OFFSETS AND EU LAW

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THE EUROPEAN UNION

1st Pillar
Internal Market

2nd Pillar
CFSP
(Common Foreign And Security Policy)
ESDP
European Security and Defence Policy

3rd Pillar

The EU legal framework

- This differentiation in the intensity of integration refers primarily to the following:

  a) Decision making process - instruments
  b) Role of the European Commission
  c) Adjudication role of the Court of Justice of the EU
  d) Role of the European Parliament

- Accordingly:
  - Internal Market -> high degree of intensity of integration (supranational)
  - CFSP -> lower intensity, limited role for Commission, CJEU, Parliament (intergovernmental)
THE EUROPEAN UNION

1st Pillar
Internal Market

2nd Pillar
CFSP
ESDP

3rd Pillar

Defence Procurement
Offsets (defence)
Offsets (civilian)
The European Union

1st Pillar
Internal Market

2nd Pillar
CFSP
ESDP

3rd Pillar

Defence Procurement Directive
Code of Conduct Defence Procurement (EDA)
THE EUROPEAN UNION

1st Pillar
Internal Market

2nd Pillar
CFSP
ESDP

3rd Pillar

DP Directive and Offsets???

Code of Conduct on Offsets (EDA)
Offsets – Compatible with EU Law?

Offsets in defence procurement appear mainly as:

• condition for participation of foreign firms in domestic defence procurement processes

and/or

• award criterion
Offsets – Compatible with EU Law?

Offsets - a barrier to trade? (C- 8/74 Dassonville)

Can they be justified? (e.g. Article 346 TFEU)

• Indirect **civilian** offsets (i.e. industrial compensations not related to defence) are **manifestly unsuitable** for securing the essential security interests of a Member State – Article 346 TFEU not applicable
Offsets – Compatible with EU Law?

- What about defence related offsets?
- Factors that could play a role:

1) CJEU’s Interpretation of Article 346 TFEU

   e.g.:
   - Case C- 414/97 Commission v. Spain
   - Case C-252/01 Commission v. Belgium
   - Case C-337/05 Commission v. Italy
   - Case C-409/05 Commission v. Greece
   - Case C-239/06 Commission v. Italy

2) Degree of willingness on the part of the Commission to challenge offset practices
Offsets – Compatible with EU Law?

So far:

- The Commission believes that offsets are not automatically justified under Article 346 TFEU

- However the Commission has been reluctant to institute proceedings (this has changed after the adoption of the DP Directive)

- Commission’s Interpretative Communication of Article 296 EC (now 346 TFEU) (December 2006) AND Guidance Note Offsets
Article 346 TFEU and Offsets

Collaborative defence procurement- work sharing/juste retour

Understanding between the Commission and the European Defence Agency that armament collaborative projects (including issues such as work-sharing among participating MSs) are to be dealt by the EDA
DP Directive and Offsets

- No express reference

- However potentially affected by the provisions on “subcontracting” and Article 20 Defence Procurement Directive

- “Non discriminating” award criteria
Article 346 (1b) TFEU:

Any Member State may take such measures as it considers necessary for the protection of the essential interests of its security ..... the production of or trade in arms, munitions and war material: such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.
Art. 346: The Great Unknown

Commission’s position (see Interpretative Communication on 296 EC):

• Article 346 TFEU is subject to a proportionality test
  i.e. MSs have to show that derogation from the rules of the Treaty in the field of arms trade is linked with their essential security interests and necessary to protect them. This can only be ad hoc

The key questions:
- How strong is the intensity of judicial review?
- Classic Proportionality?
- Adapted Proportionality (Manifest unsuitability/lack of necessity)?
Conclusions

• Many “givens” of arms trade (internal/external) in EU are being challenged

• The whole re-evaluation of the EU competences (Commission, CJEU) in this area can have knock on effects on both the internal and external EU arms trade dimensions

• Shift of the centre of gravity of policymaking in the field
Conclusions

• Offsets are not automatically exempted from EU rules through Article 346.

• However at the moment it seems that the low level of scrutiny established by Art 346 renders “prosecution” by the Commission of most offsets practices difficult (potential impact of the DP Directive?)

• The Code of Conduct on Offsets is an attempt to “contain” offsets in the medium term.
Thank You

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Revisiting Offset Practices in European Defence Procurement: The European Defence Agency’s Code of Conduct on Offsets*

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1. Background

Since 2003 steady efforts have been undertaken by various EU institutions under the first and the second pillar of the Union alike for the opening up of the segregated domestic defence markets of the EU and the creation of a genuine European defence market.

In particular the Council of the Union established under the second pillar of the European Union in 2004¹ the European Defence Agency² (EDA) as a body entrusted with, among other tasks, the promotion of European armaments cooperation and the strengthening of the European Defence Technological and Industrial base. The EDA has already undertaken a number of initiatives in the area of the European Defence Equipment market in particular with the adoption of the Code of Conduct for

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¹ Following the Conclusions of the Thessaloniki Summit in 2003. See Presidency Conclusions, Thessaloniki European Council, Thessaloniki, 19-20 June, 2003, para. 65

Armaments Procurement\textsuperscript{3} and the Code of Best Practice in the Supply Chain (CoBPSC).\textsuperscript{4}


Defence Procurement, 6 the publication of the interpretative Communication on Article 296 EC7 (now Article 346 TFEU) and finally the Commission’s initiatives have reached their culmination –at least from a regulatory point of view- with the adoption of the two instruments of secondary legislation -namely the Directive on defence and sensitive security equipment procurement8 and the Directive for intra-community defence transfers9).

