Pursuant to Section 723 of the Defense Production Act of 1950, as Amended, March 2015 1, 5, in 2013, direct offsets provided by US contractors accounted for 34.9 per cent of the actual value of reported offset transactions. During the period 1993–2013, direct offsets accounted for 41 per cent of the actual value of the reported offset transactions.

[15] According to the BIS, *Offsets in Defense Trade*, Nineteenth Study, in 2013, indirect offsets provided by US contractors accounted for 65.1 per cent of the actual value of the reported offset transactions. During the period 1993–2013, indirect offsets accounted for 58.4 per cent of the actual value of the reported offset transactions. The Study does not specifically differentiate indirect defence and non-defence related offsets.

[16] According to the *Study on the Effects of Offsets*, 35 per cent of offsets were indirect military offsets.

[17] According to the *Study on the Effects of Offsets*, 25 per cent of offsets were indirect civil offsets.

[18] For a useful synthesis of the economic case against offsets based on existing economic literature, see Schoeni, 'Second-Best Markets', 389–395 and citations therein.

[19] Ibid., citing at 390, fn. 139 A. Markusen, 'Arms Trade as Illiberal Trade' in J. Brauer and J. P. Dunne (eds), *Arms Trade and Economic Development: Theory, Policy and Cases in Arms Trade Offsets* (London: Routledge, 2004).

[20] Schoeni, 'Second-Best Markets', 391–5 and citations therein.

However, legal debate has, perhaps, placed lesser emphasis on the economic case for offsets, generally stated, that defence offsets may serve an important corrective function in light of particular market failures.[21] The economic case for offsets includes that offsets may, in fact, create efficiencies by reducing transaction costs, for example, by enabling the bundling of products and their accompanying services and technical support.[22]

Beyond the macro-level arguments about economic (in)efficiency arguments, offsets may specifically affect access and treatment of foreign contractors in defence procurement procedures for a number of reasons. For example, a foreign contractor must have significant financial resources and expertise to meet the risk exposure associated with offsets before even considering whether to bid for a defence contract.[23] Further, the procurement process may be undermined if the offset package becomes a factor which overrides the quality of the contractor's offering for the main procurement contract.[24] In addition, foreign contractors may be required to meet offset obligations under an offset agreement which grossly exceed the value of the original procurement contract and may be subject to variation, in turn, leading to uncertainty for the contractor in their management.[25] Even after award, the foreign contractor

[21] For a useful synthesis of the economic case for offsets based on existing economic literature, see ibid., 395–403.

[22] Ibid., 399–401 restating the arguments of R. Howse, 'Beyond the Countertrade Taboo: Why the WTO Should Take An- other Look at Barter and Countertrade' (2010) 60 *University of Toronto Law Journal* 289, 294–296 (citing J.-F. Hennart and E. Anderson, 'Countertrade and the Minimization of Transaction Costs: An Empirical Examination' (1993) 9(2) *Journal of Law, Economics and Organization* 290–313, 290.

[23] It has been observed that: "[. . .] Lockheed Martin, for example, 'is on the hook for at least $27 [billion] of offset deals' which was '10 times its net profit' in 2012 [. . .] and that underestimating offset costs by just ten percent could wipe out a whole year's profits at Lockheed, making offsets a high-stakes gamble." See Schoeni, 'Second-Best Markets', 370 citing at fn. 7; C. Hoyos, 'Defence Groups Agree $57bn of Sweeteners to Win Big Contracts', *Financial Times*, 10 October 2013 at 1 (also reporting offset obligations of $12.6 billion for Boeing, $7.9 billion for Raytheon, $7.6 billion for Airbus, and $4 billion each for BAE and Saab).

[24] M. Trybus, *Buying Defence and Security in Europe: The EU Defence and Security Procurement Directive in Context* (Cambridge: Cambridge University Press, 2014), pp. 56 and 409.

[25] Ibid. In practice, many offset regimes apply a "multiplier" to the contract. A multiplier is a factor applied to the actual value of certain offset transactions to calculate the credit value earned (i.e., the nominal value attributed to the actual value of the offset). Contracting authorities use multipliers to provide firms with incentives to offer offsets that benefit targeted areas of economic growth. Offset multipliers can generally range from approximately 100 per cent to 135 per cent of the contract value in some cases. See *Study on the Effects of Offsets*, pp. 21–2.

may have to invest substantially, or otherwise establish a link or presence, in the domestic industry of the purchasing state.

2.3 *Significance in the Context of Transatlantic Defence Trade*

It has been estimated that, since the 1950s, approximately $500 billion in offsets have been imposed globally.[26] It has been acknowledged, however, that it is difficult to obtain detailed statistics on offsets because so few countries collect offset data.[27] As will be discussed in Section 4.1.2, the USA is a rare exception as it statutorily mandates offset reporting where offsets are connected to FMS. By contrast, the EU does not undertake statistical tracking or monitoring of foreign military sales or offsets rendering it difficult to gauge a sense of the economic significance of government-to-government contracts and offsets as a proportion of total EU defence expenditure.[28]

US data provides some indication as to the overall economic significance of FMS and offsets as a feature of transatlantic defence trade but US observers have cautioned that such reports only provide the US perspective as a primary arms exporter with most countries constituting offset recipients.[29] Further, even in the USA, there has been "systematic underreporting".[30] Annual monitoring of the impact of offsets on the US defence industrial base dates as far back as 1984.[31] According to the latest 2015 US Bureau of Industry and Security ("BIS") Report, in 2013 alone, 17 US firms reported entering into 67 contracts with 18 countries valued at $9.4 billion which were accompanied by related offset agreements.[32] The accompanying offset agreements were valued at $5.0 billion, equalling 52.9 per cent of the value of the signed defence export sales contracts.[33] As a proportion of the defence export sales contract value, reported offset agreements ranged between 10 per cent and

[26] Schoeni, 'Second-Best Markets', 388 and citation at fn. 121.
[27] Ibid., 386. For a discussion of some of the reasons, see 404–8.
[28] A. E. Ippolito, 'Government to Government contracts in EU defence procurement' (2014) 6 *Public Procurement Law Review* 249, 254.
[29] Schoeni, 'Second-Best Markets', 387 citing at 114 Bernard Udis and Keith E. Maskus, 'US Offset Policy', in S. Martin (ed.), *The Economics of Offsets: Defence Procurement and Countertrade* (Amsterdam: Harwood, 1996).
[30] Schoeni, 'Second-Best Markets', 388, citing at fn. 122 S. Marshall, 'Money for Nothing? Offsets in the US–Middle East Defense Trade' (2009) 41 *International Journal of Middle East Studies* 551, 552.
[31] For a more detailed discussion of statutory reporting requirements, see Section 4.1.2.
[32] BIS *Offsets in Defense Trade*, Nineteenth Study, 3. [33] Ibid.

104 per cent.[34] Concerning offset transactions entered into in fulfilment of offset obligations, 21 US firms reported concluding 541 offset transactions with 32 countries to fulfil offset agreement obligations with a reported actual value of $3.14 billion and a credit value of $3.51 billion.[35] This trend appears to be relatively consistent across the last two decades.[36] Therefore, the scale of US offsets trade has been described as "staggering" not least given that, as will be discussed in Section 4.1, the US officially opposes offsets.[37]

Focusing more specifically on US offsets concluded with European countries, according to a 2012 BIS report, in 2010, US firms reported entering into six new offset agreements with EDA members valued at $736.3 million.[38] EDA members accounted for 25 per cent of the new offset agreements reported by US firms based on quantity and 36.12 per cent based on value.[39] US firms reported 205 offset transactions with EDA members with an actual value of $1.22 billion, and an offset credit value of $1.69 billion.[40] According to an EDA study, the estimated value of offset transactions performed between 2000 and 2005 in the EU amounted to €5.6 billion.[41] Based on this data, FMS and accompanying offsets constitute a significant feature of US trade, a sizeable proportion of which flows to EU Member states.

From a US perspective, the BIS reports have acknowledged that, given the variety of reported defence export sales contracts and the number of reported offset transactions, it is not possible to determine the precise impact of defence export sales contracts, offsets agreements and offsets transactions on industrial activity and employment.[42] Officially,

[34] Ibid. [35] Ibid., 4.

[36] During 1993–2013, 54 US firms reported entering into 995 offset-related defence export sales contracts worth $158.4 billion with 45 countries and two multi-country arrangements for which the associated offset agreements were valued at $99.8 billion. Further, during 1993–2013, a total of 62 US firms reported 13,377 offset transactions with 46 countries and two multi-country arrangements. The actual total value of the offset transactions reported from 1993–2013 was $66.7 billion and the total credit value was $79.4 billion. Ibid., 3–4 citing Table 3–1 (source: BIS Database).

[37] Schoeni, 'Second-Best Markets'.

[38] US Department of Commerce Bureau of Industry and Security, *Offsets in Defense Trade*, Sixteenth Study, Conducted Pursuant to Section 723 of the Defense Production Act of 1950, as Amended, January 2012 1, 5.

[39] Ibid. [40] Ibid. [41] *Study on the Effects of Offsets*, p. 23.

[42] BIS, *Offsets in Defense Trade*, Nineteenth Study, 12. However, BIS has developed a method to approximate the value added shipment and employment impact of offset activities across the US economic sectors. For a discussion of the results in this regard, see 12–13. For a general critique of BIS formulae, see M. J. Nackman, 'A Critical Examination

the USA has recognised a number of benefits to defence export sales. In particular, such sales can be an important component of defence contractors' revenues and further US foreign policy and economic interests.[43] Exports of major defence systems can also lower overhead and unit costs for the DoD and help sustain production facilities, workforce expertise and the supplier base to support current and future US defence requirements.[44] Exports are also said to promote interoperability of defence systems between the US and allies, and contribute to US international trade account balances.[45] However, it has also been observed that the negative impact of offsets on subcontractors is often overlooked.[46] Sales with direct offset requirements are said to displace US subcontractors with foreign sources on export versions of initial systems designed by those subcontractors, in turn, resulting in the disclosure of intellectual property and other technical "know-how" which enables foreign sources to become competitors.[47] Notwithstanding, as will be discussed in Section 4.1, it is generally accepted in practice that the USA has "turned a blind eye" to offsets specifically in order to aid domestic firms.[48] Official US reports acknowledge that US defence contractors generally see offsets as a reality and, indeed, necessity of the marketplace for companies competing for international defence sales.[49]

From a European perspective, historically, most Member States have used offsets when acquiring defence goods.[50] The economic significance of offsets within Europe is perhaps signified by the fact that many EU

of Offsets in International Defence Procurements: Policy Options for the United States' (2011) 40(2) *Public Contract Law Journal* 511, 523.

[43] BIS, *Offsets in Defense Trade*, Nineteenth Study, 7. [44] Ibid. [45] Ibid.

[46] See Nackman, 'A Critical Examination of Offsets', 523. See also G. Ianakiev, 'The United States and the "Offsets in Defence Trade" Issue' (2006) *Proceedings of the 10th Annual International Conference on Economics and Security* 308. Available at www.city.academic.gr/special/events/economics_and_security09/2006/11-Ianakiev.pdf. Last accessed 20 September 2015.

[47] Nackman, 'A Critical Examination of Offsets', 522. See also BIS, *Offsets in Defense Trade*, Nineteenth Study, 7 citing at fn. 15 GAO report on offset activities, 'Defense Trade: US Contractors Employ Diverse Activities to Meet Offset Obligations', December 1998 (GAO/NSIAD-99–35), 4–5.

[48] Nackman, 'A Critical Examination of Offsets', 527.

[49] Schoeni, 'Second-Best Markets', 384, referring at fn. 95 to a report by the Presidential Offsets Commission, Status Report of the Presidential Commission on Offsets in International Trade (2001) reporting that an Office of Management and Budget survey found that eight large US aerospace firms systems integrators indicated that they would lose fifty to ninety per cent of their exports without offsets.

[50] For a useful examination of the extent of offset use, see, generally, *Study on the Effects of Offsets*.

Member States have traditionally supported considerable offset administrations as part of their ministries for economy as opposed to ministries of defence.[51] According to one EDA Study, Member State practice with regard to offsets has been variable.[52] Prior to the Defence Directive, Member State approaches have ranged from imposing specific national offset laws and policies to adopting no formal offset laws or policies at all.[53] This has been most recently confirmed by the EU Commission's Report on transposition of the Defence Directive according to which, historically, eighteen out of twenty-eight Member States maintained offset policies.[54] Several Member States have mainly tended to accept indirect offsets.[55] Another group of Member States have tended to accept a higher proportion of direct offsets.[56] Some of the smallest Member States appear to have limited or no experience of offset provision and tend towards receipt of indirect civil offsets.[57] Whilst the literature has tended to emphasise the issue of Member State dependence on offsets for the survival of their domestic defence technological industrial bases, it has also been observed

[51] D. Eisenhut, 'Offsets in defence procurement: a strange animal – at the brink of extinction' (2013) 38(3) *European Law Review* 393, 394 and fn. 2 who indicates that many Member States have recently shifted the competence to their ministries of defence in order to emphasise the importance of defence and security considerations as a basis of offset requirements. See also Trybus, *Buying Defence and Security in Europe*, 56, who suggests that this reorganisation is possibly motivated by a wish to hide the economic rationale for offsets.

