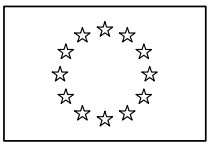

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23.09.2004
COM(2004)608 final

GREEN PAPER

Defence procurement

(presented by the Commission)

CONTENTS

INTRODUCTION 3

I. REASONS FOR ACTION IN THE FIELD OF DEFENCE PROCUREMENT 3

1. Fragmented defence markets 4

2. Specific features of defence markets 4

2.1 Dominant role of the state 4

2.2 Security of supply and confidentiality requirements 4

2.3 Complexity of arms acquisition programmes 5

3. Limits to the existing legal framework 5

3.1 Community exemption system 5

3.2 Differing national legislation 7

3.3 Special procedures for cooperation programmes 8

II. DEFINING ACTION AT EU LEVEL – ISSUES FOR CONSIDERATION 8

1. Clarification of the EU's existing legal framework 9

2. Supplementing the EU's legal framework with a special instrument 9

2.1. Objectives 9

2.2 Content 10

CONSULTATION ARRANGEMENTS 12

INTRODUCTION

This Green Paper is one of the measures announced by the European Commission in its Communication "Towards a European Union defence equipment policy", adopted on 11 March 2003[1]. Through these measures, the Commission intends to contribute to the gradual creation of a European defence equipment market (EDEM) which is more transparent and open between Member States and which, whilst respecting the sector's specific nature, would increase economic efficiency.

Moving towards a truly European market is crucial for strengthening the competitiveness of European industry, improving the allocation of defence resources and supporting the development of the Union's military capabilities under the European Security and Defence Policy (ESDP).

The establishment of the European Defence Agency with its responsibilities in the field of defence capabilities, research, acquisition and armaments, makes the development of such a market even more important.

Creating an EDEM would require a set of complementary initiatives, including the establishment of an appropriate regulatory framework for the procurement of defence equipment. The opening up of defence markets, which are currently fragmented along national lines, would increase the commercial opportunities for European companies in the sector, including SMEs, and contribute to their growth and increase their competitiveness.

The purpose of this Green Paper is to develop the debate on these issues, bearing in mind the principle of subsidiarity[2]. For this purpose the Commission set up two working parties consisting of representatives of the Member States and European industry to contribute to the preparatory stages of the Green Paper.

In the first part, the Green Paper identifies the reasons for specific action by giving a summary of the current state of defence procurement markets, their numerous special characteristics and the existing regulatory framework. In the second part, on the basis of this analysis, it considers possible lines of action.

I. REASONS FOR ACTION IN THE FIELD OF DEFENCE PROCUREMENT

Defence expenditure constitutes a large part of Member States' public spending, to the order of €160 billion for the 25 Member States, one fifth of which is used for the procurement of military equipment (acquisition plus research and development)[3].

Defence procurement is currently characterised by the fragmentation of markets along purely national lines (point 1), by the specific features which distinguish it from other types of public procurement (point 2) and by a complex legal framework (point 3).

---

1 COM(2003) 113 final.

2 Work of the Council Working Party on Armaments Policy (POLARM), the Western European Armaments Group (WEAG), and the *Agency Establishment Team* responsible for establishing the European Defence Agency.

3 Sources: NATO (North Atlantic Treaty Organisation) and SIPRI (*Stockholm International Peace Research Institute*) 2002.

1. FRAGMENTED DEFENCE MARKETS

Although Member States' combined military expenditure is considerable, it remains split into national markets. This fragmentation poses a major problem for all Member States with defence industries. Following budgetary reductions and the restructuring of the armed forces, the size of national markets – including those of the large states – is no longer sufficient to allow for production volumes that can offset the high R&D costs of arms systems. This situation, along with the fragmentation of R&D spending in Europe, increases the cost to the taxpayer and damages both the competitiveness of the European defence industry and its ability to meet the requirements of the ESDP. Given the growing dual use potential of technologies (military and civilian), the global competitiveness of European industry is also affected.

