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Defence procurement in the European Union

The current debate

Report of an EUISS Task Force

Chairman and Rapporteur:
Burkard Schmitt

May 2005

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Preface

Nicole Gnesotto

Over the last few years Europe's armaments sector has witnessed important changes. In a first phase, between 1998 and 2000, industry was the driving force, engaging in cross-border consolidation and setting up a network of transnational companies and groups. This development, albeit limited to certain sectors, was remarkable, in particular since it was initiated in the absence of the appropriate political and regulatory frameworks, in response to the demands of the market.

In a second phase, from 2000 until today, the focus shifted from the supply to the demand side. Driven by the internationalisation of industry, budget constraints and the development of ESDP, governments started to intensify their cooperation and, most importantly, to use the European Union as a framework for action. Member states' efforts to improve their military capabilities as part of ESDP logically led to the establishment of the European Defence Agency, which is concerned with the whole spectrum of armaments issues. At the same time, the Commission launched its own initiative to advance towards a European Defence Equipment Market (EDEM).

The EUISS has closely followed these developments through a long series of publications and activities. The present report is the most recent fruit of that work for which Burkard Schmitt has been responsible. It gives an in-depth analysis of the various instruments to make defence procurement in Europe more efficient which are discussed today.

At first glance, the topic may appear purely technical, but the underlying questions are highly political and (potentially) have considerable financial implications. Will the EU be able to overcome, at least partially, the current fragmentation of defence markets? Will there be progress on the way to a common marketplace? And how will the latter be organised?

It is evident that it will require more than procurement rules to establish an EDEM and strengthen Europe's defence industrial

base. Common solutions in numerous areas are necessary to set up the defence economic and industrial conditions which are necessary to underpin ESDP. To achieve these solutions, member states must in particular develop a common understanding of what an EDEM and a truly European *defence industrial base should actually look like.*

Such an understanding, however, will not emerge overnight, but through a long – and, it can be expected, often painful – process. The current debate on defence procurement is one phase of this process. Hence the interest of this report, which gives an independent input to the debate and plenty of food for thought for those who will, by the end of this year, decide on how to proceed and which instrument(s) to develop. Reforms in this area are inevitably complex and cumbersome. However, if Europe wants to maintain a competitive industry and spend its scarce resources more efficiently, doing nothing is not an option.

May 2005

Introduction

In September 2004, the European Commission issued a Green Paper on Defence Procurement, proposing various options to improve transparency and openness of defence markets between EU member states.

The Green Paper opened a discussion on defence procurement law which rapidly expanded into a general debate on how to move towards a common European Defence Equipment Market. Starting point of the debate is the use of Art. 296 of the Treaty establishing the European Community (TEC), which allows member states to derogate from the rules of the Internal Market for the procurement of 'arms, munitions and war material'. Although this exemption is subject to certain conditions, most governments have interpreted Art. 296 as a quasi-automatism, excluding defence procurement almost completely from Community rules. It is generally recognised that this practice has led to inefficient market fragmentation and a lack of intra-European competition.

The Green Paper identifies two options for Community action to improve the situation: (a) an Interpretative Communication, which would specify the conditions governing the use of Art. 296 on the basis of existing Community law; and (b) a new Directive adapted to the specificities of defence for procurement contracts which are not covered by Art. 296, but for which the existing civil Directive may be ill-suited. On top of that, member states recently tasked the European Defence Agency (EDA) to explore possibilities of drawing up (c) an intergovernmental Code of Conduct to foster intra-European competition within the scope of Art. 296.

Following the consultation period of the Green Paper, the EDA started to work on a Code with the aim of preparing a decision by member states, at the end of 2005, on whether to proceed with the project or not. At the same time, the Commission is evaluating the various contributions to the Green Paper's consultation in order to decide how to proceed.

In other words, by the end of this year, crucial decisions will be taken for the organisation of Europe's defence markets. The financial

and political stakes are high: first, how will member states spend the €180 bn of their combined defence budgets? Second, can the EU make progress towards the establishment of a common defence market and, if so, what will be the appropriate mixture of community and intergovernmental instruments?

Given the importance of these issues, in autumn 2004 the EUISS established, a Task Force of European experts to participate in the current debate. Closely related to the work of this group, in January 2005 the Institute organised a conference which brought together representatives of the Commission, the EDA, member states, industry and academics to discuss the Green Paper. Based on the findings of the conference, the Task Force prepared a written contribution to the Green Paper's consultation process which was sent to the Commission in early February 2005.

The present report is the final product of the EUISS Task Force's work. It gives a comprehensive and independent assessment of the various options for action and concludes with concrete policy recommendations. The report aims to give an independent input to the current decision-making process and should be of interest to analysts and policy-makers concerned with procurement issues.

The state of play – time for action?

A European Defence Equipment Market as part of ESDP

Driven by the challenges of today's international environment, the European Union plays an increasingly important role in security and stability both within Europe and worldwide. In this context, the development of European Security and Defence Policy (ESDP) is particularly important, since it allows the Union to pursue a comprehensive security approach combining, if necessary, civil and military means.

Following on the development of ESDP, the EU is becoming increasingly involved in the field of armaments.[1] Several factors drive this process:

- While defence industries and markets have undeniable specificities, they remain subject to 'normal' market and business imperatives, such as profitability and competitiveness. The latter have been reinforced by the progressive privatisation of defence companies and customers' new, more commercially oriented procurement practices. Furthermore, the growing duality of technologies and company portfolios blurs the traditional dividing line between defence and civil sectors, which, in turn, narrows the gap between defence and other established EU policies in areas such as research, Internal Market, trade or competition.
- The development of Europe's military capabilities is one of the key elements of ESDP. To achieve this objective, member states must cooperate more and better than in the past, particularly in order to harmonise their military requirements and coordinate their research efforts. At the same time, military capabilities are closely linked to defence industrial and market issues. Competitive industries and cost-effective procurement systems are in fact crucial if EU member states are to equip their armed forces adequately. The future of ESDP therefore depends also on the competitiveness of a European Defence Industrial and Technology Base (EDITB) and the EU's capacity to build a more homogeneous defence economy

1. See Burkard Schmitt, 'The European Union and armaments – Getting a bigger bang for the Euro', *Chaillot Paper* 63 (Paris: EU Institute for Security Studies, August 2003).

framework, which should ultimately lead to a fully integrated European Defence Equipment Market (EDEM).

Recent initiatives demonstrate the link between ESDP, armaments and defence markets. The establishment of the European Defence Agency (EDA) in July 2004 illustrates member states' determination to combine the development of military capabilities with new approaches in the fields of defence research, armaments cooperation and defence markets. Once fully operational, the EDA may help in particular to harmonise military requirements more effectively, enhance the efficiency of cooperative projects and contribute to a more efficient use of research funding.

The European Commission has, at the same time, launched its own initiative on the creation of a European Defence Equipment Market in support of ESDP.[2] In its Communication of 11 March 2003, entitled 'Towards a EU Defence Equipment Policy',[3] the Commission presented a series of proposals for action and further reflection in the fields of standardisation, defence industrial monitoring, intra-Community transfers, competition, export of dual-use goods, procurement rules and research.

Thus far, notable progress has been made primarily in the last two areas: following a Preparatory Action[4] and the report of a high-level Group of Personalities,[5] a specific security research programme will become part of the next Framework Programme (2007-12). This activity will mobilise additional financial resources for the EDITB and has the potential to allow for a thorough exploitation of synergies between defence, security and civil research. At the same time, the Commission has issued a Green Paper on defence procurement, which may kick off new developments in the field of market regulation and advance the project of an EDEM.[6]

EDEM – specificities and obstacles

The relatively small size of European defence budgets, escalating research and development costs for complex weapon systems and the increasing internationalisation of defence industries have made it indispensable for Europe to move towards a common defence equip-

2. Since 1996, the European Commission has launched several Communications on defence–related industries. The second Communication, published in 1997, called for the creation of an European defence market, based on a proposed CFSP Common Position and an Action Plan, using a combination of legislative and non-legislative instruments under the first and second pillars. This initiative, however, has not led to any substantial progress: the draft Common Position was never adopted by the Council, the Action Plan has been dormant since 1999, and only in the areas of custom duties and standardisation has some progress been achieved. See 'Implementing European strategy on defence-related industries', COM (1997) 583, final, Brussels 12 November 1997, available online at http://europa.eu.int/comm/enterprise/defence/defence_docs/def_comm.htm (viewed 1 May 2005).

