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# COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

## on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives

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The purpose of this Communication from the Commission is to report on the contributions by stakeholders to the consultation launched by the Green Paper on defence procurement[1]. Commission also presents the actions it intends to take as a follow-up to the Green Paper.

## I. BACKGROUND

### 1. Political context

In connection with the development of the European Security and Defence Policy (ESDP), Member States have started to use the European Union as a framework to improve the coordination of military capabilities, achieve better cost-effectiveness of defence expenditure and enhance the competitiveness of the European industrial and technological base in the area of defence. The establishment of the European Defence Agency (EDA) in July 2004 was an important step towards achieving these objectives.

In March 2003, in parallel with the Member States' efforts, the European Commission launched an initiative towards a common European Defence Equipment Market (EDEM)[2], which included a number of actions in areas where the Community has competence (for example procurement, intra-Community transfers, standardisation, research).

The activities in the field of defence procurement are thus part of an overall initiative, being carried out at both Community and intergovernmental level.

### 2. Defence market characteristics

Defence equipment markets are specific markets.

Member States' combined defence budgets are worth about EUR 169 billion, which includes around EUR 82 billion for procurement. 85% of defence spending and 90% of the EU's industrial capabilities are concentrated in the six major arms-producing countries[3].

Defence markets cover a broad spectrum of products and services, ranging from non-war material, such as office material and catering, to weapon system and highly sensitive material, such as encryption equipment or nuclear, biological and chemical equipment (NBC). Many weapon systems are complex and integrate sophisticated technologies. Developed for the specific demands of a very small number of customers, they often have long development and life cycles and high non-recurring costs. This, in turn, makes it necessary for governments of producing countries to bear an important part of research and development costs. The sensitivity of defence equipment for Member States' security interests can vary depending on

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1 COM (2004) 608, 23 September 2004

2 Communication of the Commission "Towards an EU Defence Equipment Policy", 11 March 2003.

3 UK, FR, DE, IT, ES, SV

political and military circumstances. In general, however, its sensitivity is proportional to its technological complexity and strategic importance.

Due to the specificities of many defence products, governments play a predominant role both as customers and regulators. At the same time, they maintain a traditionally close relationship with their suppliers, with confidentiality and security of supply being particularly important features.

Since the organisation and operation of defence markets are closely related to the security and defence policy of Member States, defence markets in the EU remain fragmented at the national level. Fragmentation is in fact the main feature of both Europe's demand side (25 national customers) and its regulatory framework (25 different sets of rules and procedures).

## 3. The legal framework on defence procurement and its application

Public procurement law, and especially its application, is also an important feature of the market fragmentation in Europe. The Green Paper and the present Communication are focused on this particular aspect of the problem.

According to existing EU law, defence contracts fall under internal market rules. Thus, Directive 2004/18/EC[4] for public procurement of goods, works and services ("the PP Directive") applies to public contracts awarded by contracting authorities in the field of defence, subject to Art. 296 of the Treaty ("Article 296"[5]). The latter allows Member States to derogate from Community rules for the procurement of arms, munitions and war material if Member States' essential security interests are concerned. By contrast, the contracts for the procurement of items other than arms, munitions and war material, as well as for arms, munitions and war material not concerning essential security interests, are covered by Community rules.

However, since the concept of essential security interests is rather vague, implementation of Article 296 has been always very difficult. Under paragraph 2 of that article, a list of arms, munitions and war material covered in principle by the derogation was adopted by the Council in 1958. However, this list is rather generic, and it is therefore not always clear which rules should apply to which defence contracts.

At one end of the spectrum, non-war material is not included in the list based on Article 296 and (normally) does not concern essential security interests; as a result, the PP Directive applies. At the other end, highly sensitive defence equipment is included in the list of 1958 and clearly concerns essential security interests; in these cases, the use of Article 296 is legitimate. However, Member States also procure equipment which has the specific features

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[4] Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts. As from 31 January 2006 this Directive will replace Directives 92/50/EEC, 93/36/EEC and 93/98/EEC. The exception concerning Article 296 will remain unchanged in substance.

[5] According to paragraph 1 of that Article: *"(a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security; b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes."*

of defence material but which is not (necessarily) essential for their security interests. This category forms a major "grey area" where the use of Article 296 is less clear.