[52] *Study on the Effects of Offsets*, 18–23.

[53] Ibid., 29–31. For a further discussion of national practices, see J. P. Bialos, C. E. Fisher S. L. Koehl, *Fortresses and Icebergs: The Evolution of the Transatlantic Defence Market and the Implications for US National Security Policy*, Volume II, Study Findings and Recommendations (Washington, DC: Centre for Transatlantic Relations, 2009), pp. 343 (France), 388 (Germany), 432 (Italy), 479–81 (Poland), 518–19 (Romania), 554–5 (Sweden) and 610–11 (UK).

[54] See Commission, Report to the European Parliament and The Council on transposition of directive 2009/81/EC on Defence and Security Procurement, Brussels COM (2012) 565 final 1, 8.

[55] According to the *Study on the Effects of Offsets*, 23, Italy, the Netherlands, Sweden and the UK is a group of net exporters but also with considerable imports. As a group, their import patterns have a strong transatlantic orientation while, in contrast, their export has a strong European tendency. These Member States typically rely on indirect military offsets.

[56] According to the *Study on the Effects of Offsets*, Finland, Greece, Poland, Portugal and Spain are the major European defence equipment importers, although some also maintain significant exports. These Member States appear to rely to a greater extent on direct offsets.

[57] According to the *Study on the Effects of Offsets*, other EDA-participating Member States are relatively small actors in terms of both exports and imports. As a group, their defence technological industrial bases are small and the limited absorptive capacity means that they tend towards indirect civil offsets.

that offsets have become a component of the fierce competition between the US and European defence industries competing for defence contracts globally.[58]

In 2007, the EDA commissioned a study on the effects of offsets on the development of a European defence industry and market, the findings of which have been referred to in this section.[59] As part of its industry questionnaire, the study asked: "[d]oes offset tend to favour EU-based companies vs. non-EU based companies or is it neutral in this regard?"[60] Whilst the question is not unequivocal, the overall conclusion was that the findings were "rather inconclusive".[61] Most respondents stated that offsets were "neutral".[62] According to the study, direct and indirect military offsets are seen by some as advantageous to US primes as a result of their greater economies of scale and scope.[63] By contrast, it may be easier for European firms to offer indirect civil offsets in light of the fact that they are geographically and culturally closer with more developed European industrial networks.[64] The study also identified that US regulations on technology transfer presented a more fundamental advantage to European industries, although there were indications that US firms were more forthcoming in sharing their technologies than European firms.[65] Further, such differences in offset provision would not necessarily affect the attractiveness of the offered offset package.[66] Another important finding was that several respondents pointed to, and warned against, the potentially "negative effects" of "a future offset regime banning intra-European offsets but allowing them for extra-European players".[67] The compatibility of third country-offset provision with EU law is reserved for discussion in Section 4.2.1.

[58] Schoeni, 'Second-Best Markets', 383 citing at fn. 89 O. E. Herrnstadt, 'Offsets and the Lack of a Comprehensive US Policy: What Do Other Countries Know That We Don't?', 17 April 2008, Economic Policy Institute Briefing Paper No. 201 at 11 (listing EADS as an example of those European firms that were "once fledgling industries" and that "are now US competitors who benefit from a sophisticated approach to offsets that moves jobs and technology their way").

[59] *Study on the Effects of Offsets.* [60] Ibid., 44. [61] Ibid., 48.

[62] The study observed that several participating Member States answered with reference to the claimed neutrality of their own procurement practices. Ibid., 44.

[63] Ibid., 44–5, 48. [64] Ibid., 45, 48.

[65] Ibid., 45 fn. 41. This issue is discussed in more detail in Chapter 5, Section 4 with regard to ITAR.

[66] The study states that rather one should expect that US tenderers would have to accept a lower profit margin. Ibid., 45.

[67] Ibid. These "negative effects" were not specified.

3 Government-to-Government Sales Under US and EU Law

Having outlined the economic and political significance of government-to-government contracts as a feature of transatlantic defence trade, this section examines certain legal issues arising from their regulation or absence of regulation under US and EU law.

3.1 Foreign Military Sales Under US Law on Foreign Acquisition

The USA operates an extensive Foreign Military Sales ("FMS") programme which has a statutory basis under the Arms Export Control Act 1976 ("AECA"). Under the AECA, the US President is authorised to sell defence articles and services from US stocks.[68] The US President is also authorised to enter into contracts for the procurement of defence articles or services for sale to eligible foreign countries and international organisations.[69] These authorisations have been delegated to the Defense Security Cooperation Agency ("DSCA") which is the lead agency responsible for the execution of FMS.[70] The DSCA directs, administers and guides DoD execution of FMS through its Security Assistance Management Manual ("SAMM")[71] which also requires that FMS comply with DoD Regulations and Procedures.[72] The policies and procedures concerning acquisition under FMS are regulated in DFARS 225.73.[73] As indicated in Chapter 9, US foreign military sales are, therefore, regulated alongside aspects such as domestic source restrictions and international agreements under the corpus of US law on "foreign acquisition.[74]

The FMS process begins when an eligible foreign country requests information on defence articles or services (including training) being

[68] 22 USC §2761. [69] 22 USC §2762.

[70] See Executive Order 13637, March 8, 2013 (superseding Executive Order 11958, as amended of January 18, 1977, delegating the President's authority with respect to these matters to the Secretary of Defense; DoD Directive 5105.65, October 26, 212 (further delegating the authority to the Director of the DSCA). Information on the DSCA is available at: www.dsca.mil. Last accessed 20 September 2015.

[71] SAMM. [72] Ibid., C.6.3.1.

[73] Ibid., C.6.3.1 and Table C6.T1 (selected FAR and DFARS Sections Relevant to FMS Acquisition).

[74] For a useful instruction on the FMS process, see SAMM, Chapters 4 (Foreign Military Sales Program General Information), 5 (Foreign Military Sales Case Development) and 6 (Foreign Military Sales Case Implementation and Execution). Available at: www.samm.dsca.mil/listing/chapters. Last accessed 9 June 2015. For useful commentary, see Green, *International Government Contract Law*, Ch. 3.

considered for purchase.[75] Requests are generally referred to as Letters of Request ("LORs"). However, as will be discussed in Section 3.3, there is, in fact, a preceding phase referred to as "pre-LOR activities" under which the purchasing government may be assisted in defining its requirements prior to submitting a LOR.[76] In response to the LOR, a Letter of Offer and Acceptance ("LOA") is issued which constitutes the sale agreement. To fulfill the LOA requirements, the US Government may supply items or services from DoD resources. Alternatively, the US Government may act on behalf of the FMS customer and procure the item as a buyer from an industry vendor under a separate contract to which the FMS customer is not a party. In terms of financing this arrangement, there are two principal forms of FMS transaction: cash sales and credit sales.[77] In a cash sale, the purchasing government pays the price in full or makes an undertaking to pay and deposits cash in its FMS trust account in advance of performance.[78] In a credit sale, the purchasing government uses foreign military financing ("FMF") under which the US Government provides repayable loans or non-repayable grants.[79] The US Government then resells and exports the sourced or procured item to the FMS customer. It should be observed that, as a result of the existence of two separate contracts, a purchasing government cannot constitute a third party beneficiary under a contract concluded between the US Government and FMS contractor.[80] Consequently, if the purchasing government alleges, for example, that equipment is defective, the purchasing government cannot bring a direct legal action against the FMS contractor.[81] Most procurements involving FMF are made pursuant to the FMS programme.[82] However, in certain circumstances, purchasing governments may procure

[75] SAMM, C.5.1.1. [76] Ibid., C.9.3.4.

[77] These are authorised by Sections 22 AECA, 22 USC §2762 and §2763, respectively. See generally, Green, *International Government Contract Law*, §3.7.

[78] Ibid. [79] Ibid.

[80] *United Kingdom Ministry of Defence* v. *Trimble Navigation Ltd.*, in which the Fourth Circuit issued two opinions: *Trimble I*, 422 F.3d 165 (4th Cir. 2005), and *Trimble II*, 484 F.3d 700 (4th Cir. 2007).

[81] For general commentary on this position, see Major J. A. Cora, 'Foreign Military Sales, Foreign Governments Conducting Foreign Military Sales (FMS) Purchases May Not Sue FMS Contractors in US Federal Courts' (2008) *Army Lawyer* 82; See, more generally, Green, *International Government Contract Law*, § 3:21. For useful hypothetical arguments on enforceability, see J. R. Oliveri, S. G. Jacobsen, M. Chow and T. L. Ward, 'Foreign Military Sales: Contract Disputes Act Jurisdiction and Third-Party Beneficiary Issues: The 2008 McKenna Long & Aldridge "Gilbert A Cuneo" Government Contracts Moot Court Competition' (2007–2008) 37 *Public Contract Law Journal* 923.

[82] Green, *International Government Contract Law*, §3:11.

an item directly from a US contractor through a direct commercial sale ("DCS").[83] Whilst such sales do not directly involve the US Government, such sales may also be funded by FMF. In such instances, US Government involvement in the process may be significant.[84]

3.2 Open Competition in US Foreign Military Sales

It is generally accepted that there is a preference for FMS to be conducted in accordance with full and open competition to the maximum extent possible under US law.[85] One issue arising under US FMS in the context of openly competed awards concerns the extent to which the procurement process is separated from the sale and, more specifically, the extent of the purchasing government's permitted involvement in the underlying procurement process conducted between the selling government and contractor. According to US law and policy, the US Government DoD Departments can hold discussions with the purchasing government during the development of the LOA.[86] However, once the LOA is signed, the US contracting officer negotiates and awards a contract without requiring foreign country representation or direct involvement in the formal negotiation process.[87] Even if the purchasing government wishes to participate, DoD components do not accept directions from the FMS purchaser as to source selection decisions.[88] Further, the purchasing government is not permitted to interfere with a prime contractor's placement of subcontractors.[89] As will be discussed in Section 3.3, a purchasing government may only determine the placement of subcontractors where the DoD complies with a purchasing government's request that the FMS be undertaken on a sole source basis and for which a particular prime or subcontractor is designated.[90]

For a number of years, confusion had been expressed concerning the extent of permitted involvement of FMS customers in FMS procurements.[91] It had been suggested that FMS customers believed that

[83] See, generally, ibid., §3:11–14. For a useful discussion the choice to be exercised between an FMS and DCS, see D. Gilman, *Foreign Military Sales* and R. Nichols, J. C. Totman and C. Minarich, *Direct Commercial Sales*, 30 September 2014. Available at: www.dsca.mil/sites/default/files/final-fms-dcs_30_sep.pdf. Last accessed 20 September 2015.

[84] Ibid., §3:11. [85] SAMM, C.6.3.4. [86] Ibid., C6.3.5. [87] Ibid.

[88] Ibid., C6.3.5.1. [89] Ibid., C6.3.5.1. [90] Ibid.

[91] For a discussion of some of the difficulties repeatedly expressed by FMS customers, see R. L. Trope, 'A Customer Perception of an FMS Issue: Proposed DFARS Amendment to Permit Customers to Observe Price Negotiations' (1999–2000) *The DISAM Journal*, 53; and C. Hazlitt, 'Foreign Military Sales Policy Changes, Clarifications, and Initiatives' (1999–2000) *The DISAM Journal* 71.

they had been summarily excluded from the contracting process.[92] Consequently, there have been efforts since 1999 to improve "process transparency" of the FMS process for FMS customers.[93] US law now provides that the contracting officer should consult with the FMS purchaser about major contractual matters during the contracting process between the contractor and DoD.[94] Further, the FMS purchaser should be encouraged to participate with US Government acquisition personnel in discussions with industry to develop technical specifications.[95] However, the contracting officer, after consultation with the contractor, retains discretion to determine the extent of permitted involvement in negotiations.[96] Any involvement should not include the release of any contractor proprietary data except where authorised.[97] A further important qualification is that FMS customers have thirty days to comment on areas where they can demonstrate a significant deviation from the LOA but requests to reject any bid or proposal will not be honoured.[98] Most recently, the DSCA has outlined in its recent Strategic Plan Vision 2020 the need to increase confidence in FMS as a procurement option for foreign countries by providing greater and more structured customer visibility and participation during the pre-LOR phases and during FMS contracting.[99] To date, it is difficult to discern to what extent this clarification on FMS customer involvement is striking an effective balance between maintaining a competitive process and ensuring legitimate concerns of the purchasing government.