Some progress has been made in the last ten years, particularly as a result of the increase in European armaments cooperation and an initial opening-up of national markets to European competition. These initiatives have had modest success, but have not resulted in the creation of a European defence market. As regards cooperative programmes, the still frequent use of the principle of fair return on investment ("juste retour") generally limits any opening-up to the participating countries and implies a distribution of work based on purely national industrial policy criteria. As for national procurement, the share of contracts awarded by competitive procedure is still low. Irrespective of the procedures used, national suppliers are still generally awarded most of the contracts.

2. SPECIFIC FEATURES OF DEFENCE MARKETS

Defence markets have particular characteristics because of the very nature of military products and related services. These characteristics are not only economic and technological; they are also related to the security and defence policies of each Member State[4]. Defence industries are therefore of a strategic nature and have special relations with the state.

2.1 Dominant role of the state

Following privatisations and efforts to optimise procurement policies in recent years, the role of the state has been reduced, but it still remains dominant. As sole clients, states determine demand for products on the basis of military needs linked to their strategic objectives and thus define the size of the market. They participate, to varying degrees depending on the country, in the financing of R&D, thus influencing the technological know-how and long-term competitiveness of industry. As regulators, they control the arms trade by means of the licences which exporters must have, including for the delivery of equipment within the European Union, and the granting of authorisations to tender for contracts. State control also extends to industrial restructuring, although to a more limited degree, and even to the level of shareholding.

2.2 Security of supply and confidentiality requirements

The nature of defence requires sources of supply to be guaranteed for the entire duration of an arms programme from the time the equipment is designed until it is withdrawn from service,

[4] See the document of the POLARM Working Party of the Council, annexed to communication COM(1997) 583 of 4.12.1997.

at times of peace and at times of war. States may, therefore, see fit to set up special supply guarantees. The maintenance of a purely national industrial capacity for defence may seem a reliable way of being able to respond to strategic interests and emergency situations (military operations).

The nature of defence may also require states to have equipment that guarantees the technological superiority of their military forces. This superiority depends, in particular, on the confidentiality of programmes and their technical specifications. The obligation to protect this confidential information means companies must have special national security clearances.

2.3 Complexity of arms acquisition programmes

Arms development programmes are complex. Since production volumes are limited and the risk of commercial failure high, state support is required. Equipment often consists of new systems which incorporate both military and civilian technologies. It has also a long life cycle: the time between the expression of an operational need and the end of a system's life may be as long as 50 years. The quality/price ratio and risk management must be guaranteed throughout this period. States must, therefore, have access to adequate industrial and technological capacity throughout the life cycle of a system and maintain lasting, reliable relations with suppliers.

In addition to this, "off-the-shelf[5]" arms purchases are often subject to offset arrangements. This allows the purchasing country to require a return on investment that may exceed 100% of the value of the contract. Such offsets may be direct, in the form of orders for local companies or transfers of know-how and technology related to the original contract. Offsets may also be indirect and concern industrial sectors other than the one covered by the contract in question, even non-military ones.

3. LIMITS TO THE EXISTING LEGAL FRAMEWORK

3.1 Community exemption system

The special nature of the defence sector has been recognised ever since the establishment of the Community through an exemption system laid down in Article 296 EC of the Treaty. 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;

[5] Finished equipment already developed and available for purchase.

(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."[6]

Given its wide scope, this article may also apply to public procurement.

As recently clarified in Article 10 of Directive 2004/18/EC, Community rules on public procurement apply to contracts awarded by the awarding authority in the field of defence, subject to Article 296 EC of the Treaty. Consequently, Community rules also apply in principle to the defence sector, but Member States may derogate from them in the circumstances and subject to the conditions set out in the Treaty. In any event, the possibility of a derogation provided for under Article 296 EC cannot apply either to civilian goods or to those not intended for specific military purposes, even if they are purchased by national defence ministries.