In practice, most Member States make almost automatic use of the possibility of exempting nearly all defence procurement contracts from Community rules, often without taking into account the conditions defined by the Treaty and the Court for the use of Article 296[6]. The rate of publication by Ministries of Defence amounts to only 10%, while the average publication rate of central governments is about 20% (25% excluding defence)[7]. As a consequence, most defence contracts are awarded on the basis of national procurement rules, which have widely differing selection criteria, advertising procedures, etc. Member States do this partly because they consider the PP Directive not always suited to the procurement of defence material.

It is generally acknowledged that the fragmentation of national procurement rules and their practical application have the effect of limiting transparency and competition on defence markets. This, in turn, has brought negative consequences for the efficiency of public spending, for Member States' military capabilities and, finally, for the competitiveness of Europe's Defence Industrial and Technological Base (EDITB).

The Green Paper sought to identify options for action at the Community level in order to improve this situation.

## 4. The Green Paper

From January to April 2004, the Commission organised several workshops with government experts and industry representatives in order to collect technical information for the preparation of the Green Paper and to determine the expectations of the various parties concerned.

On 23 September 2004, the Commission adopted the Green Paper and launched the public consultation, inviting all interested parties to comment on how to improve the EU Defence Procurement Regulation. The Green Paper put forward proposals for those parts of the market which are not covered by Article 296 and thus come under Community rules.

The Commission suggested two possible Community initiatives:

- An interpretative communication, clarifying the existing law and in particular the principles governing the use of the derogation in Article 296.

- A directive providing new, more flexible rules for the procurement of arms, munitions and war material not concerning essential security interests. These new rules should take into account all the specificities of such defence contracts.

The two solutions were presented as not being mutually exclusive. Moreover, the Commission has made it clear that, in every possible scenario, Member States would always have the right to invoke Article 296, provided that the conditions established in the Treaty (and confirmed by the case law of the ECJ) are strictly met.

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6 See *Johnston*, case 222/84; *Commission v. Spain*, case C-414/97

7 Source : TED data base

At the same time, the two options would only concern defence procurement by national authorities inside the European internal market. Arms trade with third countries would continue to be governed by WTO rules, and in particular by Article XXIII of the Government Procurement Agreement (GPA), which allows Members to derogate from the Agreement itself, when essential security interests are at stake.

## II. THE RESULTS OF THE CONSULTATION

### 1. Participation

During the six-months consultation period, a series of bilateral meetings, seminars and working group meetings were held which allowed the Commission to explain its initiative and to gain a clearer idea of stakeholders' interests and concerns. At the end of the consultation, the Commission had received 40 contributions from 16 Member States, Institutions and industry[8]. Given the sensitivity of the issue and the relatively small number of actors involved, the Commission considers this to be a good level of participation.

### 2. Opinions

The contributions all welcomed the Green Paper and supported the objective of the Commission to contribute to overcoming market fragmentation and to increasing intra-European competition via an appropriate set of rules for defence procurement.

The vast majority of stakeholders shared the Commission's assessment of the Green Paper. They acknowledged the widespread misinterpretation of Article 296 and considered the existing PP Directive often ill-suited for defence procurement, despite the recent adaptations. The main obstacles mentioned were the following:

- open tendering procedures based on publication in the Official Journal of the European Union are not compatible with confidentiality requirements;
- the use of negotiated procedure - which is the only appropriate procedure - is too restricted and not properly defined;
- the selection criteria are based solely on technical, economical and financial aspects, and key conditions for selecting tenderers in the defence sector - such as security of supply, confidentiality and urgency - are missing;
- the rules on technical specifications, time limits and follow-up contracts are inappropriate.

Almost all stakeholders supported a Community initiative in the field of defence procurement and ruled out the "no action" option. As for the instruments presented as possible solutions, stakeholders expressed a variety of opinions:

[8] All the contributions received are published in their original language, see http://www.europa.eu.int/comm/internal_market/publicprocurement/dpp_en.htm

*2.1 Interpretative Communication*

(1) **A majority considered an Interpretative Communication to be useful. The arguments put forward in favour of an interpretative communication are as follows:**

- As a non-legislative measure, it could be prepared quickly;
- By spelling out in detail the principles defined by the Court for the use of Article 296, it could reduce the risk of legal misinterpretation and thus ensure better application of existing law by Member States (and more regular use of tendering procedures);
- Absent any further legislative action, the Commission would have a clearer and stronger legal basis for applying procurement rules.