Rather than requesting the USA to procure equipment on a competitive basis for sale, more recently, it has been observed that there is an increasing tendency of certain countries to hold their own competition inviting offerors to meet their requirements through a foreign military sale.[100] A number of reasons are said to explain this tendency. One important reason relevant to the discussion of this chapter is the fact that purchasing governments may increasingly be subject to new legal requirements

[92] DCSA Policy Letter 09–60, 'Foreign Military Sales (FMS) Customer Participation in the DOD Contracting Process', 22 December 2009.

[93] See Deputy Secretary of Defense J. J. Hamre, 'Department of Defense Customer Participation in Foreign Military Sales (FMS) Contract Preparation and Negotiations', 23 March 1999; and DCSA Policy Letter 09–60, ibid.

[94] SAMM, C6.3.5.2 citing DFARS 225.7304(b).

[95] Ibid. [96] Ibid. [97] Ibid. [98] Ibid.

[99] DSCA, Strategic Plan Vision 2020, Objective 6.3. Details available at: www.dsca.mil/strategic-plan-vision-2020/synchronizing-meet-customer-expectations. Last accessed 20 September 2015. The author is grateful to Mr Andreas Estrup Ippolito (attorney at Poul Schmith/Kammeradvokaten) from bringing this latest initiative to attention when commenting on an earlier version of this chapter.

[100] Gilman, 'Foreign Military Sales', 12.

emphasising competition in defence contracting, a cited example being the EU Defence Directive.[101] Other reasons include the belief that a competition considering FMS offers will result in lower prices or more attractive offset packages as well as the desire to leverage existing production lines or sustainment for US requirements.[102] However, a number of challenges have also been identified in this regard. One challenge is the fact that many countries have developed procurement rules which may be inappropriate for "sovereign-to-sovereign" offers.[103] Issues include the difficulty of requiring the offeror to submit to a foreign country's law in the event of dispute as well as the fact that the US Government cannot be obligated to guarantee a certain price or delivery if the US Government does not fund the FMS.[104] There have been calls for "creative but careful approaches" to these emerging practices.[105]

As will be discussed in Sections 3.4.2 and 3.4.7, the Defence Directive *prima facie* excludes government-to-government contracts from its scope. Therefore, to date, no detailed consideration has been given to the potential impact of purchasing government intervention or lack of permitted intervention in an underlying procurement on EU internal market objectives. Further, there has similarly been limited consideration of how contracting authorities may conduct contract award procedures where the intention is to award a contract in accordance with the Defence Directive but on FMS terms and the general compatibility of this possibility with EU law.

3.3 Sole Sourcing in US Foreign Military Sales

Whilst the preference under US law and policy is for FMS to be conducted on an openly competitive basis, FMS may be conducted on a non-competitive basis in accordance with one of the CICA exceptions discussed in Chapter 8. A sole source FMS procurement can be made either on the initiative of the US Government or as a result of a specific request by the purchasing government, although most FMS sole source procurements

[101] Ibid., 13–14 and fn. 57. [102] Ibid., 13–14. [103] Ibid., 14.

[104] Ibid. This also observes, however, that the US Government can attempt to secure these guarantees on the purchaser's behalf, but which is likely to result in an increase in the price of the contract given the additional burden. Where the US Government seeks to enforce such guarantees on the purchaser's behalf, any compensation provided by the contractor would be passed onto the purchaser.

[105] Ibid., 18.

originate with the foreign customer.[106] Concerning the former, the US Government determines that the FMS procurement must be conducted on a non-competitive basis irrespective of any view expressed by the purchasing government.[107] In this case, the US Government must provide a written justification for the non-competitive procurement based on one of the CICA exceptions other than the international agreement exception, the latter applying exclusively to a sole source FMS procurement requested by the purchasing government pursuant to a LOA.[108] Concerning the latter, as indicated, a purchasing government may request a sole source FMS procurement pursuant to an international agreement.[109] An authorised official of the purchasing government may submit a written request generally through the Security Cooperation Organization ("SCO") that the implementing agency procure that item from a specific entity or otherwise limit competition to certain entities.[110] A legal issue that had previously arisen concerned whether a purchasing government should be able to designate the procurement as sole source under the CICA exception not only where the foreign government uses its own funds for the purchase but also where the US funds the purchase through FMF non-repayable grants.[111] On one hand, it has been argued that sole source procurement should not be permitted if US taxpayer dollars are involved given the need to maintain competition whilst, on the other hand, it has been argued that CICA only requires the foreign government to reimburse the agency and that, provided this is done, the source of funds used to finance the purchase is irrelevant.[112] Recently, it appears to have been confirmed that the sole source exception may apply irrespective of the origin of funding.[113]

[106] See an earlier version of the SAMM Manual: Defense Institute of Security Assistance Management, Chapter 9, Foreign Military Sales Acquisition Policy and Process (undated), 9–8. Available at: www.disam.dsca.mil/pubs/DR/09%20Chapter.pdf. Last accessed 20 September 2015.

[107] Ibid.

[108] Ibid., according to which: "[a]n example of a sole source without a FMS customer's request would be a major system acquisition. If the customer wanted to purchase F-16s through FMS, the customer would not need to submit a sole source request that the F-16s be purchased from Lockheed-Martin. Under the FAR, after initial source selection, major weapon systems are considered to be single source items. The USG will not conduct a competitive procurement for these type items. The USG would unilaterally justify a noncompetitive procurement based the item being a single source."

[109] 10 USC 2340(c) as implemented in FAR 6.302 and DFARS 206.302.

[110] SAMM, C.6.3.4.

[111] Green, *International Government Contract Law*, §3:19.

[112] Ibid.

[113] Ibid., citing at fn. 20 *L-3 Communication Corp.* v *United States, and Lockheed Martin Corp.*, Intervenor, COFC No. 10–538C, May 20, 2011.

Whilst this issue may be formally resolved, it does not appear to have been more widely debated as to why sole source procurement should be justified simply because it is requested by a foreign government and even more justified if it does not involve US funds.[114]

In addition to requesting a sole source designation, the FMS customer may also request that a subcontract be placed with a particular firm, provided that the LOA or other written direction sufficiently fulfils the requirements of FAR on other than full and open competition.[115] Risks associated with the designation of subcontractors should be communicated to the FMS purchaser.[116] For instance, a specification requiring certain removes the prime contractor's responsibility for the choice and oversight of subcontractors.[117] As the prime contractor has no ability to reallocate work away from underperforming subcontractors to ensure that specific performance and cost parameters are met, the prime contractor may be relieved from certain contract liabilities; in turn, this reduces the DoD's ability to hold the prime contractor to those parameters.[118] To this extent, if problems occur in performance, the FMS purchaser must bear the increased cost of correcting the problem and be informed to this effect when the designation is requested.[119]

Formerly, it was unclear whether or not a FMS customer was required to provide a clear justification for sole source requests under FMS.[120] According to an earlier version of the SAMM, the basis and justification for a sole source request had to be based upon the objective needs of the FMS

[114] By contrast, from the perspective of EU law, it is unlikely that a selling EU government would be able to justify a sole source procurement because it was requested by the purchasing government and was funded or reimbursed by the purchasing government unless it could be strictly justified under EU law. Here, the concern would be to ensure non-discrimination and equal treatment of bidders, but also to enable the development of a competitive internal market for defence trade. As a national system, the US may take the view that it has no broader obligation to consider the impacts of sole sourcing on the markets of other states in the interests of fostering a competitive transatlantic defence market.

[115] SAMM, C.6.3.4.4, referring to FAR 6.3 and DFARS 225.7304(a). [116] Ibid.

[117] Ibid. [118] These reasons are indicated in an earlier version of the SAMM, 9–2.

[119] SAMM, C.6.3.4.4.

[120] DFARS 225.7304(a). See L. D. Anderson, 'Foreign Military Sales Sole Source Exception: The Current USASAC Practice' (1993) *The DISAM Journal* 83, referring at 85 to a "cryptic reference" contained in DFARS 225.7304(a) that the written direction should sufficiently fulfill the requirements of FAR Subpart 6.3 but otherwise containing no regulatory direction as to any other requirement for a sole source justification or the content thereof.

purchaser as stated by the purchaser.[121] Further, it was provided that the request must not contain "patently arbitrary, capricious or discriminatory exclusion of other sources".[122] Therefore, it has been observed that the policy of certain military departments was to ensure that the FMS request should state sufficient facts to justify the sole source request but that the FMS customer may have greater latitude than the US Government.[123] The legal test appeared to be whether a reasonable basis for the sole source had been stated in the written direction.[124] This did not preclude the USA from advising a FMS customer on which items might satisfy its needs on a sole source basis provided that the agency had not attempted to get the foreign government request certain sources in bad faith for the purposes of circumventing competition in the procurement.[125]

However, the most recent SAMM Guidance confirms that a detailed justification is not required from the purchasing government.[126] All that is required is that the use of other than competitive procedures must be documented in such a way that describes the terms of an agreement or treaty or the written directions in the LOA.[127] Similarly, the US Government will not investigate the circumstances behind a foreign purchaser's request to use other than full and open competition.[128] Agencies are encouraged to defer to a foreign purchaser's request under the international agreements exception.[129] However, deferral is not absolute. For instance, requests for other than full and open competition should meet the objective requirements of the purchaser and not take account of improper or unethical considerations.[130] Agencies must not, therefore, defer to the extent that they are aware of any indication that such requests violate US law or ethical business practices.[131] Further, US Governments representatives must remain objective in providing options or recommendations to the partner and may not solicit requests for other

[121] SAMM Section 80102.B as referenced in Anderson, 'Foreign Military Sales Sole Source Exception', 85.
[122] Ibid. at fn. 13. [123] Anderson, 'Foreign Military Sales Sole Source Exception', 85–6.
[124] Ibid., 86, citing at fn. 17 *Univox California Inc.*, et al., B-2525449.2 et al., December 9, 1987, 87–2 CPD ¶ 569 *aff'd on reconsideration* B-2525449.5 et al., February 23, 1988, 88–1 CPD ¶ 183.
[125] Ibid., citing at fn. 18 *Kahn Industries Inc.*, 66 COMP. Gen 360, 363 (187), 87–1 CPD ¶ 343.
[126] SAMM, C.6.3.4.
[127] Ibid., C.6.3.4.1, citing USC section 2304(f)(2)(E) and DFARS 206.302(4)(c). See also Green, *International Government Contract Law*, §3:19.
[128] Ibid., C.6.3.4.3. See also Green, *International Government Contract Law*, §3:20.
[129] Ibid., C.6.3.4.3. [130] Ibid. [131] Ibid.

than full and open competition.[132] In addition, where facts indicate the possibility of a violation of ethical business practices, the agency must consult its counsel.[133] More generally, it has been emphasised that, whilst the SAMM does not have legal effect such that a contractor challenging a sole source FMS award cannot rely on SAMM as imposing requirements not imposed by CICA, the SAMM is relevant to a court's review.[134] SAMM is the standard that Agencies use to determine the propriety of sole source requests and deviation from which could indicate decisions that are arbitrary or capricious.[135]

In certain quarters, the recent removal of substantial justification for the use of sole source FMS has been welcomed. For instance, it has been identified that under the competitive FMS process, defence companies have little influence over both the negotiation of the sale between the US Government and the purchasing government and over the outcome of a competitive procurement process because their bid is evaluated against others in open competition.[136] By contrast, it has been suggested that the relaxation of sole source FMS requests should increase confidence in the ability of defence companies to engage pre-LOR consultations directly with a purchasing government to secure a sole source contract before the purchasing government formally commences a FMS by issuing a LOR.[137] As indicated in Section 3.2 pre-LOR activities are permitted to assist the purchaser to produce a complete LOR.[138] Essentially, SAMM identifies such activities as including research and analysis, briefings, responses to requests for proposals and participation in international competitions and equipment demonstrations.[139] In recent years, it is understood that limitations placed on expenditure on such activities have prevented the FMS customer from being able to effectively obtain information necessary to produce a clear LOR and have, instead, led to multiple ad hoc and informal requests for information.[140] However, it is not clear to what extent increased flexibility regarding pre-LOR activities may, in turn, increase sole source requests to the detriment of competition given that such flexibility may enable purchasing governments to more clearly

[132] Ibid. [133] Ibid. [134] Green, *International Government Contract Law*. [135] Ibid.
[136] See, for example, views expressed by LMDefence, a company providing consulting and brokering services in this area. Available at: http://lmdefense.com/update-to-foreign-military-sales-sole-source-requirements/. Last accessed 20 September 2015.
[137] Ibid. [138] SAMM, C.9.3.4. [139] Ibid.
[140] Pre-Letter of Request (LOR) Policies, DISAM Journal 4/9/2012. See also SAMM C.9.3.4.1 and C.9.3.4.2.

define and potentially tailor requirements which can only be met by select contractors.