It is submitted that all the aforementioned initiatives aim to tackle specific aspects of the defence market –even though sometimes they seem to create certain overlaps10- for example the use of competitive procedures in the award of defence related procurement contracts, the free participation of defence contractors established in other Member

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States, the publication of defence contract opportunities, the interplay between prime defence contractors and the second and third tier contractors etc.

One important aspect of European defence market regulation that none of the aforementioned initiatives has ever dealt with explicitly is the issue of offset practices – otherwise known simply as offsets or industrial compensations.

These are practices in the field of defence procurement followed by procuring governments with the aim at safeguarding some kind of return of their “investment” – i.e. the payment given to a foreign defence contractor for the acquisition of defence equipment or related services— for their domestic industry. This “return” may take various forms. For example it can be manifested as the participation of domestic industry in the production phase of a defence contract -through co-production or through subcontracting- or by its involvement as subcontractor in future contracts of the foreign supplier. From the point of view of their position

With the exception perhaps of the Commission’s Interpretative Communication on the Application of Article 296 EC in the Field of Defence Procurement -that as we will discuss below under section 8 made some generic references to the issue of offsets.

For offsets as an industrial policy mechanism see indicatively Martin, S. (ed), 

For a more detailed presentation of the various categories of offsets see below section 5.
in the procurement process, offsets may appear as condition for participation of foreign contractors in a specific procurement or as award criterion. Offsets constitute a common feature of defence markets that has been considered as an obstacle in the effort to create a truly open European Defence Equipment Market (EDEM). One of the main reasons why offset practices have been left largely untouched and unchallenged until recently is their perceived politically sensitive nature.

Nevertheless on October 24, 2008 the Steering Board of the European Defence Agency agreed on a specific initiative that aims at taming such practices. This new initiative is the Code of Conduct on Offsets. The Code of Conduct came formally into effect on 1 July 2009. This new initiative is the latest development within the European Defence Agency that aims to promote a competitive and robust European Defence Technological and Industrial Base (EDTIB) in accordance with the Strategy adopted by European Defence Ministers on 14 May, 2007.

The purpose of the present article is to present and analyse the new instrument and to attempt to place it in its wider regulatory context.

2. An Introduction to the New Regime

It is recalled that the European Defence Agency had commissioned an independent study to assess the effects of offsets on the development of a European Defence Industry and Market. The outcomes of this study were

See also Georgopoulos, A. “Comment on the Recent Developments in European Defence Procurement Integration Initiatives” op. cit NA 10.
published in Autumn of 2007. The premise of the study had been that offsets from a legal point of view constitute barriers to trade and therefore are prima facie not compatible with EU law, however, from a practical point of view may have some beneficial effects as tools for industrial development. The study acknowledged that offsets are widely used not only in Europe but around the world. The new initiative departs from where the aforementioned study left off: in other words it approaches offsets – at least in the short and medium term- as a “necessary evil” of defence market that since it cannot be eliminated it should at least be contained.

3. The Nature of the New Regime

First of all according to the new Code of Conduct on Offsets, participating Member States recognise that the ultimate aim of the European Defence Agency’s initiative is “…to create the market conditions, and develop a European DTIB [Defence Technological and Industrial Base] in which offsets may no longer be needed.” Nevertheless until then it is deemed necessary to create a system that mitigates any negative impact of such practices on cross-boarder competition.

It is submitted in this regard that the new initiative presents the same main characteristics as the Code of Conduct on Defence Procurement that has been in force since 1 July, 2007.

17 The study was presented to the participating Member States of the EDA on 12 July 2007.
18 It is recalled that the study did not provide for a conclusive answer on the impact of offset practices on the Development of a European Defence Industry and Market, a fact that demonstrates that it is very difficult to fully measure all the positive and negative effects of this policy tool.
19 Emphasis added.
In particular the new instrument establishes an *intergovernmental* regime based on the will of sovereign Member States in the area of offset practices that are linked with the defence procurement process. This intergovernmental regime is a manifestation of a *choice* made by participating Member States to limit any adverse effects of offset practices. Thus, like the Code of Conduct for Defence Procurement, the new regime in the area of offsets does not change or challenge the principal role, from a legal and policy point of view, which Member States enjoy in the field of armaments policy.

In addition the Code of Conduct on Offsets is established on a *voluntary*\(^{21}\) basis, which is not surprising since the institutional framework under which it operates is the European Defence Agency which is par excellence a forum of voluntary participation, established under the second pillar of the European Union.

Although the relevant documents did not explicitly refer to a *reflexion period* -namely a period during which Member States would make up their minds whether to participate or not- as was the case with the Code of Conduct on defence procurement,\(^ {22}\) it is submitted that European Defence Agency Member States had effectively time to decide to choose whether to participate in the new initiative or not.\(^ {23}\) This reading is supported by the explicit reference to the *voluntary* nature of the Code of Conduct on Offsets together with the use of the term *subscribing*\(^ {24}\) as opposed to

\(^{21}\) *The Code of Conduct on Offsets, op. cit* p.1

\(^{22}\) It should be remembered that when the Code of Conduct on Defence Procurement was agreed, EDA Member States had a period to finalise their position (April 30, 2006) as to whether they would subscribe to the new regime (that came into effect on July 1, 2006).