The Case Law of the Court has interpreted the conditions of use of this derogation restrictively, stating that[7] :

– its use does not constitute a general, automatic exemption, but should be justified case by case. States thus have the possibility of secrecy regarding information which would undermine their security and the option of invoking an exemption to internal market rules for the arms trade. They are also obliged to assess whether or not each individual contract is covered by the derogation;

– use by states of national derogation measures is justified only if it is necessary for achieving the objective of safeguarding the essential security interests invoked;

– burden of proof lies with a Member State that intends to make use of the derogation;

– such proof is to be supplied, if necessary, to the national courts or, where appropriate, the Court of Justice, to which the Commission may refer the matter in the performance of its duties as guardian of the Treaty.

As a general rule, Member States may, therefore, derogate from the rules of the Treaty and Community directives, but only in well defined circumstances. Nevertheless, several difficulties of implementation arise:

– in the absence of a precise interpretation of these provisions, there is quasi-systematic use of the derogation in the area of public procurement. Despite the Court's clarifications, the low number of publications in the Official Journal of the European Union appears to imply that some Member States believe they can apply the derogation automatically;

---

6 In accordance with paragraph 2 of this Article, a list of products to which the provisions of paragraph 1 apply was adopted by the Council in 1958.

7 See among others: Johnston judgment, Case 222/84, Commission v. Spain judgment, Case C-414/97. Although the latter concerned VAT, it is applicable to public procurement.

– since the concept of essential interests of security is not defined either in Community Law or in the Case Law of the Court of Justice, in practice states allow themselves wide discretion in determining which contracts could damage them;

– the list drawn up in 1958[8] is not an appropriate reference for defining the scope of Article 296 EC, since it has never been officially published or revised since then.

Defence procurement is still, therefore, to a large extent covered by purely national legislation.

3.2 Differing national legislation

For defence procurement most national legislation provides for exemptions to the application of public procurement rules, with differing degrees of transparency. This constitutes a potential difficulty for non-national suppliers.

- The **publication of contract notice**, if it happens at all, is in special national publications, the content, frequency and method of dissemination of which vary from state to state.

- The potential for **non-publication** provided for in national legislation is vast and differs depending on the country.

- **Technical specifications** are often very detailed and based on widely differing standards.

- The **criteria for selecting** suppliers take into account, in some states, the ability of offering industrial offsets, and for most states, confidentiality and security of supply, the definition of which remains vague and the assessment of which does not take account of the same requirements, sometimes referring to the origin of the product or the nationality of the supplier.

- **Tendering** is mainly through negotiated procedures which do not all follow the same rules, particularly as regards the extent of the negotiations and the possibilities for changing the subject of the contract.

- In the **award** of contracts priority is given to best value for money. However, in some states security of supply and offsets are again taken into account at this stage.

Because of these obstacles some Member States have undertaken, under an inter-governmental political agreement of the Western European Armaments Group (WEAG)[9], to harmonise the content and publication of their national gazettes and to follow more open tendering rules. Although based on relevant principles, this system has produced limited results regarding both transparency and competition, because it is not legally binding.

---

[8] See Footnote 6.

[9] The 16 member countries, including 14 EU Member States (BE, DK, DE, EL, ES, FR, IT, LU, NL, PT, UK, AT, FI, SE), adopted guidelines on open competition in 1990 and updated them in 1999.

3.3 Special procedures for cooperation programmes

Alongside national systems, *ad hoc* rules laid down in intergovernmental agreements are used for purchases related to joint arms programmes[10]. Generally speaking, because of the heavy investment agreed by the countries participating in these programmes, it is the principle of fair industrial return ("juste retour") that determines who is awarded the contract.

To offset the high costs resulting from this practice, the transnational agency OCCAR[11] was set up in 1996 and given legal personality in 2000. Its contractual rules are more competition-based and provide for replacing the system of a "juste retour" per programme by an "overall juste retour" covering several years and several programmes. However, the success of this system will depend on the number of new programmes managed by OCCAR.