3. 'European Defence Industrial and Market Issues - Towards an EU Defence Equipment Policy', COM (2003) 113, final, 11 March 2003, available online at http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do? (viewed 1 May 2005).

4. See 'On the implementation of the Preparatory Action on the enhancement of the European industrial potential in the field of Security research'. COM (2004) 72, final, available online at http://europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0072en01.pdf (viewed 1 May 2005).

5. See 'Research for a Secure Europe', Luxembourg, March 2004, available online at http://www.iss-eu.org/activ/content/gop.pdf (viewed 1 May 2005).

6. Green Paper on defence procurement, COM (2004) 608, final, available online at http://europa.eu.int/comm/images/language/lang_en3.gif. (viewed 1 May 2005).

ment market. Current market fragmentation is in fact generally accepted to be, in the medium and long term, too costly and inefficient to maintain a competitive EDITB and to equip European armed forces adequately. The establishment of an EDEM, consisting of a set of customers served by a set of suppliers trading without restriction, would therefore constitute a key element of an effective reform of Europe's armaments sector. Its advantages for both supply and demand sides are generally acknowledged: European companies would obtain a much larger 'home' market, could restructure across national boundaries to reduce duplication, create centres of excellence and take advantage of longer production runs. At the same time, competition would encourage suppliers to optimise production capacity and help to lower costs, and thus save scarce public finances.

However, the establishment of an EDEM remains a challenging task, in particular because of the specific nature of defence products and services:

- Production and trade of defence items are closely related to the sovereignty of states and are important instruments of their security and defence policies. Defence markets are therefore extremely political in nature, with governments playing a predominant role as both customers and regulators.
- Defence systems are often highly complex and integrate sophisticated technologies. Developed for the specific demands of a very small number of customers, such systems are characterised by long development- and life-cycles and high levels of non-recurring costs, which require governments to fund most research and development (R&D) work.
- Security of supply, in particular in times of crisis, is a major concern for all governments and must be ensured throughout the life-cycle of a weapons system. In a common market, this implies specific guarantees both between suppliers and customers and between member states (as regulators of exports and transfers).
- Confidentiality of technical information is particularly important for products for which technological superiority over competitors is (literally) vital. This requires specific security measures throughout the procurement process and security certificates for qualified suppliers.

The regulatory framework of an EDEM would have to take into account all these characteristics. Specific rules and regulations would thus be needed for different areas, namely:

- procurement (of goods and services for military purposes);
- competition (merger control and state aid);
- exports (to non-EU countries) and (intra-Community) transfers;
- transits (across the territory of EU member states).

The establishment of these frameworks is per se complex and challenging.[7] The most important obstacles, however, are divergences between member states on the organisation and operation of an EDEM. These divergences are particularly difficult to overcome, since they are deeply rooted in political traditions and cultures, embedded in national armaments and defence policies, and reinforced by institutional and industrial interests.

The main dividing line in this regard lies between 'haves' and 'have-nots' in the EU: the bulk of defence industries and funding in the Union is concentrated in the United Kingdom, France and – to a lesser degree – Germany. These three countries, together with Italy, Spain and Sweden, represent more than 90 per cent of Europe's defence industrial capabilities, 85 per cent of EU total defence spending and 98 per cent of all R&D expenditure. As arms producers, these so-called 'LoI-countries'[8] have inevitably different procurement and market policies than their European partners who have no or only minor defence industrial capabilities and often buy their military equipment from US suppliers.

However, Europe's arms-producing countries do not represent a homogeneous group either. Due to their different historical backgrounds and political aspirations, each of them has very specific interpretations of (a) the function of armaments in their foreign, economic and industrial policies, and (b) the role governments should play as customers, regulators, sponsors and shareholders vis-à-vis defence industries. This, in turn, leads to important divergences on defence-related trade, procurement and industry issues (European preference, exports, competition, access to the US market, etc.).

Nor have defence industries always been driving forces for market reforms. In principle, most companies are today in favour of a common defence market. In practice, however, attitudes vis-à-vis the establishment of an EDEM vary considerably between companies and sectors: non-competitive firms fear the loss of national protection; others are afraid that a common marketplace would lead to unfair competition as long as different national practices persist with regard to state aid, public ownership, export policies, etc. Industrial support for an EDEM is thus subject to numerous caveats.

7. See Martin Trybus, 'European Defence Procurement Law – International and National Procurement Systems as Models for a Liberalised Defence Procurement Market in Europe', *European Monographs* 21 (The Hague – London – Boston: Kluwer Law International, 1999).

8. In July 1998, defence ministers of France, Germany, Italy, Spain, Sweden and the United Kingdom signed the so-called 'Letter of Intent' (LoI), aimed at facilitating cross-border consolidation and cooperation of defence industries. The following consultation process between the six LoI countries led, in 2000, to the signing of a Framework Agreement, covering six areas: security of supply, exports, harmonisation of military requirements, treatment of technical information, research and technology, security of information (see below).

On top of that comes member states' traditional resistance to a possible '*communautarisation*' of defence. According to the Treaty establishing the European Community (TEC), defence markets fall under the regulations of the Internal Market, subject to Art. 296.[9] In practice, however, member states have used that Article to exclude defence almost completely from the European integration process and to organise their defence markets on a national basis, each of them with its own rules, regulations and policies. Community instruments and policies, by contrast, have been developed for civil markets only, without taking into account the specificities of defence goods and services.

It thus comes as no surprise that the regulatory framework in Europe remains patchy. Community law de facto plays only a marginal role, and progress towards an EDEM has been slow and limited to a few intergovernmental arrangements:

- In the so-called ***Coherent Policy Document*** (CPD), the Western European Armaments Group (WEAG) laid down a set of general aims and principles for an EDEM. The CPD, which was first drafted in 1990 and revised in 1999, foresees cross-border competition and non-discrimination of suppliers on the grounds of nationality as basic principles of defence procurement. It also includes a number of specific measures to enhance transparency and competition, such as the publication of contract bulletins and the monitoring of intra-WEAG trade. The CPD constitutes a commitment by member states to change their procurement practices but it is not legally binding, nor has it led to a harmonisation of rules. Overall, its record is rather poor: its principles have hardly been implemented, and its impact on cross-border competition has been – at best – limited.[10]
- The ***LoI Framework Agreement***, signed in 2000, covers other relevant areas, in particular security of supply, exports and transfers. Aimed at facilitating defence industrial consolidation and cooperation, it is binding only for the six major arms producing countries in the EU and covers mainly cooperative projects and transnational companies. Moreover, the LoI approach has been limited, trying to make national rules and procedures compatible with each other rather than setting up a new and common regulatory framework. This self-imposed limitation has led to solutions that are often too complex, vague or not sufficiently binding. Last but not least, both ratification and implementation have been so time-consuming and painful that the Agreement is still not fully operational.[11]
- The European Union ***Code of Conduct on Arms Exports***, adopted on 8 June 1998,[12] sets minimum standards for the man-

9. Art. 296 states: '1. The provisions of this Treaty shall not preclude the application of the following rules: 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 the 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. 2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on April 1958, of the products to which the provisions of paragraph 1 b) apply.'

10. WEAG Panel III – D/45 (revised). See also Sandra Mezzadri, 'L'ouverture des marchés de la défense : enjeux et modalités', *Occasional Paper* 12 (Paris : Institute for Security Studies of WEU, February 2000),

11. Framework Agreement concerning measures to facilitate the restructuring and operation of the European defence industry, reproduced in: Burkard Schmitt, 'European Armaments cooperation – Core documents', *Chaillot Paper* 59 (Doc. 7, Paris: EU Institute for Security Studies, April 2003).