\(^{23}\) It should be remembered that initially Hungary and Spain did not participate in the regime established by the Code of Conduct on Defence Procurement. They joined a year later.

\(^{24}\) *The Code of Conduct on Offsets, op. cit* p.2
participating Member States\textsuperscript{25} in order to refer to those EDA Member States that would be covered by the new instrument.\textsuperscript{26}

Moreover the new Code explicitly states that it constitutes an “integral part of the European Defence Agency’s Regime to encourage competition in the European Defence Equipment Market”. The use of the term *integral* seems to refer to the fact that the new instrument will be a *standard* feature (not an option) of the regime *as a whole* (namely the one established by the Code of Conduct on Defence Procurement and the other relevant instruments). According to this reading opting out from the Code of Conduct on offsets would also mean opting out from the regime as a whole. In addition this logically created a presumption that the EDA Members States that were parties to the Code of Conduct on defence procurement would be covered by the new Code of Conduct on offsets, unless they explicitly stated otherwise (“opt-in” presumption).

Last but not least, the Code of Conduct is non-binding in the sense that it does not contain any enforceable obligations (in the traditional sense) for the subscribing Member States.

4. Coverage Ratione Personae

The Code of Conduct on Offsets has 26 subscribing countries. Out of these countries 25 are participating Member States of the European Defence Agency\textsuperscript{27} (all EDA participating Member States except Romania). The 26\textsuperscript{th}

\textsuperscript{25} The term participating Member States (pMS) is used to refer to the Member States of the EU that participate in the European Defence Agency. On the other hand the term *subscribing* Member States (sMS) refer to those participating Member States that decided to subscribe to a particular voluntary regime.
\textsuperscript{26} Media reports had made reference to specific deadlines for Member States to communicate their decision not to participate (1 May 2009) see J. Hale “EU Notes: Offsets, Military Projects, Ukrainian Troops”, Defense News, available at http://www.defensenews.com/story.php?i=30809001
\textsuperscript{27} Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and United
subscribing country is Norway. This means that all subscribing Members States of the intergovernmental Code of Conduct on defence procurement are also subscribing Members States of the new Code of Conduct on offsets. This observation is quite important as it will be explained below under section 8.

5. Coverage Ratione Materiae

The Code of Conduct on offsets is intended to cover “all compensation practices required as a condition of purchase or resulting from a purchase of defence goods or defence services.” In addition it states that it includes Government-to-Government off-the-shelf defence sales.

The first observation is that the field of application seems to be widely defined. It is recalled in this regard that offset practices can vary considerably with regard to the object of the offset transaction.

Although there is not a standardized nomenclature or categorization of offset practices as such, it is accepted that offsets can be distinguished in a number of categories. For example the taxonomy that was followed by the independent study on offsets commissioned by the European Defence Agency categorized offsets in the following categories:

Direct offsets: Offset transactions that are directly related to the defence items or services imported by a participating Member State.

Kingdom. It is recalled that out of the current 27 EU Member States 26 (the ones mentioned above and Romania) are participating Members States of the European Defence Agency. Denmark has a general opt-out from all EU initiatives that have military and defence implication.

28 The Code of Conduct on Offsets, op. cit p.1
29 Final Report Study on the effects of offsets on the Development of a European Defence Industry and Market op.cit p. 3
30 For example co-production, subcontracting, training, licensed production, technology transfer. The point of reference in all these is the subject of main defence procurement contract.
**Indirect offsets**: Offset transactions that are *not directly related* to the defence items or services imported by a participating Member State. Indirect offsets are subdivided into:
- **Defence (related) indirect offsets.**
- **Non-defence (related) indirect offsets** (otherwise known as “civil” offsets).

Nevertheless it is important to note at this point that the usefulness of the aforementioned categorisation (or any categorisation for that matter) has its limits since nowadays it may be difficult in practice to place some offset contracts under one of these categories. This is because modern defence systems contain technologies that are used in the defence and civil sectors alike. These technological crossovers mean essentially that the distinction between defence and civil technologies is less clear-cut than it used to be. As a result although the distinction between direct and indirect offsets seems to be straightforward, for an increasing number of indirect offset contracts the classification under the *defence indirect* or

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31 This kind of indirect offsets are not linked with the subject matter of the main defence procurement contract but still are to be implemented in the field of defence. For example the main contract regards the acquisition of 40 new aircraft by state A but the offset contract regards the purchase by the defence contractor of the main contract (the winner of the competition) of defence related services (for example maintenance services) from companies established in State A. However these services are not related with the purchase of the 40 new aircraft by State A. Instead they can be used by the defence contractor in other future contracts with this or other countries.

32 This kind of indirect offsets are not linked with the subject matter of the main defence procurement contract and they are implemented *outside* of the field of defence. For example the main contract regards the acquisition of 40 new aircraft by state A but the offset contract regards the purchase by the defence contractor of the main contract (the winner of the competition) of fax machines produced from companies established in State A. In this case the indirect offset contract has nothing to do with the field of defence.

33 Although based on the previous observation, about the hybrid character of modern technology, conceptually direct offsets may also cover technologies that are not purely defence in nature (dual use technologies).
non-defence (civil) indirect offset categories may prove particularly difficult.