Since these efforts have failed to achieve satisfactory results, the Member States recently created a European Defence Agency under the authority of the Council within the single institutional framework of the European Union, which will have the remit, among other things, to contribute, in consultation with the Commission, to the setting up of a competitive European defence market[12].

II. DEFINING ACTION AT EU LEVEL – ISSUES FOR CONSIDERATION

The above considerations relating to defence procurement show that a number of obstacles limit the access of European industries to Member States' defence markets and hence restrict their growth opportunities.

The Commission therefore proposes pursuing the debate on the case or Community action in the field of defence procurement. So far the Commission has identified two possible instruments, one limited to clarifying the existing legal framework (point 1) and the other aimed at establishing specific rules in the field of defence, taking into account the sector's characteristics (point 2).

These instruments would not prejudice any complementary measures taken by the Member States in the appropriate fora. Indeed, they could not provide exhaustive answers to all the specific aspects of defence markets. This is the case in particular for security of supply, a concept bound to change with the growing convergence of national security interests in the context of European foreign, security and defence policy. The gradual development of a common approach in this field could facilitate application of Community instruments. Equally, these instruments would constitute a useful tool for the success of cooperation between Member States.

---

[10] These contracts are usually awarded by ad hoc agencies or NATO agencies acting on behalf of the states participating in the programmes in question.

[11] Joint Organisation for Armaments Cooperation; open - subject to certain conditions - to all the Member States; at present only five states belong to it (DE, BE, FR, IT, UK).

[12] Joint action to set up a European Defence Agency (EDA) adopted by the Council on 12 July 2004.

1. CLARIFICATION OF THE EU'S EXISTING LEGAL FRAMEWORK

The legal framework could be clarified by a non-legislative instrument, such as an interpretative Communication from the Commission. This instrument would aim to explain existing Community legislation in order to facilitate application by the competent authorities and to improve the operators' understanding of it. An interpretative Communication could be adopted relatively quickly. By its very nature it could only confirm existing law.

The Commission would give a further explanation of the principles defined by the Court on the interpretation of Article 296 EC, in particular their application to public procurement, to make it easier, in practice, to distinguish between contracts covered by the exemption and those which are not. As regards the latter, the normal rules - public procurement directives- would remain applicable.

The Communication would not be legally binding as such, but it would explain the principles and rules which are. Consequently, the Commission would be obliged to abide by this interpretation in the performance of its functions as guardian of the Treaty. The Commission would also have to draw all the operational conclusions resulting from the adoption of such a clarification of existing law.

Questions

1. Do you think it would be useful/necessary/sufficient to explain the existing legal framework in the way presented?

2. Are there other aspects of the Community system in question that should be clarified?

2. SUPPLEMENTING THE EU'S LEGAL FRAMEWORK WITH A SPECIAL INSTRUMENT

2.1. Objectives

The EU's legal framework could be supplemented by a new specific legal instrument for defence procurement (goods, services and work), such as a directive to coordinate the procedures for awarding such contracts[13]. The directive would establish a special set of rules for contracts falling within the scope *ratione materiae* of Article 296 EC, but for which use of the derogation is not justified (conditions defined by the case law of the Court). It would apply to defence procurement currently falling within the scope of existing directives but it would contain rules better suited to their specific nature.

[13] This would be a similar approach to that taken in 1990 to accommodate the specific nature of procurement in the water, energy and transport sectors, by means of a special directive (which became 93/38 and was amended by Directive 2004/17/EC of 31 March 2004).

It would pursue three main objectives:

– greater legal certainty, since it would improve the classification of contracts: (a) those covered by current directives; (b) those covered by the new directive; and (c) those excluded from any Community rules;

– more information at Community level on the contracts in question, and therefore greater opening of the markets, which would allow European defence industries to participate equally in calls for tender in all the Member States;

– the introduction of the necessary flexibility for the award of these contracts by the creation of a body of rules suited to the specific features of such contracts.