(2) **Only a minority of stakeholders were sceptical about or opposed to a communication. The arguments against a communication are the following:**

- As it would do nothing to change the existing legal framework, it would not contribute to a more homogeneous regulatory framework.
- The principles defined by the Treaty and the relevant case law are sufficiently clear and should be well-known to all stakeholders; additional clarification is therefore unnecessary.
- A communication would clarify only how Article 296 is to be used, but it would not be able to specify for which contracts, since it could neither clarify the concept of essential security interests nor elaborate on the list of 1958 (both of these actions fall under the Member States' prerogatives). The uncertainty about the scope of Article 296 would thus remain.
- The decision on whether or not defence contracts concern essential security interests is a political rather than a legal one. A purely legalistic and rigid approach to a problem of political definition might create even greater confusion and increase the number of legal disputes on the borderline of Article 296.
- An Interpretative Communication would not dispel Member States' reluctance to use the existing PP Directive for defence procurement. Its impact in terms of transparency and competition would therefore be limited mainly to non-war material. This might generate some cost savings at the margins of defence markets, but would miss the main target of the initiative (i.e. to enhance the cost-effectiveness of defence markets and the competitiveness of the EDITB).

*2.2 Defence Directive*

The general picture with regard to a defence directive is more complex:

(1) **A majority of stakeholders found that a defence directive would be useful. Its main advantages would be the following:**

- By coordinating national rules in certain parts of the defence markets, a directive would contribute to a more homogeneous regulatory framework in the EU;
- As it is legally binding, a directive would have the capacity to enhance transparency, non-discrimination and equal treatment in certain parts of the defence market.
- It could offer new, more flexible and more suitable rules for procurement of defence contracts, which are not covered by Article 296 and for which the existing Directive may be too rigid and inappropriate.
- It could take into account the specific features of defence contracts which are not addressed or not adequately dealt with by the current PP Directive, such as:
  - An appropriate centralised system of publication;
  - General use of the negotiated procedure (which would allow contracting authorities, after a call for tenders, to consult and negotiate contract terms with the selected companies);
  - Scope for contracting authorities to use the negotiated procedure without prior publication of a tender notice in certain defined cases, such as urgency for military purposes;
  - New specific selection criteria to be applied in assessing tenders, such as confidentiality and security of supply;
  - Clauses to ensure adequate competition throughout the supply chain, in particular to improve market access for SMEs;
  - Clauses to harmonise offset practices.
- A Directive would not remove the difficulty of defining the borderline of Article 296, but it could be flexible enough to become a credible alternative to national procedures. In this case, the Directive could defuse the issue of choosing between Community rules and Article 296.

(2) **Among those who find the Directive useful, however, there are varying opinions as regards timing and conditions:**

- some stakeholders suggested that the work should be started;
- others favoured waiting to see whether or not the clarification of current legislation is sufficient;

- some argued that political and economic conditions in other areas (for example, the structure of the industrial base, or the mentality of buyers) must be met in order to create a level playing field for non-national suppliers before starting work on a directive;

- others argued that work on the directive could serve as a catalyst for reforms in these related areas.

(3) **Only a few stakeholders were explicitly against a directive, and put forward widely differing arguments:**

- As a legislative measure, it is unlikely to be achieved quickly;

- The existing Directive is sufficiently flexible and there is therefore no necessity for a new legislative instrument that would add extra regulation;

- It would have only a limited impact, either because it would take too long to be developed and implemented, or because it would not apply to high-value contracts (which usually concern essential security interests and would therefore remain covered by the Article 296 derogation);

- It would create three separate procurement processes with new boundaries between the various market segments. This could involve a limitation of the right to use Article 296 and make it difficult to demarcate the respective scope of the civil and the defence Directives.

To sum up, even if it is very difficult to draw a general conclusion or a single general trend, it does appear that a majority of stakeholders are in favour of an interpretative communication, and not against a directive. There is some disagreement about the timing of the latter.

Preferences for an interpretative communication or a directive, also as far as timing is concerned, do not follow the traditional dividing lines between big and small, producing and non-producing Member States. The same is true for industry, with differences being seen between European and national associations and between defence industry associations and non-defence industry association. The European Parliament expressed clear support for a comprehensive approach combining an interpretative communication and a new directive adapted to the specificities of defence (combined with the development of an intergovernmental code of conduct - see below).