12. European Union Code of Conduct on Arms Exports, adopted on 8 June 1998. ibid, pp 29-44.

agement and control of conventional arms exports by member states to third countries. Moreover, it establishes an information exchange and consultation mechanism between EU member states. The Code of Conduct is politically, but not legally binding, which leaves its actual application to the discretion of its members. Its consultation process is limited, and vague formulations leave plenty of room to interpret the Code according to member states' interests.[13]

In other words: an EDEM worth its name is still a long way off. Market fragmentation remains a major obstacle to both intra-European cooperation and competition, and a costly source of inefficiency. The challenge will thus be to improve and complement the existing rudimentary elements of an EDEM, either through adaptation and extension of Community law, further intergovernmental arrangements, or – most likely – both. However, given the traditional reticence of member states to give up national prerogatives in defence matters, a fully integrated EDEM will inevitably be a long-term project and achievable only step by step.

Defence procurement in Europe – legal bases and political practices

Procurement rules are key components of defence markets. As such, they are also an important factor in Europe's current market fragmentation.

At the Community level, there is – in contrast to other sectors such as energy or transport[14] – no specific Directive coordinating the procurement procedures in the defence sector. It is thus Directive 2004/18/EC for public procurement of goods, works and services which applies 'to public contracts awarded by contracting authorities in the field of defence, subject to Art. 296 of the Treaty'.[15]

This Directive, however, has been developed for civil markets and is thus not adapted to the specificities of (most) military equipment. Defence contract-awarding authorities can apply it without problems for the procurement of civil goods and services, and probably also for the procurement of most dual-use equipment. Its provi-

13. Ibid. Beyond that, the Code is criticised for not tackling all the relevant problems. Licensing of production abroad, for example has not been addressed. Constraints on the activities of international arm brokering agents are not included either. Several member states have controls on brokering, others not. See: http://www.fas.org/asmp/campaigns/code/EUcodereport4.pdf (viewed 1 May 2005).

14. See Directive 2004/17/EC, available online at http://europa.eu.int/cgi-bin/eur-lex/udl.pl?REQUEST=Seek (viewed 1 May 2005).

15. Directive 2004/18/EC, Article 10, available online at http://cgi-bin/eur-lex/udl.pl?REQUEST=Seek-Deliver&COLLECTION=lif&SERVICE=all&LANGUAGE=en&DOCID=304L0018 (viewed 1 May 2005).

sions, by contrast, are ill-suited to the procurement of (most) warlike equipment.

Many military systems are, for example, too complex to allow detailed technical specifications to be defined from the outset. Thus, the necessary 'translation' of a functional requirement into a system specification requires the negotiated procedure as standard procedure.[16] The civil Directive, however, allows this procedure only in exceptional cases. Another example is the long in-service life of many weapons systems, which implies specific arrangements on modernisation and logistical support. Again, the civil Directive does not foresee appropriate rules for these cases. At the same time, it makes inadequate provision for confidentiality and security of supply, which are crucial elements of defence procurement.

Yet the civil Directive is applicable to defence contracts only subject to Art. 296 TEC.[17] According to that Article member states can derogate from the rules of the Internal Market when they award contracts for 'arms, munitions and war material' which:

- concern their essential security interests;
- are included in the list attached to that Article.

According to the case law of the European Court of Justice (ECJ), derogation from Community rules is subject to certain conditions, in particular:

- derogation is only justified if it is necessary to safeguard the essential security interests invoked;
- member states must assess, on a case-by-case basis, whether defence contracts are covered by the exemption.

The exemption under Art. 296 is thus not automatic, and defence contracts which do not fulfil the criteria set by the TEC and the ECJ fall under Community rules. In practice, however, most governments have considered Art. 296 as a blank cheque, using specific national procedures for (almost) all defence contracts. Even if there is competition, it is in general organised on the basis of national procurement law and without publication in the EU's *Official Journal*.

Moreover, in the absence of a Community Directive coordinating them, national defence procurement rules and procedures differ within the EU from country to country regarding the publication methods, the conditions for non-publication, technical specifications, selection criteria, tendering rules and award criteria. The result of this is an extremely complex regulatory patchwork which lacks trans-

16. The negotiated procedure allows awarding authorities to select providers on the basis of prescribed criteria and negotiate with each – or one – of them in order to define the content of the bid together. There are negotiated procedures with and without advertisement (see section 2, defence procurement Directive).

17. See footnotes 9 and 15.

parency and is highly inefficient. It implies in particular considerable overhead costs for companies who are trying to access foreign markets – costs which are particularly difficult to bear for small and medium-sized enterprises (SME).

At the same time, exemption from the rules of the Internal Market has opened the door to discrimination against non-national suppliers. Given the importance of weapons systems for member states' security, it may appear both logical and justified to give preference to national producers. However, political (development of ESDP), industrial (cross-border consolidation of defence companies) and financial (growing discrepancy between rising costs and persisting budgetary constraints) trends increasingly undermine this argument in Europe. Moreover, national preference often serves to protect non-competitive firms (and jobs) rather than strategic interests. In these cases, it is not only an expensive but also a counter-productive policy which hinders industrial rationalisation where it is most urgently needed to maintain an EDITB.

It is true that the creation of transnational defence companies, a more competition-oriented acquisition policy on the part of many governments and the multiplication of European cooperative projects have led to the beginning of an opening up of national markets. However, this openness varies greatly within the EU and depends in particular on member states' industrial capabilities.

If countries have the industrial capabilities within their territory to develop and produce a weapons system they need, they will normally give preference to local manufacturers (which can also be in foreign ownership). For low-tech products, many member states have national capabilities and often pursue a policy of national preference. For complex weapons systems, the situation is different: since only a handful of European countries have the necessary industrial assets to develop such systems, most member states buy them off-the-shelf and on a competitive basis from foreign suppliers. However, this does not necessarily mean that competition is transparent and fair, since procurement rules and decisions often remain somewhat obscure, with political considerations and offsets[18] playing a crucial role.

Moreover, the few important arms producing countries are also those with most significant defence budgets, which means that the bulk of defence money in the EU is spent in countries where in many cases a national preference policy can be assumed. In cases where governments of arms-producing countries 'have' to select a foreign contractor for a specific product because local industries do not have

18. Offsets are compensations that governments require from defence contractors as a condition for purchasing defence articles or services. These compensations can cover a wide range of activities directly or indirectly related to the defence project object of the procurement contract. Indirect offsets, in turn, can be defence related or non-defence related.

the necessary expertise, they normally try to 'oblige' the foreign supplier to involve local companies as subcontractors.

All this results in a situation where fair intra-European competition remains the exception rather than the rule. Most defence contracts in Europe are still awarded to national suppliers, whether (national) competitive procedures are used or not. Collaborative projects add little, since they are still organised on the basis of *juste retour*[19] and normally limited to certain parts of the market.

In the long run, this situation is disadvantageous for all stakeholders: governments pay extra costs for a non-competitive market, armed forces may not get the best equipment and industries pay extra overhead costs (if they participate in foreign bids), suffer from short production runs (if they stick to their home markets) and see their competitiveness compromised (in both cases).

The current debate

It thus comes as no surprise that the European Commission, in its Communication of March 2003, identified procurement law as one area for action towards the development of an EDEM. This led to the publication, in September 2004, of a Green Paper on defence procurement in which all stakeholders were invited to comment on various options for improving transparency and openness of defence markets between EU member states.[20] Based on the findings of this consultation, the Commission will decide, by the end of 2005, on possible follow-on actions.

Taking the current situation of Europe's defence markets as the starting point, the Green Paper analyses the specificities of these markets and the negative effects of disparate procurement rules. In this context, it also identifies two shortcomings in European procurement law, which have allowed – and even encouraged – member states to actually misuse Art. 296:

- a lack of clarity as to the conditions for exemption from Community rules;
- the non-suitability of the existing public procurement Directive to many defence contracts.