Further, more generally, it may be questioned whether a shift away from an assessment of the discriminatory motive of a sole source request towards an assessment of whether the request is based on improper or unethical conduct detracts from the proper focus on whether the motive is to avoid competition, a principal concern under CICA and its exceptions.[141] It is observed that this is a general issue that is also currently facing EU law, namely the criteria by which to assess whether or not a purchasing government is seeking to circumvent competition when it requests the selling government to procurement on its behalf. It is questionable whether US law and policy offers a principled basis on which to make this kind of assessment notwithstanding its extensive practice and experience with regard to FMS.

Having considered just some of the legal issues arising under US law in relation to FMS, it may be questioned whether US law and policy has sustained its focus on competition in FMS in recent years notwithstanding some of the recent initiatives identified in this section. For instance, in the 1970s and 1980s, FMS were the subject of academic debate and a degree of public scrutiny no doubt as a result of institutional reform of international sales and export processes at the time.[142] Whilst not comprehensive, a report by the Comptroller General in 1978 was highly critical of DoD practices.[143] The report identified a number of reasons for the fact that 88 per cent of the FMS contracts sampled were awarded on a sole source basis.[144] One reason was simply that the DoD had specifically requested foreign countries to make sole source designations because it was easier

[141] For example, it is possible to conceive of a sole source request that is intended to avoid competition, but which may not be deemed sufficient to constitute improper conduct or an unethical practice (on whatever basis such an assessment is made). In such an instance, the request may not be subject to any or sufficient level of scrutiny.

[142] An illustrative but not exhaustive identification of the literature includes: D. P. Arnavas, 'Foreign Military Sales – A Current Look at Some Problem Areas' (1977) 9 *Public Contract Law Journal*; H. G. Sherzer, M. T. Janik, and A. B. Green, 'Foreign Military Sales: A Guide to the United States Bureaucracy' (1978–1979) 13 *Journal of International Law and Economics* 545; and A. B. Green and M. T. Janik, 'The Law and Politics of Foreign Military Sales' (1981–1982) 16 *George Washington Journal of International Law and Economics* 539.

[143] Comp. Gen. Report.

[144] Based on a survey based on 230 FMS procurement contracts and one major FMS contract. Ibid., 5.

than conducting full competitions in certain instances.[145] Other issues included: a lack of emphasis and attention on the application of procurement rules when contracts concerned FMS; foreign requisitions were assigned high priorities and urgency was used as a justification to avoid the competitive process; in some instances purchases were required to be made from the same firm that made the original equipment; delivery dates specified by foreign countries did not allow time for competitive procurements; design data that was required to competitively procure items was not purchased; and non-military commercial items were procured through FMS which could have been purchased by foreign countries in the commercial market.[146] However, the report did acknowledge that certain factors made the use of FMS more difficult and which, therefore, resulted in reduced competition.[147] These included: the short time to meet delivery requirements; the peculiarity of some weapon systems sold which were not common to US systems; the uncertainty of integrating foreign logistics systems with US logistics systems; political factors influencing foreign programmes; and funding problems encountered in financing some FMS.[148] Overall, it was suggested that this precluded more competitive awards leading to increased costs which conflicted with its role as trusted agent for the purchasing foreign country.[149] A 2013 GAO report has similarly continued to reiterate that FMS awards are generally non-competitive and which has negatively affected competition rates, in particular, in certain DoD components.[150] However, there is no real indication that US law or policy intends to intervene more systematically with regard to the operation of the procurement process and which, it is perhaps fair to state, is being subordinated to other points of focus, a perennial issue concerning export controls in the context of foreign military sales.[151]

As will be discussed in Section 3.4, there has been some debate within the EU regarding the interaction between the Defence Directive's exclusion on government-to-government contracts and US FMS. It is, therefore, suggested that there is scope for re-examining the current operation of the legal and policy framework supporting US FMS.

[145] Ibid. [146] Ibid., 8. [147] Ibid., ii. [148] Ibid. [149] Ibid., 15.

[150] Government Accountability Office, *Defense Contracting - Actions Needed to Increase Competition* GAO-13–325 (Washington, DC, March 2013), 15.

[151] See, for example, Government Accountability Office, *Defense Exports, Foreign Military Sales Program Needs Better Controls for Exported Items and Information for Oversight* (Washington, DC, May 2009).

3.4 Government-to-Government Contracts Under the Defence Directive

Whilst US law regulates government-to-government contracts in a dedicated DFARS Subpart supported by the SAMM, under EU law, the Defence Directive purports to exclude such contracts from its scope.[152] Article 13(f) provides that the Defence Directive does not apply to:

> [. . .] contracts awarded by a government to another government relating to:
>
> (i) the supply of military equipment or sensitive equipment,
> (ii) works and services directly linked to such equipment, or
> (iii) works and services specifically for military purposes, or sensitive works and sensitive services [. . .]

According to the Commission Report on transposition, all Member States have correctly transposed Article 13(f).[153] However, Article 13(f) has proven to be highly contentious.[154] In part, this is due to the argument that the 2009 Guidance Note on defence- and security-specific exclusions has attempted to significantly reduce the scope of the exclusion.[155] Further, the Commission has identified the potential for Article 13(f) to be interpreted in a way which "undermines the correct use of the Directive and which could jeopardise the level playing field in the internal market".[156] To address this issue, the Commission intended to publish additional guidance on this exclusion at the start of 2015.[157] However, as indicated in the Introduction, the guidance is now significantly delayed and remains unpublished at the time of writing.[158] This already indicates that an area of considerable importance from the perspective of transatlantic defence trade is experiencing significant legal uncertainty. Caution must be exercised when considering some of the possible interpretations examined in this Section and which are necessarily provisional in the absence of a definitive judgement by the CJEU.

[152] Recital 30 and Article 13(f) Defence Directive.
[153] Commission Report on Transposition, 6.
[154] Ippolito, 'Government to Government Contracts', 249. [155] Ibid., 251.
[156] Commission, 'Towards a more competitive and efficient defence and security sector', 6.
[157] Commission, A New Deal for European Defence, Implementation Roadmap for Communication COM (2013) 542; Commission, 'Towards a more competitive and efficient defence and security sector', 4.
[158] Commission, Report on the Implementation of the European Commission's Communication on Defence, May 2015 1, 2. See Preface, Section 5.

3.4.1 General Scope of the Exclusion

That government-to-government contracts are a systemic feature of defence procurement is, perhaps, reflected in the absence of any explicit exclusion in the Public Sector and Utilities Directives.[159] However, aside from their significance in practice, the exact rationale for bringing government-to-government contracts within the scope of coverage of the Defence Directive only to be excluded has never been made explicitly clear other than such contracts are "complex" and may not always be linked to the supply of defence equipment.[160]

Further, it has been questioned whether government-to-government contracts should even feature in the Defence Directive because a government-to-government sale is not, itself, a procurement from a private contractor.[161] Further, Article 13(f) merely refers to a contract awarded by one government to another and does not include any specific reference to the underlying procurement undertaken by the selling government. It is only the Guidance Note which indicates that the contract concluded between the selling government and contractor must be awarded in accordance with the Defence Directive, at least where the accompanying sale is between EU Member State governments.[162] However, as will be discussed in Section 3.4.3, it has been acknowledged

[159] The 2014 Public Sector Directive may, however, implicitly recognise such possibilities. See for example, Article 39 concerning joint procurement between Member State contracting authorities, in particular, Article 39(4) which provides: "[a] participating contracting authority fulfils its obligations pursuant to this Directive when it purchases works, supplies or services from a contracting authority which is responsible for the procurement procedure". The author is grateful to Mr Andreas Estrup Ippolito (attorney at Poul Schmith/Kammeradvokaten) for this observation when commenting on an earlier draft. Comments were provided in a personal capacity. Correspondence is retained on file.

[160] See Ippolito, 'Government to Government contracts', 257 to 258, citing at fn. 65 Report of October 16 2008 of the Committee on the Internal Market and Consumer Protection (A6–0415/2008).

[161] See Trybus, *Buying Defence and Security in Europe*, pp. 292–4, discussing the respective definitions of "contract" in Article 1(2) Defence Directive which, in turn, refers to Article 1(2)(a) 2004 Public Sector Directive. The Commission's original proposal did not contain any specific provisions on government-to-government contracts. However, Recital 32 confirmed that such contracts are also regarded as public contracts within the meaning of the procurement rules: "Sales of arms, munitions and war material between governments are also public contracts of a particular type that may be useful in improving interoperability." See Ippolito, 'Government to Government contracts in EU defence procurement', 256–7.

[162] Guidance Note, *Defence- and Security-specific Exclusions* 10, para. 26.

that it would be difficult, if not impossible, to require a third country government to comply with the Defence Directive.[163] This may also be implicitly recognised by the Guidance Note which does not insist on compliance with the Defence Directive when seeking to exclude the sale but does emphasise a requirement on the part of the purchasing Member State (rather than selling Member State) does not use such sales to circumvent the Directive.[164] Ultimately, it is suggested that a clearer distinction needs to be drawn with regard to the procurement contract between selling government and contractor and sale contract between selling government and purchasing government in order to enable a clearer determination of the respective rights and obligations of each contracting party.

As a matter of general scope, it should also be observed that even if the conditions for the exclusion are met, the primary EU Treaty obligations continue to apply unless it is possible to rely on a Treaty derogation.

3.4.1.1 Material Scope It appears to be relatively uncontroversial that Article 13(f) Defence Directive *prima facie* excludes the sale of old or surplus equipment. However, it has been questioned whether the exclusion also applies to new material. It has been suggested that, at the beginning of the legislative process, the exclusion was intended for surplus equipment.[165] More recently, it has been argued that there is no support for this proposition in the wording of Article 13(f) itself, in the definitions of 'military equipment' and 'sensitive equipment' corresponding to Article 2 defining the material scope of the Defence Directive, in the Recitals or in the preparatory documents.[166] Further, whilst expressing some caution, the Guidance Note states that the exclusion also applies, "in principle", to purchases of new material.[167] Finally, it has been argued that, by requiring that the procurement of new material must be conducted in accordance with the Defence Directive, the objective to establish a European defence market through opening contracts to competition is

[163] Trybus, *Buying Defence and Security in Europe*, p. 297; and Ippolito, 'Government to Government Contracts', 263.
[164] Guidance Note, *Defence- and Security-specific Exclusions*.
[165] Trybus, *Buying Defence and Security in Europe*, p. 298 citing at fn. 244 Schmitt and Spiegel, "The Specificities of the European Defence and Security Procurement Directive", "European Defence Procurement and Other Defence Market Initiatives" seminar at the European Institute of Public Administration, Maastricht 15 November 2010.
[166] Ippolito, 'Government to Government Contracts', 257–8 and 263.
[167] Guidance Note, *Defence- and Security-specific Exclusions*.

achieved; government-to-government sales on the "secondary equipment market" does not hamper this objective.[168]

A factor which appears to be treated as integrally linked to the question of whether the exclusion also applies to new material concerns what has been identified as a "danger of abuse" when the selling government procures from the private sector with the intention of selling to another government.[169] Precisely what is the danger has not been clearly articulated and which is linked to a more fundamental uncertainty as to what may constitute a circumvention of the Defence Directive. As indicated in Section 2.1, the selling government may seek to use a government-to-government sale as an opportunity to also obtain the same items for its own purposes and conduct a sole source procurement either on its own initiative or at the purchasing government's request. Similarly, the purchasing government may seek to avoid conducting its own competitive procurement process. Curiously, it is only in reference to purchases of new material that the Guidance Note identifies a requirement on the part of the selling Member State to procure the material according to the Defence Directive. It has been argued that the fact that Guidance Note enters this qualification in relation to new material does not change the fact that the sale of the new material is covered by the exclusion.[170] However, an issue that has arguably been overlooked in current debate is a similar possibility (albeit a lesser risk) for purchases of surplus equipment to be subject to abuse.

3.4.1.2 Personal Scope "Government" is defined in Article 1(9) Defence Directive as meaning "the State, regional or local government of a Member State or third country". According to the Guidance Note, contracts must be concluded by, or on behalf of, a Member State or a third country.[171] In this regard, Article 13(f) Defence Directive has been identified as one means by which Member States may conduct joint procedures in pursuit of NATO's recent "Smart Defence" programme, a component of which is to explore the potential for increasing pooling and sharing of military capabilities within NATO.[172] According to this model, one

[168] Ippolito, 'Government to Government Contracts', 263, citing at fn. 102 Recitals 2 and 4 to the Defence Directive.
[169] Trybus, *Buying Defence and Security in Europe*, p. 294.
[170] Ippolito, 'Government to Government Contracts', 262.
[171] Guidance Note, *Defence- and Security-Specific Exclusions*, 10 para. 25.
[172] Ippolito, 'Government to Government Contracts', 250.

government purchases equipment on behalf of all the participating governments in accordance with the Defence Directive and subsequently resells the equipment to the other governments on an ad hoc or more regular basis comparable to a central purchasing arrangement.[173] This approach is said to avoid the legal and practical difficulties of a joint procurement procedure in which all participating governments act as contracting authorities, namely reaching consensus on devolvement of responsibility and enforcement of jurisdiction between Member States.[174] For this reason, it has been argued that a high degree of flexibility is required to enable a broad and unconditional interpretation of Article 13(f).[175] However, given the relatively low uptake of central purchasing arrangements under the Public Sector Directive, it is questionable to what extent Member States are likely to use Article 13(f) for this purpose.

