

A new chapter for EU defence coordination – PESCO finally on the way

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On 11 December 2017, a Council Decision finally established the Permanent Structured Cooperation (*PESCO*) in defence. The Council Decision was ultimately approved by 25 Member States, less than a month after a joint notification by the ministers of 23 Member States on their intention to participate. Along with the Council Decision, the participating Member States published an initial list of collaborative PESCO projects. These include research, procurement and upgrade projects regarding a variety of sectors, including prototypes for infantry vehicles, autonomous maritime surveillance systems and mine countermeasures, cyber security, radio and indirect fire support solutions, logistic hubs, operational support, military mobility measures and the establishment of a European Medical HQ, as well as training centres. The pending implementation of PESCO for European defence projects raises a number of questions. We will focus on the effects on future defence procurement.

Although the legal basis for PESCO was already established through the Lisbon Treaty in 2009, it took years of deliberation at various levels to finally produce tangible results. Achieving this milestone was substantially aided by two far-reaching events in 2016: the US election victory of Donald Trump and the British vote in favour of Brexit. President Trump publically calling NATO “obsolete” during his election campaign and the prospect of Britain’s impending EU-withdrawal sharpened Europeans’ awareness of the growing need to pull their own weight in relation to the security and defence sector. The speed of the consultation process increased further, as London no longer acted as an impediment to further harmonisation of the EU’s common defence policy.

Enhanced coordination or a move towards a European defence procurement regime - What is PESCO?

PESCO intends to reduce the fragmentation and inefficiencies of national defence expenditure and to increase defence spending within the EU. It thus attempts to establish common principles and binding commitments to enhance defence cooperation between Member States and to spend public funds more efficiently on joint defence capabilities. To achieve these aims, the framework of PESCO includes stipulations on the governance, coordination and funding of defence projects within the limits set out by the Treaty on European Union.

Participation in PESCO itself is voluntary for Member States. However, PESCO-participants have to assure that their “*military capabilities fulfil higher criteria*” and that they

will make “*more binding commitments with a view to the most demanding missions and operations*”, including a commitment to increase their defence investment expenditure to 20% of their total defence spending. Countries set to participate are Austria, Belgium, Bulgaria, Czech Republic, Croatia, Cyprus, Estonia, Ireland, Finland, France, Germany, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden. Denmark, Malta and the UK will not take part in PESCO, although they have the option to join at a later stage.

In its current form, PESCO does not comprise a new procurement regime for EU defence projects. Instead, it provides methods for an increased coordination within the existing legal framework. Capability development projects, in particular, will remain the sole responsibility of Member States. However, in order to promote defence cooperation within the EU, PESCO will make use of established mechanisms such as the Coordinated Annual Review on Defence (*CARD*) and the Capability Development Plan (*CDA*), two instruments for identifying, analysing and prioritising current and future defence-related capability needs. Similarly, it will rely on existing institutions, such as the European Defence Agency (*EDA*) and the recently created European Defence Fund (*EDF*). In addition, PESCO intends to promote the interests of small and medium-sized enterprises (*SMEs*) within the European defence industry by reserving a part of the overall budget for projects involving the cross-border participation of SMEs.

What role will the EDF play?

The EDF’s funding support is a central part of the principles set out by the participating Member States. The EDF consists of two separate strands, referred to as a research and a capability window. Overall, the fund’s initial annual budget of EUR 590 million is set to gradually rise to EUR 5.5 billion after 2020. The Council Decision on PESCO envisages the EDF’s intensive involvement in joint and collaborative research, development and acquisition projects.

As intended by the participating Member States, the EDF contribution to PESCO shall primarily involve in projects with “EU added value”, i.e. projects that involve the EU defence industry. Therefore, grants will only be available for projects with at least three participants from at least two Member States. Moreover, only contractors established in the EU and effectively controlled by Member States or their nationals are eligible for funding. EDF beneficiaries and their subcontractors shall primarily use EU-based infrastructure, facilities, assets and resources. Similarly, companies with non-EU majority-owners shall not receive grants at all. It remains to be seen whether these rules are in accordance with EU and international law.

What opportunities does PESCO offer?

PESCO commitments by Member States offer significant business opportunities for defence contractors. If implemented successfully, PESCO will lead to larger contract volumes through an increase in joint multinational procurement projects. In addition, binding commitments will act as a stimulus to national defence expenditure. From a production perspective, standardised requirements and common principles may lead to cost advantages through economies of scale. Furthermore, multinational procurement projects render the specific defence needs of smaller Member States more enticing for potential bidders, as harmonised requirements may eliminate the need for adaptation to national particularities. EDF funding might also motivate Member States to increase their own defence spending.

What are the risks for defence contractors?

With PESCO underway, several challenges for defence contractors lie ahead. In the medium term, an increase in joint and cooperative multinational procurements should be anticipated. From a legal perspective, multinational projects entail a range of potential risks regarding applicable national law and jurisdiction. An increase in contract volume may be accompanied by an elevated risk of challenges by competitors under public procurement law. However, there may be an easy way out of public procurement regulation for Member States: as EU procurement law provides exemptions from tender procedures for joint defence projects regarding fundamental research, applied research and experimental development, Member States might collaborate in order to avoid national tendering requirements entirely. Member States might also increase their leverage over potential bidders by employing joint or collaborative procurement projects. Additionally, the yet-to-be-established harmonised governance rules might entail further risks. Project synchronisation and coordination between Member States might lead to substantial and costly delays.

As both PESCO and the EDF intend to strengthen the European defence industry, there is also a significant risk of discrimination against non-EU contractors. General conditions for the participation of non-EU States in individual projects are yet to be established. It is likely that third country contractors will have to consider joint ventures with European companies in order to benefit from funding through the EDF. Conversely, both PESCO and the EDF might even end up playing into the hands of President Trump's "America First"-policy, as they provide a justification for implementing reciprocal protectionist measures against EU-based companies.

What are the next steps?

Following the Council Decision of 11 December 2017 and the initial project list provided by the 25 participating Member States, the Council will likely adopt further decisions on several key issues. These include the final adoption of the initial project list, which is

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expected for early 2018, the implementation of a common set of project governance rules and in particular the establishment of conditions for third State participation in PESCO projects. Therefore, the details of PESCO may still be subject to future changes. Additionally, the commitments of individual participants may still be adapted to the evolving security environment.

BLOMSTEIN will monitor and inform about any significant developments. If you have questions regarding the potential impact on your company or sector, [Roland Stein](#) and [Pascal Friton](#) will be happy to answer your questions at any time.