Such an instrument could also serve as a reference point should a Member State decide not to make use of the Article 296 EC derogation even when it would have been entitled to do so.

2.2 Content

- The **field of application** could be determined on the basis of a general definition of the category of military equipment covered and/or a list. The list could be that of 1958 or another more accurate, updated list such as that of the Code of Conduct on arms exports[14].

- There would be a provision modelled on directives in other sectors stating that the directive would not prejudice the possibility of invoking Article 296 EC under the conditions defined by the Court. It would also identify cases in which the conditions for application of the **exemption** were clearly fulfilled (e.g. nuclear equipment).

- The **awarding authorities** would be the ministries of defence and agencies acting on their behalf and other ministries buying military equipment. Application of the directive to other bodies, such as the new Defence Agency, would have to be determined by the appropriate fora.

- Implementation of the directive would not prejudice the possibility of exemptions conferred on the Member States under **WTO** agreements such as the Government Procurement Agreement.

- The **procedures** should ensure observance of the principles of transparency and non-discrimination, bearing in mind the specific characteristics of these contracts. The rule could be general use of the negotiated procedure with prior publication of a contract notice. Use of an unpublished negotiated procedure could be envisaged in certain cases determined on the basis of exemptions laid down in existing directives and, where appropriate, other cases based on national legislation.

- **Publication** could be through a centralised system at Community level using a harmonised publication bulletin. The subject of the contract could be described in terms of technical performance in order to prevent potential discrimination between suppliers.

---

[14] Annexed to the Council Declaration of 5 June 1998 (8675/2/98, CSFP) which sets up a mechanism for transparency of arms export policies.

- The **selection criteria** approved should ensure non-discrimination and equal treatment of companies and take account of the specific features of defence contracts, such as confidentiality, security of supply. They should also take into consideration the clearance necessary under defence secrecy rules.

- The **award** of the contract would take place on the basis of defined criteria. This would require a discussion on the gradual elimination of practices such as direct and indirect offsets.

Questions

3. Do you consider the rules of existing directives suited/unsuited to the specific characteristics of defence contracts? Please give your reasons.

4. Would a specific directive be a useful/necessary instrument for creating a European defence equipment market and strengthening the industrial and technological base of European defence?

5. What is your opinion regarding the use of a possible directive for purchases by other bodies, such as the European Defence Agency?

6. Procedures: do you believe the negotiated procedure with prior publication to be suitable for the specific needs of defence procurement? In what situations should use of the negotiated procedure without publication be allowed?

7. Scope: what would be the most appropriate way of defining the field of application? A general definition? If so, what? A new list? If so, what? A combination of a definition and a list?

8. Exemptions: do you think it would be useful/necessary to define a category of products that would be excluded categorically from the directive?

9. Publication: do you think a centralised publication system would be appropriate, and, if so, how should it function?

10. Selection criteria: what criteria do you think should be taken into account in addition to those already laid down in existing directives to take account of the specific features of the defence sector? Confidentiality, security of supply, etc.? And how should they be defined?

11. How do you think offset practices should be handled?

CONSULTATION ARRANGEMENTS

This Green Paper is the start of an official consultation process lasting four months from the date of publication. It will be managed by the Internal Market Directorate-General of the Commission.

Green Paper

Consultation process

End of consultation: four months from the date of publication of the Green Paper

The parties concerned are invited to send their answers to the questions asked and any comments or suggestions to the following address:

c/o European Commission, Internal Market DG
Consultation "Green Paper on defence procurement"

Av. de Cortenbergh/Kortenberglaan 100 (1/100)

B-1049 Brussels

or by email to:

(MARKT-C3-DPP@cec.eu.int)

The Green Paper is also available at:

http://europa.eu.int/comm/internal_market/consultations

NB: Any contribution may be made public, unless the author specifically asks for it to remain confidential.