All stakeholders asked the Commission to be closely associated with and to participate actively in the development and implementation of the solutions they support.

## 3. Broadening of the debate

During the consultation period, several stakeholders put forward options beyond those mentioned in the Green Paper.

- Many saw a need for greater transparency and competition, including in the area covered by Article 296. Partly as a response to this, Ministries of Defence mandated the European Defence Agency (EDA) to explore the possibilities of drawing up an intergovernmental Code of Conduct to foster intra-European competition in this area of the market too. Such a

Code would be a political but not a legally binding instrument, which would complement Community instruments and pursue the same objective in a different segment of the defence market. It could also include a notification system on the use of Article 296.

- Others considered an intergovernmental instrument as an interim solution/intermediate step on the way to a Community directive. Although the two instruments would cover different market segments, it would be advisable, from this point of view, to foster the convergence of national procurement policies before coordinating national procurement rules.

- Some, however, believe that an intergovernmental instrument of this kind can be an alternative to Community initiatives. From this point of view, a directive would only be acceptable if the Code proved ineffective.

In addition, almost all stakeholders underlined that procurement was just one aspect of an EDEM construction. They highlighted the necessity for any Community initiatives in the field of procurement law to be accompanied by actions in other areas; this was seen as a necessary precondition for an efficient internal defence market and for the creation of a level playing field for industry. In this context, stakeholders mentioned arrangements for security of supply, transfers and transits, harmonisation of export policies, state aid, offset practice and the full privatisation of all European defence firms.

Stakeholders also expressed their concerns about the conditions of access to the EU market, particularly in view of the unbalanced situation with certain third countries. They expected all measures taken at EU level to favour reciprocal access, in particular with the US, and stressed the need to strengthen the competitiveness of EU industries on world markets.

## III. COMMISSION ASSESSMENT AND FUTURE INITIATIVES

The whole consultation process shows that the current legislative framework on defence procurement is not functioning properly, in practice, for the different reasons listed above. The appropriate initiatives therefore have to be taken, in order to improve a situation which is almost unanimously regarded as unsatisfactory. The Commission is ready to play its role in pursuit of this objective.

(1) On one hand, the dividing line between defence acquisitions concerning essential security interests according to Article 296 and defence acquisitions which do not concern essential security interests is not clear, or at least is not perceived in the same way by all Member States. As a consequence, the application of the derogation remains problematic.

The Commission will therefore adopt in 2006 an "Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement." This Communication will recall the principles governing the use of the derogation, in the light of the case law of the Court of Justice, and will clarify the criteria on the basis of which Member States have to decide when the conditions for the application of the derogation are met and when they are not.

While providing additional legal certainty and guidance for Member States, an Interpretative Communication will not alter the current legal framework. It will simply clarify the existing one, with the objective of making its implementation more uniform.

In line with the principle of better regulation, the Interpretative Communication will be accompanied by a proportionate impact assessment, aimed at verifying whether it is actually likely to bring benefits.

As the Interpretative Communication will also concern issues related to free movement of goods, it could have further consequences e.g. on intra-EU transfers for defence goods. This will be duly taken into account in the drafting of such Communication.

(2) On the other hand, a simple clarification may be insufficient. The consultation also confirmed that the current PP Directive, even in its revised version, may be ill-suited to many defence contracts, since it does not take into account some special features of those contracts.

The Commission therefore considers that a directive coordinating national procedures for the procurement of defence goods (arms, munitions and war material) and services, would be the appropriate instrument to improve the situation described. This directive could take into account all the specific needs of defence procurement, and offer new, more flexible rules for defence procurement, to be followed in cases where the derogation in Article 296 does not apply.

In accordance with the principle of better regulation, such a directive will also be subject to the results of the relevant impact assessments, which will be completed in 2006, prior to the presentation of a possible proposal.

The Commission will also follow with great interest the development of the Code of Conduct under preparation by the EDA. This code, voluntary and non binding would aim at increasing transparency and competition also in a different segment of the market, since it would apply in cases where the conditions for the application of Articles 296 are met. This kind of intergovernmental initiative would usefully complement the initiatives taken at Community level.