It is submitted that the Code of Conduct on Offsets by not making an explicit distinction between the various kinds of offsets –this perhaps reflects the recognition of the aforementioned practical difficulties of classification- intends to cover all of them. Having said this there is one limitation: work sharing arrangements in the framework of Government-to-Government Research & Development contracts seem to be allowed. This is not explicitly mentioned in the Code of Conduct but derives a contrario from the phrase “it also encompasses Government-to-Government off-the-shelf defence sales”. This is expected in a sense because the general rules of the European Defence Agency allow for types of work sharing for Research & Development projects and also the inclusion of Research & Development related offsets probably was seen as a “deal breaker” rather than a “deal maker” for the new regime (particularly for those Member States that are actively involved in collaborative Research and Development programmes and whose support for the new initiative was indispensable).

Finally the Code of Conduct stipulates expressly that the principles and guidelines of the new Code will be applied equally to all bidders from subscribing Member State and non-subscribing Member State including third countries. This essentially means that in the context of a defence procurement process carried out in one subscribing Member State all bidders will be subjected to the rules and principles of the Code of Conduct on offsets irrespective of their country of origin.

6. Principles and Rules

34 Emphasis added.
35 The Code of Conduct on Offsets, op. cit p.1
36 The Code of Conduct on Offsets, ibid p.2
The Code of Conduct on offsets, before the stipulation of the rules and principles, puts forward certain clarifications that aim to contextualize the new initiative.

Firstly the Code ascertains that “procurement in the defence market remains different than procurement in purely commercial markets and is strongly influenced by political considerations that affect the level playing field”. This seems to be at the moment a given for the Code, not a parameter that the Code aims to change radically.

Secondly the Code states that offsets would be unnecessary if perfect market conditions existed in the defence market. However because the latter is far from perfect offsets constitute a feature that has to be taken for granted for the time being. What is more the Code explains that offsets are not the only element causing market fragmentation and distortion of competition in the field of defence. Moreover it is submitted that offsets are a global phenomenon and will remain so for the foreseeable future. With this as the second given the Code pronounces that the two main aims of the new instrument are:

a) The mitigation of any adverse effects of offset practices on the development of a fair and competitive European Defence Equipment Market (EDEM) and
b) The use of offsets mainly to help shape the European Defence and Industrial Base (EDTIB) of the future.

According to the Code these two aims will be achieved by the closer convergence of offset policies and practices and the gradual reduction of the use of offsets.

6.1. The Principles of Transparency and Mutual Confidence

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37 The Code of Conduct on Offsets, ibid
In this respect the Code establishes certain commitments for subscribing Member States that are aimed at increasing transparency and mutual confidence. These two principles are considered to be instrumental for achieving the aforementioned aims of the new regime.

In particular subscribing Member States undertake the commitment to provide to other subscribing Member States through the European Defence Agency information on national offset practices and underpinning policies, where they exist. This commitment will also involve a regular review of the information provided for ensuring that it remains current. Clearly the aim of this commitment is to create an environment of mutual trust and confidence. Through this commitment each subscribing Member State becomes a provider and recipient of information. In addition this process aims to lift the veil of obscurity that is commonly witnessed in the area of offset arrangements, and try to increase transparency.

In addition subscribing Member States have the duty to provide the European Defence Agency with information “on all offset commitments (including the percentage and types of accepted offset) with effect from the implementation date of this Code, whether part of the procurement contract or agreed upon otherwise”. As will be argued below (in section 8) this commitment may prove crucial for the success of the new instrument.

6.2. The Principle of Instrumentality of Offsets in the Shaping of the European Defence and Industrial Base

Without mentioning it explicitly the evolution towards a more instrumental use of offset practices for the development of a competitive and stable European Defence and Industrial Base constitutes the main –if not the only- legitimating reason for accepting -or better tolerating- offsets as a feature of an open European defence market. For this reason the Code establishes certain guidelines that subscribing Member States should follow when using offsets in the defence procurement process.
In particular subscribing Member States should use offsets in order to assist the development of “industrial capabilities that are competent, competitive and capability driven” and that avoid unnecessary duplication. In other words Member States should use offset not as “life-support” device of ailing industries but rather use them as instruments for industrial development in areas where there is a real need. Implicitly Member States are required to consider, before using offsets for industrial development of a particular segment of the defence sector, whether there are solutions elsewhere in the European Union that could satisfy their needs or whether they could identify common opportunities with other subscribing Member States to use offsets in order to develop globally competitive Centres of Excellence.

In addition subscribing Member States are required to take into consideration ways through which they could support the involvement of small and medium size enterprises (SMEs) that would create a solid lower tier supply side in accordance with the principles of the Code of Best Practice in the Supply Chain (CoBPSC).38

6.3. The Principle of Restraint in the Use of Offsets

Moreover the Code stipulates that even when subscribing Member States manage to use of offsets as a tool that promotes the European Defence and Industrial Base, they should still try to find a balance between that aim and the aim of creation of a level playing field for competition within the European Defence Equipment Market. In this respect the Code stipulates a number of commitments that aim to ensure that such balance is in place.

Firstly the subscribing Member States that use offsets in the framework of a particular defence procurement process are under the duty to clearly stipulate offset requirements in the contract notice and make clear from the outset if the provision of offsets is a factor in the consideration of a company’s bid during the procurement process.