3.4.2 Provision on Procurement Underlying the Sale

As indicated, Article 13(f) contains no reference to the underlying procurement process in a government-to-government sale and the Guidance Note simply refers to the need for the procurement to comply with the Defence Directive. Therefore, it appears that the Defence Directive's governing assumption is that its contract award procedures are suitable for application to the modalities of government-to-government contracting in this context. In this regard, the Guidance Note identifies certain ways in which it may be possible to comply with the Defence Directive. For instance, procuring Member States may use framework agreements or options in existing supply contracts awarded under the rules of the Defence Directive.[176] However, it is submitted that the Guidance Note's suggestions simply confirm the need for debate on whether or not the Defence Directive's provisions are suitable for application in this context, an issue which has not yet been considered. For instance, aside from offering very limited options by way of illustration, the Guidance has not provided a justification as to why framework agreements and options are credible options for ensuring that the Defence Directive's objectives are not circumvented. Framework agreements and options are often identified as archetypal examples of practices that are susceptible to abuse in limiting competition.

Even if there could be relatively certainty as to the conduct of a government-to-government contract in accordance with the Defence Directive, as indicated in Section 3.2 a host of other legal issues have arisen

[173] Ibid., 250–1. [174] Ibid. [175] Ibid. [176] Ibid.

under US law which have not been considered from the perspective of the exclusion under Article 13(f). For example, the Defence Directive is silent on issues such as the extent of permitted participation, if any, of purchasing governments in negotiations between the selling government and contractor. It is understood that, in joint procedures at least, participating Member States may agree in advance how the procedure should be conducted, for example, through signature of a MoU.[177] However, in the context of foreign military sales, there is always likely to be a need for participation, or risk of intervention, by the purchasing government irrespective of what is agreed at the outset. There may also be good reasons for or against enabling a degree of participation in light of its potential impact on a competitive procurement outcome and which may need to be monitored or controlled as is the case under US law. Another issue concerns whether, and the extent to which, a purchasing government may conduct preliminary discussions with a prospective contractor in the Member State of the selling government and which may result in a purchasing government's request for the selling government to make a sole source award to that contractor. In addition, drawing on the USA's experience, it is not clear how difficult it may be for either the selling or purchasing Member State to justify procurement undertaken on a sole source basis. Therefore, there is scope for further debate on whether the Defence Directive and Guidance Note adequately deal with the underlying procurement aspect of an excluded government-to-government sale. It is hoped that the revised Guidance Notes will bring a further degree of clarity.

3.4.3 Third Country–EU Government Sales and Procurement from Third Countries

Section 3.4.1.1 highlighted a risk of abuse where an EU government purchases new equipment from another EU government and, thus, a need for any underlying procurement to be conducted in accordance with the Defence Directive. However, this raises the question as to the position where an EU government purchases equipment from a third country government. A common sense interpretation suggests that a third country government cannot be compelled to conduct a procurement procedure in accordance with the Defence Directive given that the Defence Directive

[177] The author is grateful to Mr Andreas Estrup Ippolito (attorney at Poul Schmith/Kammeradvokaten) for this observation when commenting on an earlier draft. Comments were provided in a personal capacity. Correspondence is retained on file.

is only addressed to EU Member States. To this extent, the US, could not, for example, be required to comply with the Defence Directive.

Nevertheless, it has been suggested that sales under the US FMS program are likely to be of particular interest to the Commission from the perspective of internal market policy.[178] For instance, it has been observed that:

> Notwithstanding the fact that US contractors are the only possible suppliers of certain types of military equipment, it is obviously not conducive for the establishment of a European defence market that direct awards are made by Member States to third country suppliers. However, policy is one thing, law is another, and the reality of the market, with its constraints on the purchaser, is still another.[179]

Concerning the policy position, it has been observed that the Commission's position in relation to third countries may be justified to some extent by the Defence Directive's general objective to submit government defence contracts to competition and improve the EU defence market. It has further been observed that:

> It has been the prevailing position in legal theory that art. 13(f) has clarified that FMS purchases fall outside the scope of the EU public procurement directives. Nevertheless, the conflict of interests between the US FMS programme and the continued development of the European defence market remains: when EU Member States opt for FMS acquisitions on a larger scale it undeniably improves the balance of payments of the US, retains jobs in the US defence industry, and lowers the prices of US goods and services through the economies of scale – in theory at least – all at the expense of the European industry's competitiveness.[180]

This policy rationale appears to correspond to statements in the Guidance Note. The Guidance reiterates a more general obligation on the purchasing EU Government to ensure that if it purchases new military equipment from a third country, it must do so with due regard to its obligation under Article 11 not to use such contracts for the purpose of circumventing the provisions of the Directive.[181] Again, the Guidance does not provide any significant indication as to how Member States may otherwise be said to use such contracts to circumvent the Directive. The only indication is

[178] Ippolito, 'Government to Government Contracts', 263. [179] Ibid.

[180] Ibid., 250, citing at fn. 9 B. Heuninckx, 'Lurking at the boundaries: applicability of EU law to defence and security procurement' (2010) 19 *Public Procurement Law Review* 91 for the statement that this interpretation reflects the prevailing position in legal theory.

[181] Guidance Note, *Defence- and Security-Specific Exclusions*, 10, para. 2.6.

that this consideration is particularly relevant in situations where market conditions are such that competition within the internal market would be possible.[182] In its enforcement role, the Commission has indicated that circumvention would occur where competition with "participation of EU suppliers" would be possible.[183] This reference is unclear. This may indicate that a purchasing EU government cannot award contracts to third country governments (even if the third country uses an openly competitive procurement process) where EU competition is possible. As will be discussed below, an assessment of whether competition within the internal market is possible is likely to be problematic.

Concerning the legal position, as indicated above, there appears to be an increasing academic consensus that US FMS of old or surplus equipment may be excluded under Article 13(f). It has also been observed that Article 13(f) could also allow open intergovernmental arrangements allowing states to procure from each other or exchange military equipment, for example, through the NATO Logistic Stock Exchange.[184] However, there is no academic consensus on whether US FMS of new equipment may fall under Article 13(f). The argument against, broadly stated, has proceeded on the basis that it would require a very wide interpretation of Article 13(f) and considerable compromising of the Defence Directive's competition and free movement objectives to permit a direct purchase from the USA through a government-to-government contract when the product or service could be procured in the EU when there is competition in the internal market.[185] On this interpretation, it is only possible to rely on Article 13(f) where there is no alternative to the third country equipment in the EU in that there is no competition for that equipment in the EU.[186] This interpretation would seem to preclude recourse to Article 13(f) where one or more EU contractors can provide an alternative to a third country offer such that it can be said that competition is possible but a third country offer is a more competitive alternative. However, it has been acknowledged that the Guidance is not particularly clear and

[182] Ibid.

[183] See Separate letters of May 15 2012 to the Defence Ministries of Romania, the Czech Republic and Bulgaria.

[184] Heuninckx, 'Lurking at the Boundaries', 111.

[185] Trybus, *Buying Defence and Security in Europe*, pp. 296–7, referring to the Guidance Note requiring a "primacy of the internal market, in other words, procurement on the basis of the Defence Directive", over the government-to-government purchase from a third country.

[186] Ibid., p. 297.

requires clarification in its reference to "situations where market conditions are such that competition within the Internal Market would be possible".[187]

Conversely, it has been argued that emphasis should rather be placed on the status of the contract as opposed to any unstated test of whether competition within the internal market is possible.[188] For instance, it has been acknowledged that, whilst it could be argued that the US government is merely a "middleman" for a contact concluded between the purchasing government and US contractor, as indicated in Section 3.2, the purchasing government only concludes a contract with the US Government.[189] On this basis, the LOA comprising the FMS contract is clearly a government-to-government contract within the meaning of the Defence Directive. Therefore, the contract is discrete from any procurement process which is not mentioned in the Defence Directive and which must be excluded irrespective of whether competition within the internal market is possible. Further, it has been argued that there is, in fact, no support for the Commission's position either in the preparatory works or as a matter of teleological interpretation taking into account the aims of the Directive.[190]

In addition, any assessment of whether internal market competition is possible is problematic. Fundamentally, there has been no focus on whether the requirement for such an assessment is justified in principle. As a general and somewhat absolutist proposition, it is not clear why an award of a contract to a third country government would constitute a circumvention of the Defence Directive and EU law more generally simply because competition is otherwise possible within the EU. It has been argued that the Commission is seeking to import the kind of "no competition" possible requirement that is otherwise required for invocation of the technical reasons or exclusive rights grounds for use of the negotiated procedure without publication to enable a direct award without a competitive procedure.[191] It has been suggested that if such an exacting standard were intended, it seems likely that the EU legislature would have

[187] Trybus, *Buying Defence and Security in Europe*, p. 297.
[188] Ippolito, 'Government to Government Contracts', 253.
[189] Ibid., citing fn. 34 and 264 and fn. 106 in reference to the US Court of Appeals for the 4th Circuit, Decision of May 10, 2007 in *Secretary of State for Defence as represented by the United Kingdom Ministry of Defence, Defence Procurement Agency* v. *Trimble Navigation Limited.*
[190] Ibid., 264.
[191] Ippolito, 'Government to Government Contracts', 264. This ground is discussed in more detail in Chapter 5, Section 4.2.3.

included it in the wording.[192] In addition, the Commission has not identified any criteria by which Member States or contracting authorities would be able to make such an assessment of hypothetical or actual competition in practice.

This discussion arguably further reinforces a fundamental uncertainty which has predominated throughout Part I of the book. As a matter of EU law, it is unclear what, and how, measures taken by Member States in relation to third countries can be said to affect the internal market in such a way as to require compliance with EU law or which might otherwise be deemed to be incompatible with EU law. Inevitably, a Member State may engage in any number of transactions with third countries many of which will directly or indirectly impact competition within the EU internal market. However, it does not necessarily follow that all such measures could or should be deemed to be incompatible with EU law.

In light of the above, it is at least arguable that US FMS of new equipment are *prima facie* excluded irrespective of whether or not competition is possible within the internal market. However, it has been observed that this argument still recognises that Member States do not have an "unlimited margin of discretion".[193] It has been suggested that the application of the proportionality principle arguably means that a Member State cannot choose to procure new defence equipment through US FMS merely to avoid using a procurement procedure pursuant to the procedural rules of the Defence Directive.[194] However, this does not resolve the fundamental issue of how to determine the basis for, and circumstances, requiring compliance with the Defence Directive.

Concerning the reality of the market, the inference appears to be that many Member States will continue to rely on US FMS, even where competition within the EU is possible and notwithstanding any legal argument as to the compatibility of any government-to-government contract with EU law. Ultimately, this exposes the broader question of whether or not Article 13(f) and the Commission's Guidance will be sufficient to prevent widespread recourse to third country sales. At present, it is difficult to avoid the conclusion that the terms of Article 13(f) alone and the Commission's Guidance are unlikely to dramatically affect the continuation of US FMS. It should also be observed that the Commission has not (yet) outlined any particular enforcement strategy in relation to government-to-government sales.

[192] Ibid. [193] Ibid. [194] Ibid.

More generally, caution must be exercised against assumptions that Member States will systematically abuse Article 13(f) to request more US FMS. As indicated in Sections 3.2 and 3.3, whilst US FMS has certain advantages, it also has certain disadvantages. Further, US FMS may require Member States to agree to terms and conditions of purchase that they are not otherwise subject to when choosing to procure an item directly from a US contractor under a DCS.[195] In addition, it may be necessary rather than desirable in certain cases to have recourse to US FMS, for example, because there is no or no reasonable alternative within the EU, because an item is not available or because urgent operational requirements or interoperability requires it.[196] Moreover, it is further recalled that it is by no means easy for a Member State to seek redress in US courts in an FMS case given that the Member State is not party to the procurement. Therefore, far from constituting a convenient means by which to circumvent the Defence Directive, recourse is likely to be taken on the basis of genuine practical need rather than convenience with intent to avoid competition. In the absence of research and evidence exploring the motivations for FMS choices by US contracting partners, it is difficult to discern to what extent convenience may override need.