19. According to the *juste retour* principle, the industry of each participating nation should, within the framework of a collaborative programme, be awar ded a work share that is proportional to the financial contribution of its government.

20. Green Paper on defence procurement, COM (2004) 608, final, available online at http://europa.eu.int/comm/images/language/lang_en3.gif (viewed 1 May 2005).

Based on this analysis, the Green Paper proposes two options for Community action:

An ***Interpretative Communication***, which would not change the existing legal framework, but clarify it. Explaining the principles defined by the ECJ for the interpretation of Art. 296, the Communication would specify the conditions that member states have to fulfil when they invoke an exemption from Community rules.

A new ***public procurement Directive*** adapted to the specificities of defence markets. Such a Directive would not call into question member states' right to invoke Art. 296 for military equipment which concerns their essential security interests. It would, by contrast, apply to defence contracts which are not covered by the exemption under Art. 296, but for which the existing civil Directive may be ill-suited.

During the public debate initiated by the Green Paper, several member states proposed the establishment of a ***Code of Conduct*** on defence procurement to foster intra-European competition. In early March 2005, the EDA was given a mandate to develop such a Code by the end of the year. A Code would be a politically – but not legally – binding intergovernmental instrument; its scope would, by definition, be limited to defence contracts covered by Art. 296 (since Community law applies to all others).

The following sections will assess these three options and their consequences for Europe's armaments sector. The study asks, for each option, whether it would:

- provide better value for money?
- improve transparency and competition?
- harmonise existing rules and regulations, advancing the creation of an EDEM?
- foster and improve European armaments cooperation?
- enhance the competitiveness of Europe's industry?
- influence transatlantic armaments relations (and if so, how)?
- be politically feasible (and if so, in what timeframe)?

Such an assessment must take into account differences between member states (in terms of defence industrial capabilities and procurement practice), but also between the various segments of the defence market (in terms of sensitivity and relevance for essential security interests). Up to now, member states have used Art. 296:

- always for highly sensitive items, such as NBC material and cryptology (market segment 1);
- always for complex weapons systems, such as combat aircraft,

which clearly concern essential security interests (market segment 2);
- normally also for warlike items, which do not – or not necessarily – concern essential security interests, such as rifles (market segment 3);
- sometimes even for non-warlike, non-sensitive items, such as boots (market segment 4).

One could add to this, as a fifth market segment, sensitive homeland security items. Although the latter are not included in the list of 'arms, ammunitions and war material' annexed to Art. 296, they may concern essential security interests, and member states can refer to Art. 296 (1a) if they consider a security item so sensitive that they do not want to apply the rules of the civil Community Directive.

Such a distinction is admittedly somewhat arbitrary, and the borderline between the various market segments is often neither clear nor consensual. However, for methodological reasons, the distinction is useful as a means to identify in greater detail the impact that each option would have on defence markets.

Options at hand

An Interpretative Communication

Given the quasi-systematic use of Art. 296 for defence procurement, the Commission is considering issuing an Interpretative Communication, which would not change the existing legal framework but would clarify it.

The aim of an Interpretative Communication would be to give further explanation of the principles defined by the ECJ for the interpretation of Art. 296, making it easier for national authorities to distinguish between contracts covered by the exemption and those which are not. As regards the latter, the normal public procurement Directive would remain applicable.

A Communication could rapidly become reality, since the Commission would draft it on its own. However, questions as to the content of such an Interpretative Communication remain. How would the Commission clarify the existing law?

Content

According to the Green Paper, implementation of the principles defined by the ECJ raises difficulties because of:

- the absence of a precise interpretation of these provisions;
- the absence of a definition of essential interests of security both in Community Law and the Case Law of the ECJ;
- the fact that the list annexed to Art. 296 has never been published or revised.[21]

An Interpretative Communication could contribute very little to the clarification of the last two points: first, it is not within the competence of the Commission to define member states' security interests. Second, the Commission could suggest a revision of the list annexed to Art. 296, but only the Council could decide on it (by unanimity), which seems unlikely. Since the current list is sufficiently vague to cover new

21. See Green Paper, pp. 6-7.

technological developments and to allow for a flexible interpretation of the scope of Art. 296, member states in general see neither the need for nor the interest in making such a revision. Moreover, an updated, more precise and public list of defence items covered by Art. 296 on which all 25 member states could agree would probably become very comprehensive, since each government would endeavour to include as many of its national industrial products as possible. A modification of the current list, even if it were feasible, could thus turn out to be counter-productive, potentially leading to even less intra-European competition.

For these reasons, an Interpretative Communication would not (directly) clarify which defence contracts come under Art. 296, but rather specify which criteria member states have to respect if they want to derogate. Taking into account the existing legal framework, as well as recent developments in the relevant case law, it could try to give a more precise interpretation of the conditions defined by the Court for the use of Art. 296. These conditions are that:

- derogation is only justified if it is necessary for safeguarding the essential security interests invoked;
- member states have to assess, case-by-case, whether each individual contract is covered by the exemption;
- the burden of proof that essential security interests necessitate derogation from the rules of the Internal Market lies with member states;
- such proof is to be supplied, if necessary, to the national courts or, where appropriate, the ECJ.

A Communication would probably spell out these principles and underline that the use of Art. 296 must be a proportionate measure, i.e. necessary to safeguard national security, put forward in good faith and having no alternative, less detrimental effect on the Internal Market.

By doing so, a Communication would generalise the ECJ case law, clarifying that the principles defined by the ECJ apply not only to those contracts which were put before the Court for judgement, but to defence procurement in general. It would not call into question member states' right to use Art. 296, but would make it clear that the execution of this right is subject to Community rules and judicial control.

Moreover, and even more importantly, the Communication would commit the Commission to ensuring that member states use Art. 296

according to the interpretation given in that document. In other words, after decades of a lenient policy in this area, the Commission would publicly and clearly declare its intention to play its role as guardian of the Treaty, acting as a 'watchdog' over member states' use of Art. 296. This statement would certainly not lead to the establishment of a formal notification system, but it would encourage companies to inform the Commission about cases where the use of Art. 296 may be considered inappropriate. The prospect of regular and detailed evaluation by the Commission would then probably ensure that member states assess more carefully whether the use of Art. 296 is justified or not.

Impact

Provided the Commission sticks to its commitment, a Communication may thus lead to better application of existing law and curtail the use by member states of derogation under Art. 296.

However, a Communication would have a number of shortcomings and weaknesses. As a non-legislative measure, it would, by definition, neither change the current Community law nor harmonise national defence procurement rules for contracts covered by Art. 296. It would thus not contribute to rationalising Europe's fragmented regulatory framework.

Since a Communication can neither render the list attached to Art. 296 more precise nor clarify the concept of essential security interests, it would not clarify for *which* contracts Art. 296 may be used. It seems doubtful, therefore, that a Communication would actually facilitate the application of existing Community legislation.

A Communication would enhance transparency and competition mainly for non-warlike items (market segment 4). Since this segment lies at the periphery of defence markets and clearly outside the scope of Art. 296, a less lenient Commission could certainly ensure that use of the civil Directive became the rule. This would result in better value for money, in particular since this market segment covers a broad spectrum of goods and services, ranging from catering and cleaning to uniforms, construction services and non-military equipment. However, actual cost-savings are difficult to estimate, since the extent to which member states already apply Community law to such contracts is unclear.

For less sensitive warlike items which do not concern essential security interests (market segment 3), competition may increase as well, but only to a limited extent and with potentially problematic side

effects. Whether or not Art. 296 applies would still be a question of legal interpretation, since the concept of essential security interests remains vague. As a consequence, implementation of European law in this market segment would remain difficult and probably controversial. Faced with a choice between the use of Art. 296 or the civil Directive, which they consider ill-suited for the procurement of much warlike material, member states may well try to interpret Art. 296 as broadly as possible. In this case, a more proactive Commission policy would certainly increase the number of legal disputes.