Secondly when offsets are used as a selection criterion or award criterion, they should be afforded of “a less significant weight” or be used as a subsidiary criteria in case of offers with the same weight. The aim of this is to ensure that the epicenter of the decision making process for the award of a particular defence contract remains the best available and most economically advantageous solution for the particular requirement. Although the aim behind this requirement is clear, namely to limit the relevance of offsets to an ancillary role in the procurement process, the particular phrasing is a little ambiguous. For example it is not clear what exactly is meant by the phrase “offsets will be considered of a less significant weight”. “Less significant weight ” by comparison to what? Each of the other award sub-criteria? All of the other award sub-criteria seen together? This element needs further clarification. It should be also mentioned at this point that -even before the establishment of the new initiative- offset arrangements more often than not do not constitute the main criterion -in comparison to the financial and technical offers- for the award of defence procurement contracts. In any case it will be interesting to see how subscribing Member States will deal with this ambiguity.

Thirdly when subscribing Member States require or accept offsets, the value of the latter should not exceed the value of the procurement contract. In practice many offset regimes require the provision of a high percentage of offset value sometimes surpassing the value of the main procurement contract. It is important to recall, of course, that this higher offset value does not correspond to actual monetary value but is rather nominal, the result of calculations that take into account various “value multipliers”. As mentioned already offset arrangements can take various forms (direct, indirect, defence, non-defence, co-production,
subcontracting, licensing etc.). Multipliers essentially convey the significance that the procuring states attach to specific type of offsets arrangements. For example State A values more offsets arrangements that entail technology transfers from the prime contractor to State A’s industry (category 1) than offsets that involve low tech subcontracting opportunities for State A’s domestic industry (category 2). For this reason State A may attach a multiplier of 7 for category 1 offset arrangements and a multiplier of 3 for category 2 offset arrangements. Accordingly a category 1 offset arrangement whose actual monetary value is £ 10 million will have a net offset value of £70 million (£ 10 million x 7= £ 70 million) whereas a category 2 offset arrangement with the same monetary value will have a net offset value of £ 30 million (£ 10 million x 3= £ 30 million).

From a political point of view these value multipliers and the resulting percentages are used by national governments for political reasons for example in order to show that the money allocated to defence procurement return to the country in other forms and sometimes more (in cases where the calculations for example return of more than 100%). It is not clear from the Code whether the limitation of the amount of offsets value to the value of the main procurement contract refers to actual value of the offset contracts or the nominal value, namely the result of calculations with multipliers. In any case it has been agreed that the application of the 100% ceiling be deferred until 15 October 2010.

Fourthly subscribing Member States will let foreign suppliers providing offsets to select themselves the most cost effective business opportunities within the purchasing country for the offset fulfillment. This is a very important addition to the system that aims to infuse some competition and transparency. It is recalled that often national governments use offset contracts to extend the life line of obsolete, non-competitive national (more often than not state owned) defence contractors. Through this new commitment it will be up to the foreign defence contractor that undertakes the obligation to provide offsets to identify the best partners in that country. As a result offsets may be used as opportunities for first tier
defence contractors to forge new relationships with lower tier contractors in various Member States that could prove beneficial not only in the context of the fulfillment of the offset obligation but also for future cooperation.

Finally subscribing Member States are invited to establish, wherever practicable and on a voluntary basis, reciprocal commitments for offset reduction.

7. The First Tangible Steps of the New Regime

7.1 The Web Portal on National Offset Policies and Practices

The main vehicle for the envisaged exchange of information regarding national offset policies is the European Defence Agency’s web portal on National offset policies and practices.39 This portal contains information of all the National offset policies followed by the Code’s subscribing countries.

This is quite important because until very recently these national offset policies were not easily available on the public domain and certainly not gathered in one place. Thus the portal disseminates the relevant information not only among the subscribing countries but also to all other stakeholders (including the general public, i.e. the taxpayer). Moreover it allows for a convenient means to communicate any changes in offset policies and practices which is useful for the industrial partners and the other subscribing countries since it may identify quickly specific policy trends.

In particular the portal identifies for each subscribing state important information regarding the:

- Applicable regulatory framework

- Objectives of offset policy (for example the development of the national defence industrial base, technology transfer etc)
- Applicable offset threshold value in EURO
- Role of offset in the procurement procedure (for example condition of participation, selection or award criterion etc)
- Process for concluding offset agreements
- Responsible government authorities and their respective areas of responsibility
- Offset requirements (for example minimum offset value expressed as a percentage of the monetary value of the main defence procurement contract; requirement for SMEs participation etc)
- Accepted offset activities
- Industrial sectors where offset obligation can be discharged (for example whether the offset arrangement are implemented only in the defence sector or whether other industrial sectors are also eligible)
- Fulfilment period
- Existence of confidentiality clauses (for example regarding the subject matter of the contract, timetable, monitoring of the programme)
- Use of Multiplier 40 (expressing national preferences towards particular types of offset agreements)
- Relevant monitoring national authority
- Penalties foreseen by national law for non completion or non-timely completion of offset agreements
- Use of abatements/swaps 41
- Use of guarantees (Use of performance guarantees etc)
- Selection of the offset receivers (whether the foreign companies are free to select the national industrial partners or not)

It is important however to point out that the portal does not contain information on specific offset agreements, since more often than not they

40 For an explanation see above under section 6.3
41 For more on the use of abatements see below under section 7.2.
may contain sensitive information and may be subject to confidentiality clauses.