3.4.4 EU–Third Country Government Sales

The preceding sections have considered government sales between Member States and sales from third country governments to Member States. Another conceivable scenario is one in which an EU government conducts a procurement for the purposes of a sale to a third country government. It has been remarked that the omission of this scenario from the Guidance Note is surprising given that exports to third countries are a common practice.[197] In light of the above discussion, it may be argued by analogy to government-to-government contracts between Member States that the Member State must comply with the Defence Directive's procedures when purchasing new equipment.[198] However, it has also been observed that the case could be made that because such purchases are intended for export, they are outside the internal market and the scope of the Defence Directive.[199] Since this is unclear, it has been suggested that it might be

[195] The author is grateful to Mr Andreas Estrup Ippolito (attorney at Poul Schmith/Kammeradvokaten) for this observation when commenting on an earlier draft. Comments were provided in a personal capacity. Correspondence is retained on file.
[196] Ibid. [197] Trybus, *Buying Defence and Security in Europe*, p. 297.
[198] Ibid. [199] Ibid., p. 298.

advisable for the selling EU government to publish a voluntary *ex ante* transparency notice in the OJEU and identify that this is an Article 13(f) case in order to limit the potential risk that the contract will be deemed ineffective.[200]

However, again, it is suggested that this further reinforces uncertainty on the issue of what, and how, measures taken by a Member State in relation to third countries can be said to affect the internal market in such a way as to require compliance with EU law or which might otherwise be deemed to be incompatible with EU law. For instance, whilst it may be argued that the purchase is intended for a destination outside the internal market, a direct award to a domestic contractor in the Member State may put its domestic industry at a comparative advantage where such a contract could have been opened to EU-wide competition. Further, even if the contract is *prima facie* excluded, a Member State must comply with its broader obligations under the EU Treaties unless a derogation can be invoked.

3.4.5 Award of US Foreign Military Sales Without Recourse to the Exclusion

The preceding sections have considered certain potential scenarios in which Member States may seek to exclude government-to-government contracts under Article 13(f). However, it has been observed that the exclusion is not necessarily mandatory. It has been argued that if an EU Member State chooses to undertake a procurement procedure using one of the available procedures under the Defence Directive, another state could become a candidate or tenderer for a contract to be awarded in line with the provisions of the Defence Directive using that procedure.[201] To illustrate, assuming the USA would compete in a procurement procedure conducted by an EU Member State, it is theoretically possible that if the USA were to be awarded the contract, the resulting contract would be an FMS LOA. Of course, this is contingent on the USA not objecting to a US FMS offering being put in competition with other providers.

In light of this possibility, it has been suggested that the USA fears that, when EU Member States intend to award contracts in line with the

[200] Ibid. On this option generally, see Chapter 3, Section 2.3.

[201] Heuninckx, 'Lurking at the Boundaries', 111, citing at fn.141 a private communication from I Maelcamp d'Opstaele, United States Mission to the European Union, 17 November 2009. The author is grateful to Dr Baudouin Heuninckx for further amplifying his statements in the article in private correspondence given in a personal capacity. Correspondence is retained on file.

provisions of the Defence Directive, Member States could reject offers made by the USA through its FMS on the basis that it is not European, thereby creating some form of "fortress Europe".[202] However, as indicated in Chapter 4, the Defence Directive simply permits Member States to determine whether or not third country contractors may participate in contract award procedures conducted in accordance with the Defence Directive.[203] The operating assumption is that, on admission of the third country participant, the Defence Directive's provisions apply equally to EU and third country contractors. In any event, in practice, the US is unlikely to be willing to go through the process of formal selection and tender evaluation.

However, again, this possibility raises the issue of whether the Defence Directive is suitably adapted for government-to-government contracting practices. It is not clear that the possibility of a third country government tendering for a defence contract was within the express contemplation of the drafters of the Defence Directive given that Recital 18 only refers to "economic operators from third countries". Further, it has been questioned from the perspective of EU law whether such a possibility could raise issues of state aid not least given that private companies would be competing with a state, or with an entity that is affiliated with a state.[204] More generally, as indicated in Section 3.2, it has been observed in the USA that such procurement processes may not necessarily be well adapted to government-to-government offers. In light of just some of the issues raised in this section, it is submitted that there is a need for a more engaged comparative discourse on the legal and policy aspects of foreign military sales in the US and EU in light of the conceivable interaction between these regimes.

4 Offsets Under US and EU Law

As indicated in Section 2.2, whilst government-to-government contracts are a systemic feature of defence procurement practice, offsets are often characterised as an endemic feature. Generally, it has been observed that although international trade in defence offsets generates billions of dollars in revenue, it is remarkable how lightly offset trade is regulated.[205]

[202] Ibid. [203] Section 2.1, referring, in particular, to Recital 18 Defence Directive.
[204] Heuninckx, 'Lurking at the Boundaries', 111.
[205] Lt Col. R. J. Lambrecht, 'The Big Payback: How Corruption Taints Offset Agreements in International Defense Trade' 70 (2013) *Air Force Law Review* 73, 89.

The GPA expressly prohibits offsets on the basis of their potential to discriminate against foreign suppliers. Article XVI (1) GPA provides that:

> Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets.[206]

However, it has been argued that offsets could otherwise be justified pursuant to the essential security interests derogation contained in Article XXIII(1) identified in Chapter 2.[207] It has been suggested that this provision has led to a de facto categorical exemption of armaments from the GPA and its prohibition of offsets.[208] To date, there have only been limited challenges relating to offsets under the WTO.[209] Consequently, it has been observed that the absence of substantial WTO regulation has left states with a "free hand" with the EU attempting to restrict offsets and the US leaving offsets largely unregulated.[210]

4.1 Offsets Under US Law on Foreign Acquisition

As a primary offset provider, it is perhaps unsurprising that the USA does not regulate in any detail offsets which foreign contractors may provide to the USA. However, as will also be discussed, US law and policy on offset provision has also been limited.

4.1.1 Offsets Connected with Foreign Military Sales

It is often overlooked in academic and policy discussions that, historically, US law not only mandated the use of offset agreements as part of its FMS programme but also receipt of offsets. For example, an offset was classified not only as a compensation to be provided by a FMS contractor to a purchasing government, but also as an agreement in which

[206] This is subject to a limited exception in Article XVI(2) GPA permitting the use of offsets for developing countries.

[207] Section 3.1. US observers have also raised the question of whether indirect offsets should be required to qualify under this exception. See Nackman, 'A Critical Examination of Offsets', 518, fn. 44 and citations therein.

[208] *Study on the Effects of Offsets*, 24.

[209] See WT/DS163/1, Document (99–0676), 22 February 1999; WT/DS163/7 Document (004–4679, 6 November 2000 cited in C. H. Bovis, 'Public–Private Partnerships in the Defence Sector: How Offset Agreements Interface between the Private and Public Stakeholders' (2008) 4 *European Public Private Partnership Law Review* 200, 205–206 and fns 23 and 24.

[210] Lambrecht, 'The Big Payback'.

the purchasing government was permitted to bid on DoD procurements up to a certain percentage of the FMS contract value in return.[211] Offset agreements would be negotiated before the foreign government accepted the LOA and the DoD would subsequently obtain waivers of the BAA and other laws identified as impeding foreign competition.[212] As discussed in Chapter 9, these laws were waived for countries that had concluded an RDP.[213] However, by the late 1970s, the DoD preferred to avoid entering into offset agreements.[214] Reasons included the fact that foreign governments found it difficult to compete for US business to achieve offset targets.[215] Further, offset agreements were said to suffer inherent legal difficulties and significant administrative effort given that waivers of the BAA and other domestic preference rules had to be obtained by the DoD.[216] It was also identified that foreign governments were extremely hostile to DoD contracts on which they could bid because of DoD requirements placed on foreign sources to comply with various procurement rules.[217] Today, perhaps the closest practice to offset receipt in the USA is its scheme of domestic preference legislation discussed in Chapter 9. Beyond the application of such legislation, the USA also inevitably imposes broad requirements on foreign contractors to undertake production in the USA or to subcontract to US companies. Given that the US law and policy has not focused extensively on offset receipt within the USA, there is relatively limited insight into, or oversight of, such requirements. It is, therefore, questionable whether the USA is ever likely to adopt a regulatory strategy that deals expressly not only with offset provision but also offset receipt within the USA.

Concerning offset provision, it has been identified that the DoD adopts a "hands-off" approach to offsets.[218] From a policy perspective, official policy states that the government considers offsets to be "economically inefficient and trade distorting".[219] From a legal perspective, US law prohibits any US agency from encouraging, entering directly into, or

[211] Sherzer et al., 'Foreign Military Sales', 576 at fn.152, citing DAR §6–1310.1.
[212] Ibid., 577 citing at fn. 159 MASM C12–13.
[213] Ibid., fn. 160. For a discussion of the Buy American Act, see Chapter 9, Section 2.1 and 2.1.1.
[214] Ibid., 577. [215] Ibid. [216] Ibid. [217] Ibid.
[218] GAO, Defense Trade, Issues Concerning the Use of Offsets in International Defense Sales, Statement of Katherine V. Schinasi, Managing Director, Acquisition and Sourcing Management, Testimony before the Committee on Armed Services, House of Representatives, July 8 2004 1, 2.
[219] Presidential Policy on Offsets in Military Exports, Statement by President Bush's Press Secretary, 16 April 1990.

committing US firms to any offset arrangement in connection with the sale of defence articles or services to foreign governments.[220] This position is formalised in DFARS which provides that the US Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs when a US defence contractor seeks to recover its costs incurred for offset agreements under a FMS LOA financed by, or on credit for, the foreign government.[221] Further, the US Government does not otherwise formally involve itself in negotiating the offset agreement itself between the US contractor and the FMS customer and plays no formal role in judging the merits of these agreements.[222] However, as indicated in Section 2.3, for a host of primarily economic reasons, the USA continues to tolerate offsets notwithstanding such that US firms may undertake responsibility themselves to commit to, negotiate and execute offset agreement in connection with FMS.[223] In addition, the LOA and resulting FMS contract between the US Government and the FMS customer do not include any of the terms of any associated offset agreement.[224]

However, offset costs provided by industry should be included as part of the unit cost and in estimated prices quoted in the LOA and which the contractor must disclose.[225] Whilst increasing the LOA sale price, these costs are often included in order for the vendor to recover those offset costs in performance.[226] Consequently, the US contractor bills the US Government for the defence item under the FMS and the offset and the US Government then recovers such costs from the purchasing government.[227] The SAMM indicates that it is inappropriate for US Government personnel to discuss with the purchaser the nature or details of an offset agreement other than to confirm the fact that offset costs have been included in the LOA price estimate in the event that the purchasing government enquires and that beyond such confirmation any discussion of offset costs must be avoided.[228] It has been observed that "while not perfect", this does provide some deterrent to placing illegal charges within an LOA.[229] The

[220] Defense Production Act Amendments of 1992 Pub L 102–558, Title I, Part C, §123. Also implemented in DFARS 225.7306.

[221] DFARS 225.7303–2(a)(3)(i) and (ii). [222] Ibid. [223] Ibid.

[224] DFARS 225.7301(a). [225] SSAM, C.6.3.9.1. and C.6.3.9.2.

[226] Lambrecht, 'The Big Payback', 94, referring to the US Government as the "banker" for offset transactions. See also SAMM, C6.3.9.1 and C.3.9.2.

[227] Ibid. [228] Ibid., C.6.3.9.3.

[229] Lambrecht, 'The Big Payback', 94 and citations at 185 and 186, noting, in particular, A J Perfilo, Foreign Military Sales Handbook §5:27 that a contracting officer may not have much visibility over offset costs in a competed FMS contract.

offset cost recovery process has been described as "awkward" not least because, whilst it may appear that the customer is receiving the offset at no cost, the offset cost will result in a higher LOA price for the main FMS contract to be paid by the FMS customer.[230]

It has been commented that the detachment of the US Government from the offset agreement between the purchasing government and the US contractor is an "odd arrangement" given that the US Government does not retain any obligation to enforce a contractor's performance of the offset agreement.[231] However, it is arguable that is not necessary for the US Government to enforce or safeguard performance because a failure by a contractor to perform its offset obligations will ultimately be determined by the market in that non-performance will adversely affect the contractor's market position.[232] Rather, a more significant issue is the logically prior one that US contractors typically rely heavily on US government cooperation when seeking to provide offsets but the US Government does not provide any formal means of assistance to US contractors in doing so.[233] Therefore, it is the dissonance between formal detachment in theory and heavy reliance on the US Government to facilitate cooperation with a purchasing government in practice that continues to be a pressing policy issue that the US has not addressed.

Overall, it has been observed that the USA restricts offsets through its rules for FMS and that these restrictions are "indirect", "broad and unsophisticated".[234] However, it has equally been acknowledged that the FMS rules place at least some restraint on offset subcontracting and accounting practices.[235] As will be discussed in Chapter 11, it remains to be seen whether the USA will seek to adapt its policy and regulatory strategy in relation to offsets in the medium to long term.[236] By contrast, as will be discussed in Section 4.2.3, the government-to-government contract exclusion under Article 13(f) Defence Directive is silent on the issue of any offsets accompanying a government-to-government contract. Because the prevailing view is that EU law cannot allow, prohibit or regulate offsets,

[230] SAMM, 9–20. [231] Ibid.

[232] The author is grateful to Major Daniel Schoeni (US Air Force JAG Corps) for this observation reviewing an earlier version of this chapter. The views expressed are personal and do not reflect an official position of the Air Force or any other federal agency. Correspondence is retained on file.