The impact on market segments 1 and 2 would be close to zero. Occasionally member states may be obliged to justify the use of Art. 296. In general, however, sensitive items and complex weapons systems are so important for national security interests that it is difficult to conceive many cases where the EC or the ECJ would not accept such justification.

Last but not least a Communication would have no impact on the homeland security market (segment 5). If member states invoke Art. 296 (1a) they can refuse to disclose information on the contract concerned, which makes an evaluation by the Commission de facto impossible. A less lenient Commission policy would thus be extremely difficult, if not impossible to implement in this market segment.

Given its limitation to market segments at the lower end of the technological spectrum, an Interpretative Communication would contribute little to the competitiveness of European defence industries. Nor would it foster armaments cooperation (which normally takes place at the higher end of the spectrum).

To sum up:

- The principles defined by the ECJ are fairly simple, understandable and (hopefully) known to all relevant stakeholders. Further explanation seems therefore, at first glance, unnecessary.
- In practice, however, member states have often interpreted the possibility to derogate as an automatism. From that perspective, an explanation of the principles governing the use of Art. 296 makes sense. Besides, the Communication would commit the Commission to ensuring that member states use Art. 296 according to the interpretation given in that document. Provided the Commission sticks to that commitment, an Interpretative Communication could be useful for limiting misuse of Art. 296.
- At the same time, however, an Interpretative Communication would improve transparency and competition only on the margins

of the defence market. Its contribution to the establishment of an EDEM and the strengthening of the EDITB would be limited. For these reasons, an Interpretative Communication seems by itself a largely inadequate instrument.

A defence procurement Directive

The second option for Community action would be a new procurement Directive especially adapted to the defence market. As an instrument of Community law, a defence Directive would apply to the procurement of arms, munitions and war material subject to Art. 296. In other words, member states could still invoke Art. 296 for military equipment which concerns their essential security interests. Rather, the Directive would apply to defence contracts that are not covered by the exemption under Art. 296, but for which the civil Community Directive may be ill-suited.

A defence procurement Directive would coordinate procedures for the award of contracts. As such it would set 'targets' that member states would have to translate into national law and implement through national administrative acts. This approach would contribute to a more homogeneous and efficient regulatory framework and, as experience in civil sectors shows, has the potential to increase transparency and competition. Implementation of previous Directives has often been slow and cumbersome, but public procurement markets in the EU have become more open, to the benefit of both public finances and the competitiveness of industries.[22]

However, a Directive would be more difficult to prepare than a Communication, since it would be adopted according to existing co-decision mechanisms, involving the Commission, member states and the European Parliament. It would require in particular the negotiation and agreement of a series of binding rules and procedures. In view of previous reluctance by member states to follow Community regulation in this area, such negotiations would probably be complex and protracted. However, the time the preparation of a defence Directive actually takes would also depend on the extent to which it differed from existing Directives.

22. According to the Commission, public procurement Directives have allowed customers to make cost savings of about 30 per cent. See http://europa.eu.int/comm/internal_market/publicprocurement/studies_fr.htm (viewed 1 May 2005).

The content

A Directive on the coordination of procedures for the award of defence contracts would – as its core – include:

1. definition of its field of application (including possible exemptions) and awarding authorities;
2. rules on tendering procedures;
3. rules on publication;
4. criteria for the selection of suppliers and the award of contracts.

A defence Directive that takes all specificities of arms, munitions and war material into account would probably differ considerably from the existing Directives. The latter can serve as a useful basis for the former, but many provisions need to be adapted and complemented for them to become applicable to defence. In general, the challenge would be to strike an appropriate balance between the need for flexibility (in order to take into account the specific characteristics of the defence sector), on the one hand, and transparency and competition, on the other. Where this balance would lie is mainly a question of political goals. However, to be suitable for *all* warlike material outside the scope of Art. 296, and to serve even as a 'reference point should a member state decide not to make use of Art. 296 derogation even when it is entitled to' (as stated in the Green Paper), a defence Directive would have to allow for a considerable degree of flexibility.

How to make it work – the challenges

1. Field of application

a) Defining the scope: list versus general definition

The scope of the Directive would fall between the area covered by Art. 296, on the one hand, and the area that comes under the civil public procurement Directive, on the other. It would thus cover warlike items (arms, munitions and war material) which do not concern member states' essential security interests.

In theory, a list would be the best instrument for defining precisely which items come under the Directive. However, covering warlike items, the scope of the Directive would in any case have Art. 296 as its reference point. Drawing up a list for the Directive without revising the one annexed to Art. 296 would thus mean having two lists, both covering arms, munitions and war material. The two might differ with

regard to the level of detail, but they would inevitably overlap in many areas. This, in turn, could create even more problems of interpretation and implementation.

A revision of the 1958 list, however, is no solution either. First, it would involve politically difficult negotiations. In particular, an attempt to render the list more precise could provoke member states into including as many items as possible in order to maintain the possibility of invoking Art. 296. The consequence would be an awkward and time-consuming exercise, and there is no guarantee that the outcome would be satisfactory.

Second, establishing precise lists means deciding beforehand for which items which procedures are to be used. This, in turn, would probably lead to a rigid implementation of procurement law. For at least two reasons, it seems more appropriate to give member states flexibility on whether they prefer to invoke Art. 296 or use the Directive:

- Whether a defence item is essential to a nation's security interests depends not only on its complexity and sensitivity, but also – even mainly – on specific circumstances. Member states should be able to change their procurement practices according to these circumstances, including the right to use Art. 296 in times of crisis also for items which would normally come under Community Directives.
- Conversely, member states should also be able to apply the Directive, on a voluntary basis, to contracts for which they could theoretically invoke Art. 296. This possibility, which is mentioned in the Green Paper, is more than a theoretical option. Depending on the way they tailor contracts to procurement projects, member states may, for example, choose Art. 296 to develop and produce a complex system, but use the Directive for follow-up contracts, such as those for supply of non-specific spare parts, repair and maintenance services, management of logistics systems, provision of training facilities and services, etc. With the appropriate research funding and intellectual property rights (IPR) arrangements in place, they could even use Art. 296 specifically for the development phase and the Directive for the production phase.

For all these reasons, the Directive's scope would be better presented as a general definition rather than a list. Such a definition could simply state that:

This Directive applies to arms, munitions and war material (plus the related services), for which member states do not invoke an exemption from Community rules according to Art. 296 and the principles defined by the European Court of Justice.

Such a definition would (a) draw a distinction vis-à-vis the field of application of the civil Directive (arms, munitions and war material), (b) protect – and qualify – member states' ability to invoke Art. 296, and (c) allow voluntary application of the Directive to contracts covered by the exemption.

However, if member states insist, for political reasons, on a list that defines the scope of the Directive, they should at least avoid drawing up a new one – which would certainly be a complicated and time-consuming exercise – and use rather the existing list of the EU Code on Arms Exports.

The challenge would be different if the Directive were also to become applicable to the procurement of non-military security items. In principle, such an extension of the Directive's scope would make sense, since:

- In today's threat environment, the dividing line between external and internal security is becoming blurred, and non-military security (e.g. protection against bioterrorism) can be as sensitive as defence.
- Military and non-military security applications increasingly draw on the same technology base, and there is an intense technology transfer between the two sectors.
- Internal security represents a growing market, and many defence companies also have important activities in the field of non-military security.

Today, member states can use Art. 296 (1a) to exempt non-military security items from the rules of the Internal Market if their essential security interests are concerned. Moreover, the civil Directive contains escape clauses allowing the use of national procedures for this kind of procurement.[23] However, not unlike defence, there is no Community instrument adapted to the specificities of sensitive security items, which again hinders intra-European competition in an increasingly important market. The defence Directive could fill this gap.