7.2 The Study on Abatements

The second tangible step of the initiative launched by the Code of Conduct on offsets is an in-house study carried out by the European Defence Agency (Industry and Market Directorate) examining the application of abatements as a possible tool for streamlining practices in the field of offsets. The EDA’s in-house study was carried out from November 2009 to February 2010 in close consultation with all subscribing States and its findings were included in a report entitled *Abatements: A Pragmatic Offset Tool to Facilitate the Development of the European Defence Equipment Market.*

It should be clarified at this point that an *abatement* or *swap* in its simplest form involves four parties: two national authorities (State A and State B) and two economic operators each established in the territory of one of the two aforementioned States (Company A and Company B) with mutual offset obligations in the territory of the other State (in our example Company A established in State A has offset obligations in State B whereas Company B established in State B has offset obligations in State A). The abatement or swap agreement is essentially a bilateral agreement that involves the reciprocal waiver of all or part of the Companies’ offset obligations by the two governments.

In practice a company that has difficulty in fulfilling its offset obligations may request assistance by means of abatement —provided that this is allowed by the national offset regulatory framework. The recipient of the

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43 At the moment only some but not all subscribing state of the Code of Conduct on offsets allow for this possibility. In particular based on the information available of the EDA’s offset portal the states that allow explicitly abatements are:
request i.e. the national authority of the state that oversees the offset implementation programme, may decide to consider whether companies established on its territory have offset obligations in the state where the company requesting for assistance is based. If this is the case then the national authority contacts its counterpart in the other State for exploring whether there is a possibility of mutual abatement of the offset obligations.

The calculation of the reciprocal obligations takes into account the net offset value after the calculation with multipliers. Moreover it is not necessary for the reciprocal offset obligations to be of the same net offset value. For example: Company A has offset obligations of £ 70 million (net offset value i.e. after calculating the applicable multipliers) towards State B and Company B has offset obligations of net offset value £ 30 million towards State A. An abatement agreement between the relevant parties could involve the complete waiver of Company B’s offset obligations towards State A and the partial waiver of Company A’s offset obligations up to £ 30 million. In other words in this example Company A would still have to fulfil offset obligations of net offset value £ 40 million towards State B.

The abatement mechanism tries to deal with a common problem which is the difficulties faced in the implementation of offsets programmes – attributable to the complex nature of these agreements and also problems of coordination between the prime contractor and the beneficiary domestic companies. Belgium, Finland, Hungary, Italy, Lithuania, the Netherlands, Norway, Portugal, Slovenia, Spain, Sweden and the United Kingdom. However anecdotal evidence exist that also Germany, who formally does not have an offset policy, engages in such practices. Moreover Denmark although not a part of the Code of Conduct on Offsets has concluded with the United Kingdom and the Netherlands a trilateral Memorandum of Understanding (MoU) entitled “Best practice for the application of abatements in offset” on 24 September 2008.

44 In practice it can be quite challenging for the beneficiary companies to be integrated on the existing supply chain management practices of the prime contractor.
obligations that in turn may lead to forfeiture of performance guarantees, imposition of damages and could possibly jeopardise the prime contractor’s eligibility for participation in future defence procurement opportunities of the buyer state.

The study has identified in close consultation with subscribing States that abatements have a number of advantages. However the study clarifies that abatements do not constitute a panacea that will cure all the problems in the field of offsets and also that at the moment these findings do not reflect the views necessarily of all subscribing states.  

The advantages of this tool as identified by the study are: The lessening of the offset burden by providing a sound economic solution; the reduction of fragmentation of the European Defence Technological and Industrial Base (EDTIB); the retention of key defence industrial capabilities; export assistance to European defence companies by providing them with breathing space in Europe that enables them to be reliable partners with third country governments; support to SMEs.

The study encourages subscribing States to use this instrument for limiting the most harmful effects of offsets (for example industrial duplication) although at the same times recognises that the use of abatements will not be always practicable.

Finally the study touches upon a very interesting aspect that is often overlooked in the debate regarding offsets in Europe, namely the global dimension of offsets. Specifically the study provides that offsets are in some cases a response to entry barriers that European defence contractors face abroad and stipulates the need for the development of a

45 A Pragmatic Offset Tool to Facilitate the Development of the European Defence Equipment Market p. 5.
48 Ibid p.18.
dialogue between the US Authorities and the EDA regarding offsets (and of course market entry barriers) since the majority of offset agreements in the EU are reached between EDA participating Member States and U.S. contractors.

8. Commentary- Conclusions

It is self evident that a truly open, competitive European Defence Procurement market needs to have a system in place that deals with offset practices. The latter have been used for a long time by governments to support their domestic industrial base and by defence contractors to promote their bids. Moreover offsets as a phenomenon are not limited in Europe but are widely spread around the world. Although here is not the place to try to articulate all the possible benefits and disadvantages associated with offsets, it is appropriate to note that there seems to be an agreement that offsets lead to additional costs in the procurement process. This fact seen in the context of reduced defence expenditure means that the limited resources allocated to defence equipment are not used optimally.

Thus it is submitted that in principle the establishment of an instrument that tries to optimize offset practices and limit their negative consequences is a positive development towards the establishment of an open and transparent European Defence Market.

Looking at the substance of the new Code one could, of course, highlight its non-legally binding nature as a potential problem. It is argued however that the mere agreement of Member States to establish an instrument that tries to limit albeit in a non-legally binding or enforceable way the use of offsets is on its own right significant; not least because until recently the issue of offsets was considered a taboo. Thus the non-legally binding nature of the regime should be looked at as the necessary compromise in order to attempt to deal with a politically sensitive issue.
The fact that 25 out of the 26 EDA Member States –namely all EDA member States that are parties to the Code of Conduct decided to participate in an initiative that in the current time of economic austerity can be associated with political costs at home is indeed noteworthy. It is true of course that Member States could have decided to opt out from the regime. As argued elsewhere,\textsuperscript{49} although this was theoretically possible, it was in practice highly unlikely for two main reasons that are linked with the fact – discussed in section 3 above - that opting out from the Code of Conduct on offsets would also mean opting out from the regime as a whole (namely the Code of Conduct on defence procurement, the online portal for contract opportunities etc).