[233] Again, the author is grateful to Major Daniel Schoeni for this observation provided in a personal capacity.

[234] Lambrecht, 'The Big Payback', 92 and 93. [235] Ibid. [236] Section 3.3.

EU law does not deal in any explicit way with a contracting authority or Member State's broader role in the negotiation of offset agreements.

4.1.2 Statutory Obligations to Report Offsets

Whilst US law does not expressly regulate offsets, US law nevertheless imposes statutory offset reporting obligations. In 1984, Congress amended the Defense Production Act 1950 ("DPA") to require the US President to submit an annual report to Congress on the impact of offsets on the US defence industrial base.[237] In 1992, Congress amended the DPA and directed that the Secretary of Commerce function as the President's Executive Agent.[238] The DPA authorises the Secretary of Commerce to develop and administer the regulations necessary to collect offset data from US firms.[239] The Secretary of Commerce has delegated this authority to the BIS which published its first offset reporting regulation in 1994.[240] The BIS report is prepared by the Interagency Working Group established by Congress to consult with foreign nations on limiting the adverse effects of offsets in defence procurement.[241] The findings of recent BIS reports have been discussed in Section 2.3 and the extent and impact of the Interagency Working Group's consultations will be discussed in Chapter 11.[242]

Although this statutory requirement is an important means to improve offset transparency, not all offsets continue to be reported. Further, methods of offset reporting continue to be criticised.[243] In 2014, BIS published a notice in the *Federal Register* reminding US firms to report annually on contracts with foreign governments or firms concerning the sale of articles or defence services subject to offset commitments for which a foreign

[237] See Defense Production Act Amendments of 1984 Pub L 98–265 (1984) 98 Stat 149.

[238] See Defense Production Amendments Act of 1992 Pub L 102–558, Oct. 28, 1992, 106 Stat 4198. See also Part IV of Exec. Order No. 12919, 59 Fed. Reg. 29525 (June 3, 1994).

[239] Ibid., Section 723.

[240] See 59 Fed. Reg. 61796, December 2, 1994, codified at 15 CFR §701. BIS amended its offset regulation in 2009. See 74 Fed. Reg. 68136, December 23, 2009, codified at 15 CFR §701. For a useful historical discussion of US initiatives in offset reporting, see Nackman, 'A Critical Examination of Offsets', 524.

[241] See Defense Production Act Reauthorization of 2003 Pub L 108–95, Dec. 19, 2003, 117, Stat 2892, which required the US President to establish an interagency team to consult with foreign nations on limiting the adverse effects of offsets in defence procurement without damaging the economy or US defence industrial base, or its defence production or defence preparedness. The statute provided that the interagency team be comprised of the Secretaries of Commerce, Defense, Labor and State, and the United States Trade Representative.

[242] Section 3.3. [243] Nackman, 'A Critical Examination of Offsets', 525–6.

representative has claimed offset credit of $250,000 or more.[244] However, US experience indicates that there are, at least, certain legal mechanisms available for improving transparency and accountability on offset costing.

By contrast, the EU procurement Directives contain no such reporting requirements. One reason may be due to the fact legal requirements to this effect could undermine the EU's official position that offsets are *prima facie* prohibited by EU law. Further, given that there has been hardly any serious legal debate within the EU on whether Article 346 TFEU invocations should be subject to a notification and detailed reporting requirements, it is unlikely that offsets which could potentially be justified under Article 346 TFEU, are likely to be subject to similar requirements.[245] Another reason may be that there are few reporting requirements under the Defence Directive generally except for the purposes of monitoring transposition and review of the Directives. US legal experience further questions whether the EU should introduce centralised and more detailed reporting requirements on such issues with a clearer enforcement strategy for ensuring compliance. Such possibilities ought to be considered even if Member States may try to argue that essential security reasons preclude reporting in certain cases.

4.2 Offsets Under EU Law

The EU Treaties do not expressly authorise or prohibit offsets. Further, the 2004 Public Sector Directive, 2014 Public Sector Directive and Defence Directive do not contain any express provisions on offsets. In addition, there is no definitive CJEU judgement on offsets. Notwithstanding, the legality of offsets appears to be of such great concern that the Commission has taken the unprecedented step of issuing a Guidance Note on offsets notwithstanding that the Defence Directive contains no offset provisions. The Guidance serves two principal functions. Firstly, it emphasises the legal argument that offsets are *prima facie* incompatible with the EU Treaties and which provides the justification as to why the Directive "cannot allow, tolerate or regulate them".[246] The Guidance confirms that, for

[244] See 79 Fed. Reg. 18, 886 (April 4, 2014). According to BIS *Offsets in Defense Trade*, Nineteenth Study, 2, twenty-one firms reported offset agreement and transaction data to BIS for 2013.

[245] For a discussion of the possibility of justifying certain offsets under Article 346 TFEU, see Section 2.4.

[246] Guidance Note, *Offsets* 1, para. 2. Indeed, it has been suggested that perhaps neither the TFEU nor the Defence Directives mention offsets because it is so obvious that they make

some time, it has been argued that offsets represent clear violations of the core free movement regimes relating to goods, services and establishment as well as the general prohibition of discrimination on grounds of nationality discussed in Chapter 2.[247] The Guidance Note also identifies certain provisions of the Defence Directive that would preclude the use of offset requirements as part of a contract award procedure.[248] Secondly, the Guidance Note states that security-related justifications for offsets and offers are accommodated within the Defence Directive's security of supply and subcontracting provisions which are, therefore, considered to be "non-discriminatory alternatives" to offsets that will drive competition into the supply chain of successful tenderers.[249] Offsets may often take the form of subcontracting requiring the foreign prime contractor to award contracts to domestic contractors to ensure sufficient domestic industrial participation. To this extent, the Defence Directive's subcontracting provisions aim to open up supply chains to competition and improve the visibility of subcontracting decisions thereby attempting to facilitate EU-wide industrial participation by other means.[250] It is ultimately beyond the scope of this book to examine whether those provisions constitute an effective alternative to, or even substitute for, offsets, although it is certainly questionable whether such provisions are likely to have any significant impact on offsets in practice.

Therefore, according to the Guidance Note, the combined effect of the EU Treaties and the Defence Directive is that contracting authorities may

an open, transparent and competitive procurement procedure without discrimination very difficult or entirely impossible. See M. Trybus, 'The Tailor-made EU Defence and Security Procurement Directive: Limitation, Flexibility, Descriptiveness, and Substitution' (2013) 38(1) *European Law Review* 3, 26. See also B. Heuninckx, 'The EU Defence and Security Procurement Directive: Trick or Treat?' (2011) 20 *Public Procurement Law Review* 9, 25 who states: "an EU legal instrument cannot possibly regulate a practice that is by definition in breach of EU law". See also more recently, Commission, 'Towards a more competitive and efficient defence and security sector', 6: "[o]ffset requirements are discriminatory measures which stand in contrast to both EU Treaty principles and effective procurement methods. They can therefore not be part of the internal market for defence."

[247] These include Articles 18, 34, 35 and 56–62 TFEU. See Guidance Note, *Offsets*, 2, paras. 5–8 and Chapter 2, Section 2.

[248] These include Articles 4, 20, 38 to 42 and Article 47 Defence Directive. See Guidance Note, *Offsets*, 2, paras. 9–17.

[249] Ibid.

[250] For a brief outline of the Defence Directive's subcontracting provisions, see Chapter 7, Section 5.2.2.

not "require or induce by whatever means" tenderers to commit themselves to: purchase goods or services from contractors located in a specific Member State; award sub-contracts to contractors located in a specific Member State; make investments in a specific Member State; or generate value on the territory of a specific Member State.[251] Further, contracting authorities may not require tenderers to mobilise other undertakings to make such purchases, subcontracting or investments whether related to those undertakings or not.[252]

The Guidance Note nevertheless acknowledges that it may be possible to justify certain forms of offset if Article 346 TFEU can be validly invoked.[253] However, a justified derogation exempting the main procurement contract from compliance with the Defence Directive and EU Treaties does not also legitimate the accompanying offset.[254] Therefore, any offset must be justified on its own terms separately. In terms of the justification posited, the Guidance Note states that economic or employment related interests are not accepted given that the measure must be necessary for security interests.[255] Hence, a Member State cannot plead that it is necessary to secure an economic return on an investment made abroad.[256] Reflecting language in the GPA exception, the Guidance Note states that a Member State must be able to prove that the specific requirement is "indispensable" to protect its essential security interest.[257] Notwithstanding, it has been observed that whilst offsets are difficult to justify under Article 346 TFEU because they normally meet economic as opposed to security considerations, economic considerations will not always be at the centre of an offset agreement.[258]

[251] Guidance Note, *Offsets*, 5, para. 19. [252] Ibid.

[253] The Guidance Note, *Offsets*, 6, para. 21 observes that where a Member State intends to rely on Article 346 TFEU to require offset and related compensation practices, the Member State must be prepared to: (a) specify the essential security interest that makes the specific requirement necessary; (b) demonstrate that this requirement is an appropriate means to protect that interest; and (c) explain why it is not possible to achieve the same objective by less restrictive means.

[254] Ibid., 7, para. 23. [255] Ibid., para. 22. [256] Ibid.

[257] Ibid., para. 23. For a brief outline of Art. XXIII(1) GPA. See Chapter 2, Section 3.1.

[258] See Trybus, 'The tailor-made EU Defence and Security Procurement Directive', 26, citing at fn. 195 an observation made by Heuninckx who states that requiring licensed production facilities in an offset agreement, for example, could be considered necessary to create a local maintenance capability that could be relied on to repair the military equipment in cases where the supply chain is disrupted by conflict. On this view, offsets that clearly aim at ensuring national security and meet the test of Article 346 TFEU could still be justified, just like any other Member State measure. A further example might concern a scenario

Before publication of the Guidance Note on Offsets, it had been argued that any national offsets regime would be incompatible with EU law if based on a legally binding, automatic and abstract offsets requirement for all defence contracts because of the need for a 'case-by-case' determination of the decision to invoke Article 346 TFEU.[259] The Guidance Note on Offsets has subsequently confirmed this view.[260] The Report on transposition indicates that most Member States have either formally abolished their respective offset rules or revised their legislation.[261] The report indicates that "major legal changes" have, therefore, been implemented.[262] According to the latest 2013 Communication, the Commission will verify that these revisions comply with EU law as well as ensure that such changes in the legal framework lead to an "effective change in Member States' procurement practice".[263] In this regard, the Commission has indicated that it will "ensure the rapid phasing out of offsets",[264] although the Commission has not given a projected timescale. The Commission has begun to commence infringement proceedings against Member States which continue to impose offset requirements.[265] This confirms that the Commission's current enforcement strategy is ad hoc on a case-by-case basis.

in which Cyprus is subject to a NATO embargo and faces a credible military threat from Turkey (a non-EU NATO member). For instance, Trybus cites one scenario identified by Heuninckx (in private correspondence) as follows: "[a] scenario where offsets could be justified is a contract in which the Republic of Cyprus aimed to ensure its defence by anti-aircraft missiles, as Cyprus has no combat aircraft. There is an at least theoretical possibility that Cyprus could be subjected to an effective blockade enforced by Turkey. If Cyprus bought anti-aircraft missiles, it could require offsets to build these missiles on Cypriot territory in order to have the capacity to fulfil the additional demands of: (1) resisting an invasion, (2) resisting air attack, even (3) in case of a blockade [. . .] In this scenario the offset could be a proportionate measure to safeguard a national security interest, more specifically a strategic security of supply need, for a contract on an item on the 1958 list and possibly justified by Article 346(1)(b) TFEU." See Trybus, *Buying Defence and Security in Europe*, p.416 and citations at fn. 58.

259 *Study on the Effects of Offsets*, 27. 260 Guidance Note, *Offsets*, pp. 7–8, para. 26.

261 Commission, Report on Transposition, 9. 262 Ibid.

263 Commission, 'Towards a more competitive and efficient defence and security sector', 6.

264 Ibid.

265 Eisenhut, 'Offsets in defence procurement', 396 citing at fn. 14 the issuance of a reasoned opinion with regard to the Czech Republic's purchase of military aircraft as well as a formal request to Greece to remove a 35 per cent offset requirement for the purchase of submarine batteries, rejecting Greece's claim of justification based on national security. See Press Statement IP/10/501 Public Procurement: Commission calls on Czech Republic to respect public procurement rules (May 5 2010) and Press Statement IP/10/1558 Public Procurement: Commission calls on Greece to amend procedure for awarding supply contract for submarine battery kits (November 24 2010). Both cases were settled and not brought before the EU courts.

Ultimately, it has been observed that offsets are likely to continue in some form.[266]

To this extent, it is difficult to sustain the view expressed by US observers that, because the revised 2014 Public Sector Directive remains silent on offsets, Member States may seek to bring procurement for certain defence material within the scope of the Public Sector Directive in order to enable offsets.[267] As indicated, it now appears to be relatively certain that offsets are generally prohibited under EU law unless justified. The more uncertain issue is whether a direct legal prohibition represents the best regulatory strategy for the EU and, if so, whether it is backed by a credible enforcement strategy.