The challenge here would be to distinguish between security items for which the use of the defence Directive is justified and those

23. According to Art. 14, Directive 2000/18/EC shall not apply to public contracts when they are declared to be secret, accompanied by special security measures or when the protection of member states' essential interests so requires.

which should still fall under the civil Directive. The crucial borderline for the Directive's application to security items is thus (in contrast to defence) the one at the lower end of the range. At the same time, the conceptual complexity of internal security, the strong dual-use character of these technologies and the great variety of awarding authorities make it particularly difficult to draw this borderline.

To cope with these problems, the Directive's field of application should be defined with maximum flexibility for defence, but with maximum precision for internal security (if the latter is to be included). Consequently, a specific list would be – at best – an option for defence items, but probably a 'must' for security items. However, establishing such a list could again be a difficult task. The inclusion of security items in the Directive's scope should therefore not be a prerequisite for its application to defence.

b) Exemptions

For reasons similar to those indicated above, it seems politically wise not to exclude from the outset certain categories from the Directive's field of application. The most obvious items to exclude would be highly sensitive ones, such as NBC or cryptology (market segment 1). But since Art. 296 (plus the annexed list) remains in place, member states would in any case be able to use national procedures for this category. Categorical exclusion of complex and sensitive systems, whether developed nationally or in cooperation (market segment 2), is already more complicated, since it would raise problems of definition and limit member states' flexibility to choose between national and Community procurement procedures. For all other categories, automatic exemption should be out of the question, since it would completely deprive the Directive of its sense.

c) Awarding authorities

A Directive would in any case be applicable to national defence ministries and their respective procurement agencies. However, in order to widen the scope of a Directive to include security items (and to cover possible procurement specificities of individual countries), it seems more appropriate to make it applicable to national governments in general.

International procurement agencies, whether they be programme-specific (like NATO Agencies) or permanent structures (such as the Organisation for Joint Armaments Cooperation (OCCAR)), are international organisations or their subsidiary bodies.

As such, they are exempt from Community Directives. Moreover, international agencies are set up to manage complex systems which in any case would remain covered by Art. 296. On this basis, they would still be able to use their own rules and regulations. At the same time, however, they should also be permitted to use the Directive on an ad hoc basis. Participating member states would then decide for each programme (and each procurement phase) whether they wanted the agency concerned to apply the Directive or not.

The situation is different in the case of the EDA, which is – in contrast to OCCAR – not established on the basis of an international treaty. However, whether a defence Directive would be applicable to EDA is a theoretical question, since the latter is not designed as a procurement agency. At least for the time being, EDA has only a small operational budget to fund feasibility studies, which are pre-competitive research activities and should in any case not come under the Directive. This may change with the integration of other bodies (Western European Armaments Organisation (WEAO) and OCCAR) into EDA, following which member states participating in a project should again be allowed to decide on an ad hoc basis whether they want to apply the Directive.

2. Tendering procedures

As many military systems are highly complex, especially at the higher technology end of the spectrum, it is often impossible to develop detailed technical specifications from the outset as the basis for open or selective tendering procedures. The necessary 'translation' of a functional requirement into a system specification requires the negotiated procedure to become the standard award procedure.[24]

The negotiated procedure with prior publication offers a high degree of flexibility and therefore seems well suited to the specificities of the defence sector. At the same time, it guarantees a certain level of transparency and improves market access for non-national suppliers. This may be less relevant for complex systems where only a few companies in Europe have the necessary (system integration) capability, but it could foster competition in other areas further down the technology spectrum where other companies, SME in particular, can act as contractors as well. Publication can also make it easier for SME – and even civil companies – to acquire in good time the necessary information to access defence-related service markets (repair, maintenance).

24. In this context, the competitive dialogue is often mentioned as an appropriate procedure for defence contracts. However, the negotiated procedure offers a higher degree of flexibility; if it became the standard procedure of a defence Directive, it would probably not be necessary to include the competitive dialog as an option. The same is true for open or restricted tendering procedures. They are suited for civil procurement, for which defence contract awarding authorities have to use the civil Directive. If a defence Directive allowed choosing freely between open or restricted tendering procedures, competitive dialogue, and the negotiated procedure with prior publication, one could fairly assume that the latter would always be used.

The negotiated procedure without publication is the procedure that entails the lowest level of competition and transparency. It should therefore only be allowed in certain well defined cases where the nature of the contract de facto excludes competition. Existing Directives already cover some cases, which could be used – in an adapted form – for a defence Directive as well. For example, additional deliveries of a given item by the original supplier are accepted in the civil Directive as grounds for the use of the negotiated procedure without prior publication.[25] But the length of those contracts, as a general rule, may not exceed three years. Given the long life-cycle time of most defence equipment, there should be no time limit. Similar adaptation would also be necessary on other grounds, such as single provider and research.[26]

On top of that, new cases specific to defence would have to be added, such as:

- ***Logistics and interoperability***. To streamline logistics and improve interoperability between a broad range of sensors, weapons systems, and command centres (for instance in the framework of network enabled operations), procurement authorities must be allowed to purchase the same components or subsystems for integration into different systems. In general, this requirement could be incorporated into the respective system requirements, but in many instances – e.g. combat improvement or upgrading measures – it should become a ground to allow for the use of the negotiated procedure without competition. The same is true for standardisation of logistics and maintenance, if, for example, the procurement of a specific subsystem or component for different systems helps to reduce life-cycle costs.
- ***Extreme urgency*** (in times of humanitarian, political or military crisis).[27] In a time of crisis the supply of even non-sensitive equipment could become a crucial military asset and must be dealt with as an issue of procurement regulation. For more sensitive items, emergency cases can imply surge production of spare parts and munitions, accelerated procurement of planned programmes, modification of existing equipment and the production of new systems at short notice. For such specific circumstances, the Directive should accept urgent operational requirements as a ground to use the negotiated procedure without competition in order to give national procurement authorities maximum flexibility.

25. Directive 2004/18/EC, Art. 31.

26. Given the complexity and long life-cycle of many defence systems, the single provider ground should probably be more flexible than in the civil Directive. Research as a ground for non-publication should also be more broadly defined, since it is related in defence to the specific purpose of strengthening the EDITB.

27. The civil Directive accepts extreme urgency also as a ground for negotiated procedure without publication, but only if it is brought about by events unforeseeable by the contracting authority.

3. Publication

A centralised publication system would be crucial if the Directive is to achieve its objective of enhancing transparency and competition. It could be a specific defence publication system or a supplement of the *Official Journal*. In order to satisfy the needs of SME, it must be easily accessible (electronically) and accommodate the Union's language diversity. To achieve these objectives, the Publication Office should extend the so-called 'Common Procurement Vocabulary' (CPV) of the existing publication system for civil procurement and include all relevant terms for defence contracts.[28]

4. Selection of suppliers

In addition to the requirements mentioned in the civil Directive (financial standing, technical capacity, etc.), ***security of supply*** and ***confidentiality*** must be guaranteed by companies in order to qualify as defence suppliers.

In principle, member states could use security of supply and confidentiality as *eligibility* criteria for a common list of certified companies. On the basis of that list, national procurement authorities could then organise fair European-wide competition among 'pre-qualified' defence suppliers. In practice, however, a common list would probably be too complex to operate and seems politically impossible, since member states have very different practices and views on such pre-qualified lists. In consequence, security of supply and confidentiality should form selection criteria for the contract-awarding process.

At the contract level, for the supplier ***security of supply*** mainly implies two commitments: (a) to give priority to the needs of the customer and/or to accelerate production in times of crisis; (b) to inform the customer in due time if a change in its situation (ownership, restructuring, abandonment of production, etc.) could have an impact on supply. These commitments must then be underpinned by an arrangement between the supplier and its national authorities. The security of supply criteria used for the defence Directive should combine all these elements.

At the same time, the Directive would have to be accompanied by an intergovernmental arrangement in which member states undertake not to hinder the supply of defence articles and services to any other member state if it so requests in order to meet the needs of its armed forces.