The first reason is that the operation of the Code of Conduct on defence procurements the last three years has demonstrated some clear benefits that arise from participation in the latter. This was the main reason why Spain and Hungary decided to abandon their initial opt out and join the regime after a year.

The second, equally important, reason is the parallel initiatives of the European Commission and the eagerness of the latter to assert its position as a player in the field of defence procurement regulation and enforcement. It is recalled that the participation of Member States in voluntary regimes that try to open up national defence markets – even if it is not whole-hearted - limits the ammunition of the Commission in a significant way and reduces the odds of the Commission taking action against them. On the other hand, if a Member State decides to stay completely outside such regimes and follow manifestly protectionist and non-transparent policies in the field of defence procurement then immediately becomes an easier target for the Commission.

\textsuperscript{49} “The EDA’s Real Message: The Codes of Conduct on Procurement and Offset are ‘All or Nothing’ Ultimatums” interview given by Aris Georgopoulos Countertrade and Offset, Vol. XXVII, No. 9, May 11, 2009.
Thus it could be argued that even if there is no enforcement mechanism for compliance with the new Code there is an incentive for compliance embedded in the system as a whole. This is manifested by the fact that for the first time all key features of national offset regulatory frameworks are concentrated in one place and made available on the public domain.

Concerning the coverage of the new regime it is observed that it is meant to be wide and that it does not distinguish between the various categories of offset practices. It is submitted in this regard that the decision not to make such a distinction was sensible. This is so for two reasons.

First the Code wanted to avoid the unnecessary consumption of energy and resources in an effort to try to categorise borderline cases - in other words offsets arrangement that cannot squarely fit in one of the categories. Instead the European Defence Agency wanted to bring the message home that subscribing Member States need to change their ways. Making distinctions at this stage would harm the message because it would lead to the conclusion that certain kinds of offsets are a priori accepted.

Secondly, one of the most important aspects of the new regime seems to be the collection by the European Defence Agency of information for all kinds of offsets, something that has been extremely difficult in the past. The agreement of Member States to this may prove significant. This information will be useful in order to ascertain if for example a particular kind of offset is more beneficial or more detrimental for the European Defence Technological and Industrial Base than others or identify best practices that could then be shared by other subscribing Member States. The EDA’s in-house study on abatements constitutes the first but not the last, it seems, tangible step in this direction.

Moreover it should be underlined that the dissemination of information on the portal made abundantly clear that some Member States still do not fully comprehend the obvious conflict of some offset practices with EU law. For example there are subscribing Member States that state as one of the
objectives of their national offset policies the maintenance of high levels of employment or they identify areas outside the defence sector (for example the automotive sector) where offset arrangements could be implemented. Clearly the aforementioned practices cannot be justified under the exemption of Article 346 TFEU (ex article 296 EC) because they are not linked in anyway with the protection of the essential security of the State.

Directly linked with the aforementioned points is the observation that the new Code of Conduct on Offsets establishes not only an instrument but more importantly a process. This process is evident in the element of information sharing that, as mentioned above, can only make sense if it foresees a review of the instrument down the line. Also the element of subscribing Member States as providers and recipients of information regarding the national offset policies will lead ideally to more transparency and mutual confidence.

Another interesting observation is that although the Code itself articulates certain premises regarding the imperfect market conditions as justification of the tolerance towards offset practices in the medium term, it does not mention explicitly anywhere that the ultimate aim of the regime is the elimination of offsets. The closest to such statement is the phrase “The [subscribing Member States] share the ultimate aim to create the market conditions, and develop a European DTIB in which offsets may no longer be needed”. This tone is also repeated in the EDA’s in-house study on abatements. This implies that the final elimination of offsets is not a predetermined aim but rather a possible development. It is submitted that this is another instance of language trade-off in order to reach an agreement on the new instrument.

50 “[O]ffsets are persistent and increasing, remaining a global phenomenon of an imperfect marketplace unlikely to disappear in the near future” A Pragmatic Offset Tool... op.cit p. 5.
Moreover the assertion of the Code of Conduct that offsets are justified because defence markets do not operate in perfect market conditions needs further analysis. It is submitted that perfect market conditions very rarely exist and that this notion constitutes more a theoretical concept rather a tangible reality. This in turn means that markets normally are not perfect – far from it - and yet in other non-perfect markets offsets or similar practices do not exist or are deemed unlawful. This observation shows that from an economic point of view the non perfect nature of a market does not render the recourse to offsets inevitable or necessary.\textsuperscript{51}

Furthermore it is argued that one important feature of the new regime is the requirement to involve competitive elements in the offset process for example by allowing the prime contractor to locate those smaller and medium size enterprises (SMEs) that they believe are better suited for absorbing the offset benefits.

As mentioned earlier this could be crucial for changing the ongoing practice in some Member States of using offsets for prolonging the life of uncompetitive state owned industries instead of using offsets for supporting competitive SMEs. Needless to say, a large part of the success in this regard lies with the prime contractors. If the latter really use this as an opportunity to identify new lower tier partners and increase their supply base then the initiative will prove useful. The section of the electronic portal of the European Defence Agency that relates to Industry contract opportunities could be a useful tool in this regard.