4.2.1 Third Country Offset Provision

The EU has not sought to specifically differentiate the origin of offsets for the purposes of determining the compatibility of offsets with EU law. By contrast, EDA publications have made a number of references to third country offset provision specifically. For instance, the now defunct EDA Offsets Code identified in Chapter 1 stated that its principles and guidelines will be applied equally to all bidders from subscribing Member States and non-subscribing Member States, including third countries.[268] The Code also identified offsets as a global phenomenon and that, while addressing offset on the EU level, cognisance will need to be taken of the global practice of offset and, in particular, the involvement of third parties and their effect on European industry competitiveness.[269] In addition, the Code also envisaged its application not only to offsets but all compensation practices including government-to-government off-the-shelf defence sales.[270] Finally, the Code identified that subscribing Member States will

[266] See Trybus, 'The tailor-made EU Defence and Security Procurement Directive', 29; and Heuninckx, 'Trick or Treat?', 26; and EDA, *Study on the Innovative and Competitive Potential of the Defence-related Supplier Base in the EU12* (2009) conducted by PwC Polska Sp.zo.o. (PwC), Swedish Defence Research Agency (FOI), Netherlands Organization for Applied Scientific Research (TNO) and ProCon Ltd (ProCon), under contract with PricewaterhouseCoopers EU Services EESV, Final Report, 74–5.

[267] C. Yukins, 'The European Procurement Directives and The Transatlantic Trade & Investment Partnership (T- TIP): Advancing US–European Trade and Cooperation in Procurement', GW Law School Public Law and Legal Theory Paper No. 2014–15 GW Legal Studies Research Paper No. 2014–15 1, 12.

[268] EDA, *The Code of Conduct on Defence Procurement of the EU Member States Participating in the European Defence Agency*, 21 November 2005, 2. For a brief discussion of the EDA Codes, see Chapter 2, Section 2.7.

[269] Ibid. [270] Ibid.

use, wherever practicable and on a voluntary basis, mutual abatements to reduce reciprocal offset commitments.[271] Abatements are generally understood as agreements concluded to reduce or cancel reciprocal offset agreements.[272] According to the EDA, abatements could be addressed through an "EDA–US Government Offset Dialogue", the prospect of which is discussed in Chapter 11.[273] Perhaps unsurprisingly, a 2011 NIAG study also indicated that many European defence industry associations considered that offsets should be dealt with on an intergovernmental level through the EDA on the basis that offsets deal with aspects closely related to national sovereignty and do not fall entirely within the Commission's purview.[274] As a result, the Study indicated that these associations encourage the EU not to promote the Commission's Guidance Note on Offsets and to support the EDA's work in this field.[275]

Importantly, however, as indicated, the EDA Offsets Code has been abolished. Therefore, in the event that a Member State can lawfully derogate under Article 346 TFEU to justify offsets, there is no longer any intergovernmental framework in place under the EU's auspices to govern offset practices.

4.2.2 Third Country Offset Receipt

It is recalled from Section 2.3 that a 2007 EDA study indicated that several respondents expressed concern about a potential future offset regime within the EU which prohibited intra-EU offsets but permitted offsets to be provided by third country contractors. There has been some uncertainty as to the permissibility of third country offsets where a third country contractor is permitted to participate in a contract award procedure pursuant to the Defence Directive. According to one view, a contracting authority cannot require offsets.[276] According to another view, as a consequence of the general prohibition on offsets received from EU contractors,

[271] Ibid. See, generally EDA, *Abatements: A Pragmatic Offset Tool to Facilitate the Development of the European Defence Equipment Market*, 2010.

[272] Ibid. [273] Ibid., 18. See Chapter 11, Section 3.3.

[274] NATO NIAG High Level Advice Study No. 154, 'Developments in Europe to Reform Export Control and Defense Procurement Processes and Implications and Opportunities Resulting, Particularly with Regard to Multinational Programs Supporting NATO Capabilities and Interoperability' (2011) 14.

[275] Ibid.

[276] Statement made by Mr Burkhard Schmitt, panellist at the International Chamber of Commerce conference: 'The New EU Directive: Towards Market-based Defence and Sensitive Security Procurement', Paris, France, Tuesday 1 February 2011. Notes are retained on file.

EU contracting authorities could be compelled to prefer third contractors to EU contractors placing them at a comparative advantage.[277] The EDA Study committed to the view that illegality "lies on the receiving side irrespective of whether suppliers are European or not or where they reside" and that a possible solution would be to prohibit acceptance of offsets regardless of origin.[278]

The reference to illegality lying on the "receiving side" may derive from Article 18 TFEU which prohibits discrimination on grounds of nationality. It could be argued that a third country offset requirement requires industrial compensation to the requiring Member State's national industry, thereby placing the Member State and its industry at a comparative advantage vis-à-vis other Member States. On this basis, it could be considered analogous to a "buy national" requirement that would otherwise be contrary to EU law unless justified.[279] Alternatively, it could be argued that by enabling third country contractors to provide offsets whereas EU contractors would be prohibited, third country contractors derive a comparative advantage, for example, by improving their ability to tender for contracts in other Member States.[280] This interpretation is also further reinforced by the fact that the EDA Offsets Code referring to third country offsets only applied to contracts excluded pursuant to Article 346 TFEU thereby indicating that third country offsets were also considered to be *prima facie* incompatible with EU law. Conversely, the EDA's former position indicates that it must have considered that there may be potential circumstances in which it is possible to invoke Article 346 TFEU to justify receipt of offsets from third countries. It has been argued that allowing unfettered opportunities to third countries to offer offsets whilst at the same time phasing out or reducing the same possibility for EU contractors puts EU contractors at a disadvantage and which is said to explain the reference to third countries in the EDA Offsets Code.[281] The authors of the 2007 EDA Commissioned Study also indicated that an outcome whereby offsets were prohibited for EU contractors but permitted for

[277] Statement made by Mr Michael Abels, Partner, Oppenhoff & Partner (Germany), panellist at the International Chamber of Commerce conference: 'The New EU Directive: Towards Market-based Defence and Sensitive Security Procurement', Paris, France, Tuesday 1 February 2011. Notes are retained on file.

[278] *Study on the Effects of Offsets*, 11 and 47.

[279] The author is grateful to Dr Baudouin Heuninckx (Head of Aeronautical Programmes at the Belgian Armed Forces Procurement Division) for discussions on this issue in private correspondence. Comments were provided in a personal capacity. Correspondence is retained on file.

[280] Ibid.

[281] Trybus, *Buying Defence and Security in Europe*, p. 200.

third countries is "hardly a policy advocated by any European actors" and is "not likely to become a European policy".[282] To the extent that the prevailing view is that offsets are generally prohibited under EU law, it is submitted that the prohibition applies irrespective of origin. An issue that has not been specifically addressed is whether the Commission will seek to enforce the offset prohibition against Member States and third countries equally or accord greater priority to one or other. If the objective is to secure the rapid phasing out of offsets, the Commission should focus primarily on offset receipt from US contractors given the extent of US offset provision within the EU. However, it remains to be seen whether this will be the case in practice.

Finally, it is observed that the overriding focus on offset receipt means that there has been limited consideration of offset provision by EU contractors to third countries from the perspective of EU law. It is possible to conceive of the potential application of EU law, for example, where a Member State subsidises domestic defence companies to enable them to sustain the provision of offsets to third country markets. However, again, it might be argued that such measures have limited impact on the internal market. Further, EU law is unlikely to have a significant impact on individual offset agreements negotiated between EU contractors and third country governments in practice especially where there is no Member State involvement. That this issue has been substantially overlooked is perhaps reflected by the fact that it is only recently that the Commission has indicated its intention to address the impact of offset requirements in third countries on the European defence sector.[283]

4.2.3 Offset Receipt in Government-to-Government Contracts

As indicated throughout this chapter, government-to-government sales may often be accompanied by offset agreements. In current debate on Article 13(f) Defence Directive, it has not been considered whether Member States are prohibited from requiring any offset alongside the government-to-government sale. According to one US observer, Article 13(f) "swallows the Directive's rule against non-discrimination" such

[282] *Study on the Effects of Offsets*, pp. 11, 47.

[283] Commission, A New Deal for European Defence, Implementation Roadmap for Communication COM (2013) 542; 'Towards a more competitive and efficient defence and security sector' COM (2014) 387 final 13, para. 2.7. For a discussion of the likelihood that the Commission will address this issue in the short to medium term, see Chapter 11, Section 3.1.

that the "anti-discrimination rules are toothless for offsets connected to those procurements".[284] By contrast, according to the Guidance Note on Offsets, whilst government-to-government sales are excluded from the Directive, possible related offset requirements would have to be separately justified on grounds that they are "necessary for the protection of the essential interests of the purchasing Member State".[285] This appears to refer to the need for justification under Article 346 TFEU. Again, the Guidance Note does not explicitly differentiate between a Member State-to-Member State sales contract with an accompanying offset and a third country-to-Member State sales contract with an accompanying offset. It is suggested that similar to the position concerning offsets which are not tied to a government-to-government sale, the prohibition is likely to apply to offset agreements accompanying such a sale, irrespective of origin, unless otherwise justified under Article 346 TFEU. This also appears to be consistent with the now-defunct EDA Offsets Code which stated that it applied to both offsets and government-to-government sales provided by third countries.[286] It is, therefore, arguable that offsets provided by US contractors under FMS are *prima facie* incompatible with EU law unless separately justified pursuant to Article 346 TFEU. However, as indicated above, it is open to question to what extent offsets accompanying US FMS will be challenged in practice.

5 Conclusions

This chapter has sought to scratch the surface of the legal issues surrounding government-to-government contracts and offsets under US and EU law. This chapter has indicated the overall political and economic significance of government-to-government contracts and offsets for transatlantic defence trade. However, whilst government-to-government contracts are subject to a degree of regulation, offsets remain largely unregulated. An analysis of the US FMS programme revealed a host of insights which have not been considered from a perspective inside the EU not least as a result of the Defence Directive's *prima facie* exclusion of government-to-government contracts but also because little is known about the national legal and policy approaches of EU Member States to government-to-government sales. Issues arising under the US FMS concern, *inter alia*: the extent to which FMS procurements are openly

[284] Lambrecht, 'The Big Payback', 91.
[285] Guidance Note, *Offsets*, 7, para. 24.
[286] EDA Offsets Code, 2.

competed; the extent of permitted participation by purchasing governments; justifications for sole source FMS procurement; use of competitive procedures by purchasing governments for FMS; and the ability of purchasers to challenge FMS contractor provision. To date, there has been no detailed debate as to whether the FMS legal framework is effectively functioning in line with its founding objectives and in the interests of transatlantic defence trade. By contrast, Article 13(f) Defence Directive does not purport to regulate government-to-government contracts but rather *prima facie* excludes such contracts from its scope. At a fundamental level, questions may be asked as to whether the Defence Directive should: include an exclusion; include more detailed provision regarding exclusion; or bring government-to-government contracts within its scope on the basis of any analogy that might be drawn with joint procurement procedures that fall within the scope of the EU procurement Directives. At present, considerable legal uncertainty has arisen regarding the scope of the exclusion. A particularly contentious issue has concerned whether US FMS may be used to circumvent the Defence Directive. At the very least, this should provoke debate regarding the interactions between and overall coordination of the US and EU legal regimes in this field.

This chapter has also examined offsets. As indicated, the USA does not regulate offset receipt by foreign contractors; rather, US law and policy focuses primarily on offset provision by US contractors under FMS. Whilst this chapter has not sought to interrogate the political and economic bases for US offset policy, the US position appears to be largely a product of circumstance than design. The USA does not officially support or regulate offsets yet US contractors are likely to experience difficulty in providing offset without informal support. Therefore, US legal intervention is limited to the imposition of statutory reporting requirements a requirement which is not otherwise imposed centrally under EU law. By contrast, offsets are considered to be *prima facie* incompatible with EU law unless justified. The legal position regarding third country offset provision is unclear, but it appears that such offsets are similarly prohibited. However, as indicated, legal uncertainty results from the fact that it is not clear precisely when Member States are likely to be able to legitimately invoke Article 346 TFEU to enable an offset requirement. Therefore, there is now a position in which US law does not formally prohibit offsets whilst the EU does prohibit offsets. Moreover, it is questionable whether the EU has in place an effective strategy for enforcing this prohibition on offsets irrespective of their origin as well as whether the legal machinery

is in place under the Defence Directive to provide non-discriminatory alternatives to offsets.

All of the above aspects raise important issues for comparative discussion within the US and EU legal communities. At the very least, this necessitates a more sustained formal dialogue on government-to-government sales and offsets, a possibility considered in Chapter 11, to which this book now turns.