28. The Common Procurement Vocabulary (CPV) is a single classification system which endeavours to cover all requirements for supplies, works and services. By standardising the references used by contracting authorities to describe the subject matter of their contracts, the CPV improves the transparency of public procurement covered by Community directives. The CPV attaches to each numerical code a description of the subject of the contract, for which there is a version in each of the official languages of the EU. See Commission Regulation (EC) No 2195/2002, available online at http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Regulation&an_doc=2002&nu_doc=2195 (viewed 1 May 2005).

The second selection criterion – ***confidentiality*** – entails the proven capacity of companies to handle classified information. To make it applicable in the case of a defence Directive implies that all member states mutually recognise security certifications issued by national authorities to defence companies established on their territory. This should be no problem for NATO countries, which have standardised procedures and criteria for these certifications. For non-NATO member states, ad hoc arrangements would be necessary (along the lines of the Swedish case in the LoI).

5. Subcontracting and offsets

Public procurement law by definition applies only to contracts between public authorities and companies. In other words, it does not apply to contracts between a prime contractor and subcontractors, which constitute private law. However, defence contracts in general include provisions on the relationship between primes and subcontractors:

- In the case of off-the-shelf procurement, subcontracting is generally part of the related offset arrangements.
- In the case of development projects, practice differs between member states: some governments explicitly ask primes to select their subcontractors on a competitive basis and even define conditions for that selection, whereas others remain vague or do not mention subcontracting at all. In all cases, however, primes must provide a procurement plan in the selection process which specifies their supply chain. In other words: governments always have a *droit de regard* in the prime contractor's selection.

Differing from the civil Directive,[29] the defence Directive should therefore explicitly deal with subcontracting. For development projects it should stipulate, in general terms, that primes should choose their subcontractors on a competitive basis. Even such a general formulation would foster competition, as it serves as a reference for non-selected suppliers, creating the possibility to take a case to the ECJ. This would 'oblige' prime contractors to organise their supply chain in a transparent and non-discriminatory way and thus foster intra-European competition at the subcontractor level. Once again, however, such a provision could fulfil its purpose only with the appropriate transfer regime in place.

29. In Directive 2000/18/EC, subcontracting is just treated under the headline of specific rules governing contract documents. It allows contracting authorities to ask the tenderer to indicate in his tender any share of the contract he may intend to subcontract.

For off-the-shelf procurement and offsets, the challenge is different. In principle, offsets are hardly compatible with transparency and fair competition in open markets. In practice, however, most member states find them highly attractive and regularly demand offsets as part of off-the-shelf procurements. It is therefore politically impossible to eliminate them completely. With regard to non-European, in particular US suppliers, it would even be counter-productive to do so: As long as the US defence market is protected against European investment and sales, there is no reason not to claim offsets as an entrance fee for US companies accessing European markets. However, if member states demand US suppliers for offsets, European producers must be allowed to offer them as well, in order to have a level playing field.[30]

The Directive's provisions for offsets should therefore aim at both greater transparency and fair treatment of European suppliers vis-à-vis competitors from third countries. In general, it should allow for direct offsets (activities related to the initial procurement contract, such as technology transfer and subcontracting), but prohibit indirect offsets, which often lack transparency and can even lead to distortion of civil markets.

At the same time, the defence Directive should (like Directive 2004/17/EC, which coordinates the procurement procedures of entities operating in water, energy, transport and postal services sectors) include a third country clause. That Article would apply to tenders covering products originating in third countries with which the Community has not concluded an agreement, ensuring comparable and effective access for Community undertakings to the markets of those third countries. Any tender submitted for the award of a contract may be rejected where the proportion of products originating in third countries exceeds 50 per cent of the total value of the products constituting the tender. This would ensure that an important part of the value of the project was generated in Europe and strengthen the EDITB.

Impact

The impact of a Directive would differ greatly between the various market segments. Since it would neither replace Art. 296 nor limit the right of member states to invoke exemption for contracts which concern their essential security interests, most of market segments 1 and 2 would remain outside the scope of the Directive. Given their obvious relevance to national security interests, a defence Directive would not change the current practice for (highly) sensitive contracts, and

30. In particular since US companies often offer lower prices per unit, since their sizeable home market allows them much longer production runs.

neither the Commission nor the Court could (or would) challenge member states' use of Art. 296. The same is true for complex weapons systems: member states may be obliged occasionally to justify the use of Art. 296, but it is seems highly unlikely that the Commission or the Court would not accept such justification. Although member states could make use of the Directive on a voluntary basis, probably little would change in those market segments that are of the highest value.

Since the notion of 'essential security interests' remains vague, it would remain difficult to draw the line between contracts covered by Art. 296 and those which are not. A defence Directive would not do away with this problem of definition, but it could help to limit its negative effects. Moreover, it has the potential to enhance competition for defence contracts which do not concern member states' essential security interests (market segment 3):

- In cases where the use of Art. 296 is controversial, it would become easier for member states not to invoke the exemption (and thus avoid legal disputes) if a Directive with rules adapted to the specificities of defence procurement were at their disposal.
- At the same time, the very existence of a 'credible alternative' to national procedures could make it more difficult for member states to justify the use of Art. 296. This effect would be helpful in opening up, at least partially, certain segments of the defence market.

In principle, a defence Directive would not be applicable to non-warlike items and therefore not concern market segment 4. However, it could state in its introduction what would otherwise appear in the Interpretative Communication, i.e. a generalisation of the ECJ case law, committing the Commission to ensure respect for the Treaty. The Directive would then indirectly have the same effect on market segment 4 as the Communication and help to ensure that non-warlike items come under the existing civil Directive.

A defence Directive could also be applicable to certain security items (market segment 5), which are too sensitive to come under the civil Directive. The market for such items has similar conditions as defence markets (public customers, specific IPR rules, confidentiality needs, etc). In these cases, a new Directive adapted to the specificities of the defence market could offer a useful alternative to national procurement procedures (similar to segment 3).

The extent to which all this would strengthen the EDITB is difficult to foresee. The Directive might not concern the high technology end of the spectrum, but it could have a positive effect on market

segments and industry sectors lower down the technology spectrum, where competition and consolidation are probably even more urgent. However, how beneficial a Directive would be in terms of competitiveness depends to a considerable degree on the extent to which member states use it for borderline Art. 296 contracts. The more they accept a Directive as an appropriate tool for fostering competition and cost-effectiveness, the greater its importance for the competitiveness of industry. In this respect, one should not forget that openness vis-à-vis a Community Directive would probably increase once the latter had been established and 'tested' in reality.

It is clear, however, that both fair competition and the strengthening of the EDITB necessitate more than just the coordination of defence procurement rules. The absence of common regimes for security of supply, transit, transfer and exports, in particular, discriminates against non-national defence suppliers and thus represents an important obstacle to fair intra-European competition. The same is true for certain practices with regard to state aid. This does not mean that a defence procurement Directive would not help, but it should be regarded as one element of a comprehensive approach to establishing an EDEM and serve as a catalyst for reform in related areas.

As far as European armaments cooperation is concerned, a Directive may have positive effects at two levels: First, by opening up national defence markets, it would increase the pressure for industrial consolidation and foster cross-border restructuring of defence companies in those areas which are still nationally organised. Second, the prospect of coming under Community law for national procurement may be seen as an incentive for member states to seek European cooperation in order to bring the project under the (more flexible) rules of international management agencies. In both cases, the Directive would foster, albeit in an indirect way, European cooperation.

In transatlantic armaments relations, a Directive would have an impact on two levels. With regard to defence imports from the United States, it should include provisions for offset arrangements. A third-country clause along the lines of that in Directive 2004/17/EC seems to be the appropriate instrument to ensure equal conditions between European and US competitors in European bids. Implemented in the right way, this would contribute to maintaining a diversified EDITB, in particular among SME, and strengthen Europe's position with a view to negotiating mutual market access with the United States. The second aspect in this context is the treatment of US-owned firms established in the EU. A Directive would have to ensure equal treatment of

these companies, with regard to both their rights and their obligations. In other words, if they fulfilled the relevant selection criteria, in particular security of supply and confidentiality, their extra-EU ownership would not constitute a valid argument for excluding them as candidates for contracts which come under the Directive.