Lastly it is pertinent to examine the new instrument by reference to the wider web of initiatives in the area of European defence procurement including the ones of the Commission. It is recalled in this regard that the Commission’s proposal for a defence procurement directive does not deal with the issue of offsets at all on the understanding that such practices

\textsuperscript{51} Although it must be observed that the inherent monopsonistic character of the defence market –namely the existence of only public buyers- is a feature that differentiates the latter from other markets, at least to a certain extent.
are in principle not compatible with EU law. Furthermore it is recalled that the *Interpretative Communication on the Application of Article 296 EC in the Field of Defence Procurement*\(^{52}\) implied that ultimately some but not all offset agreements may be compatible with Article 346 TFEU (ex Article 296 EC).\(^{53}\) Furthermore the Communication mentioned that the case of *indirect non-military* offsets would be hard to justify because the link with the essential interest of national security seems extremely weak.

Thus the question that arises is whether the new instrument is compatible with the initiatives and view of the Commission in the field of defence procurement and the treatment of offsets in particular. As argued elsewhere\(^{54}\) the initiatives of the European Commission and the European Defence Agency seem complimentary in principle but in reality are antagonistic especially if approached from a legal point of view. This assessment is valid prima facie for the new Code of Conduct on Offsets. This is because it is certain that according to the Commission a lot of the offset agreements that will be covered by the new Code would be illegal under European Union law.

Nevertheless despite this observation there seems to be a *de facto complementarity* of the new Code with the initiatives of the Commission especially the Defence Procurement Directive. This is because, as was mentioned above, the Commission has refrained from adopting a concrete initiative on offsets, under the pretext that offsets are *obviously* contrary to EU law -following the wide definition of measures having equivalent


\(^{53}\) “[M]ember States must therefore make sure that *offset arrangements* related to defence contracts covered by Article 296 (1b) EC do respect this provision”, COM (2006) 779 final *op.cit* p. 8

effect to quantitative restrictions of the *Dassonville* jurisprudence.\textsuperscript{55} In addition the Commission, despite being the watchdog of EU law, has so far refrained from instituting proceedings against Member States for these “illegal” practices before the European Court of Justice knowing that such a legal challenge would pose significant legal questions that are yet to be decided and would carry a considerable risk for the Commission to lose such a case.\textsuperscript{56}

For these reasons it seems that the Commission should in principle welcome an initiative that aims to impose some *self-restraint* to practices that could potentially damage intra-community trade, especially when it is recalled that offset practices may affect intra-community trade in fields beyond the defence market.

Finally, as a preliminary conclusion, the first impression of the Code of Conduct is that it constitutes an important initiative. However like any other “soft law” initiative the degree of success depends greatly on the willingness of participants to exercise self restraint and comply with their commitments. The only difference in this case is that the new instrument is linked with a wider system that has proven successful so far and therefore carries an inherent incentive for compliance.

\textsuperscript{55} Case C-8/74 *Procureur du Roi v Benoît and Gustave Dassonville* [1974] ECR p 837. para 5.

\textsuperscript{56} This may change since the Commission has issued a reasoned opinion to the Czech Republic in May 2010 for breaching of EU public procurement rules by not opening up the procurement process for the acquisition of four military tactical transport aircraft to EU wide Competition. If the Commission is not satisfied by the response of the Czech authorities then it may decide to institute proceedings before the European Court of Justice. See “Public Procurement: Commission Calls on Czech Republic to Respect Public Procurement Rules” IP/10/501, Brussels, 5 May 2010.
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Dr Georgopoulos is Lecturer in European and Public Law at the School of Law of the University of Nottingham. He is also Advocate, member of the Athens Bar, registered at the Athens Court of Appeal and Head of the Research Unit for Strategic and Defence Procurement of the Public Procurement Research Group (PPRG). (http://www.nottingham.ac.uk/pprg/units/defstratprocurement.aspx). Dr Georgopoulos was also a visiting scholar at the Law School of the University of Michigan for the academic year 2009-2010 after having received a Grotius Fellowship from the Center for Comparative and International Law of the University of Michigan Law School.

Dr Georgopoulos has acted as expert advisor and consultant to a number of national authorities of EU Member States, International Organisations and national authorities of other countries in the framework of European Union’s CARDS capacity building program -on the review of their domestic public procurement legislation. Moreover he has been an expert advisor to the World Bank, the European Central Bank and the USAID Millennium Challenge in capacity building projects as well as comparable public procurement programs of the Organization for Economic Cooperation and Development (OECD) for the countries of the EU’s Sixth Enlargement.

He has published a number of articles and book chapters on aspects of European Union Law, public procurement and defence procurement. He has been an invited speaker at various conferences in Europe, Asia, North and Latin America. Dr Georgopoulos has given lectures on European Union Law and Public Procurement Law at Universities in the United States, China, Turkey and Malaysia. He is also member of the editorial board of the Public Procurement Law Review. Currently he is working on a monograph that examines the European defence market integration process. Moreover Dr Georgopoulos received a grant from the British Academy for the aforementioned project.

Dr Georgopoulos read law at the Kapodistrian University of Athens, in Greece and the Catholic University of Leuven (ERASMUS), in Belgium. He read for a PhD at the Law School of the University of Nottingham after having been awarded with a doctoral scholarship by the same academic institution. His PhD thesis on aspects of European Integration was awarded a special distinction by the European Group of Public Law.