To sum up:

- Coordinating procedures for the award of contracts in certain segments of the defence market, a Directive would be a contribution, albeit limited, to a more homogeneous regulatory framework in Europe and thus a useful and necessary step towards an EDEM.
- A defence Directive would not call into question the possibility of invoking Art. 296. As a consequence, it would foster transparency and competition mainly for defence contracts which do not concern essential security interests. However, the more member states used the Directive for Art. 296 borderline cases (and voluntarily for contracts falling within the scope of the Article), the greater its potential for cost-savings would be. On top of that, it could also be applicable to the procurement of security items which are too sensitive to come under the civil Directive.
- Offering greater flexibility than the civil Directive, a defence Directive could smooth the effects of competition in areas not covered by the exemption. Moreover, it could become a credible Community alternative to national procedures and thus attenuate the difficulty in defining the Art. 296 borderline.
- The Directive's effect on the competitiveness of the EDITB would depend on its use by member states. It might not cover the very high value segments of the market, but competition could even be more important further down the technology spectrum.
- The consequences of a Directive on transatlantic armaments relations would depend very much on its offset provisions. However, it would certainly not contribute to a 'fortress Europe' and not discriminate against US-owned companies established in the EU. On the other hand, appropriate selection criteria and flexible tendering procedures should be sufficient safeguards to protect European industrial interests.
- A defence Directive would have to tackle a large set of thorny issues, such as offsets and security of supply, which can only be resolved if member states reach consensus among themselves. The time taken to draft a Directive would therefore depend mainly on member states' political will.

- Accompanying measures in related areas, such as transfer, transit or state aid, would be necessary for the Directive to be fully effective. However, solutions in these areas should not be preconditions for a Directive. Rather, the preparation of the latter should be seen as an opportunity to tackle problems that must be resolved anyway, if an EDEM is to become reality.

The intergovernmental approach – a Code of Conduct

In the course of the debate initiated by the Green Paper, some member states have proposed a Code of Conduct on defence procurement to foster intra-European competition. At its meeting of 2 March 2005, the EDA Steering Board tasked the Agency to prepare, by the end of 2005, the grounds for the decision on whether or not to proceed with such a Code.

The content

A Code would be a politically, but not legally, binding instrument. It would be open to all EU member states, and participation would remain voluntary. A Code would probably have two reference points: on the one hand, WEAG's provisions for the establishment of an EDEM, which can provide useful lessons to be learnt; on the other, the EU Code of Conduct on Arms Exports, which can serve as a model for a Code of Conduct on defence procurement. The latter would then consist of a set of common principles, plus a notification and consultation system to ensure that the agreed principles are respected.

The scope of a Code would by definition be limited to contracts covered by Art. 296 (all others coming under the rules of the Internal Market). Within this field of application, certain categories will certainly be exempt from the Code's competition rules: highly sensitive systems (market segment 1), which are too important for member states' national security to be open to competition, and probably also cooperative projects, which are governed by specific rules.

At the current stage of the debate, one can assume that the ***principles*** of a Code will include mainly two commitments from member states:[31]

31. See, for example, 'A European Defence Equipment Market, a Non-Paper by the United Kingdom', attached to the UK Government response to the Green Paper. available online at http://forum.europa.eu.int/Public/irc/markt/markt_consultations/library?l=/public_procurement/marchs_publics_dfense/etats&vm=detailed&sb=Title (viewed 1 May 2005).

- To use Art. 296 restrictively, i.e. according to the Treaty and the ECJ's principles (whether this is stated explicitly or not). Member states would thus commit themselves to assessing case-by-case whether the use of Art. 296 is necessary for the protection of their essential security interests, and to invoke the exemption only if justified.
- To foster competition for those defence contracts which are exempt from the rules of the Internal Market through the use of Art. 296. This would imply, as additional guidelines:
  - using (national) competitive procedures wherever possible (except for highly sensitive programmes and specific circumstances, such as emergency cases);
  - opening-up competition to suppliers from all Code members;
  - fostering participation of these suppliers, in particular through transparency (explanation of national procurement regulations and practices, publication of contracting opportunities);
  - ensuring security of supply (authorising suppliers to deliver defence items whenever another Code member requires it to fulfil the needs of its armed forces);
  - not misusing security of supply (not excluding suppliers located on the territory of another Code member state).

These principles would be similar to those of the existing WEAG system, with the possible exception of an explicit reference to the use of Art. 296. Given the poor record of WEAG's attempts to foster intra-European competition, critics have raised doubts about the effectiveness of such non-legally binding commitments. However, there is reason to hope that an EU Code would be more relevant than WEAG arrangements:

The Code could take advantage of a favourable political context. Driven by budget constraints, there is a growing willingness in most member states to apply competition as a principle for defence procurement. At the same time, the internationalisation of defence industries increasingly undermines the traditional national basis for the customer-supplier relationship. Last but not least, the EU offers a much stronger and dynamic political framework than WEAG. The close relationship to ESDP and other EU policies in particular can serve to optimise the impact that such a Code could have.

On top of that, two additional elements are envisaged to ensure compliance with the principles of the Code:

1) A ***notification system***. WEAG has also implemented a data-gathering system covering cross-border contracts, the number of contracts published in the WEAG national bulletins and contracts placed with or without the application of WEAG rules. Recent proposals aim at a more detailed and ambitious notification system, whereby member states would have to report:

- all defence procurements exempt from the rules of the Internal Market (except highly sensitive items);
- for each exemption from Community rules, the intention to abide by the Code or not;
- justification if not;
- a comprehensive list of all contracting opportunities for foreign suppliers;
- the outcome of each reported contracting opportunity;
- state aids to defence industry, as a factor of market distortion (separately from individual reports from contracting authorities).

2) EDA would act as a ***central monitoring body***, administering the Code and its related notification system. EDA's precise role is not yet clear. However, there seems to be a general consensus that EDA, in contrast to the WEAG Armaments Secretariat, would not only receive reports from member states but also examine them and provide regular assessment to its Steering Board. The latter would then become the place for member states to discuss EDA's findings.

How to make it work – the challenges

Notification and monitoring will be crucial to the implementation of the Code's principles, since they form the basis for transparency and peer pressure, which, in turn, are the only conceivable compliance mechanisms of a legally non-binding agreement. To make them effective, notification and monitoring should thus be as comprehensive and detailed as possible. Current proposals, as described above, are quite ambitious in this regard and should therefore not be diluted.

In practical terms, national procurement bureaucracies would then have to establish exhaustive lists of (a) exemptions from Community rules (use of Art. 296), (b) contract opportunities (use of the Code's principles on competition for contracts covered by Art. 296), (c) contracts which are not awarded on a competitive basis (together with a justification). This information would need to be collected and transferred in a standardised form to the EDA. To make a difference

to the current WEAG system, the EDA would have to process the data provided by all 25 member states and use it for two additional tasks: publication of contracting opportunities and reporting to the EDA Steering Board.

A publication system for all contracting opportunities notified by member states will be crucial for the success of the Code, and EDA would be the natural place to host it. Drawing lessons from WEAG national bulletins, such a system should provide for publication which is (a) centralised, (b) standardised, (c) regular, (d) electronically available via the Internet and (e) offer a user-friendly solution to the EU's linguistic diversity.

Based on the information provided by national authorities,[32] EDA would also have to verify, for each notified contract, whether the Code's principles were being applied and inform the Steering Board of its judgement. Such an independent assessment of member states' procurement practice would in fact be a prerequisite for generating the peer pressure which is supposed to ensure compliance with the Code. In this context, it would also be important for EDA's assessment to be discussed at the highest political level, i.e. at ministerial Steering Board meetings.

Pointing out its political visibility and direct link to defence ministers, advocates of the Code argue that EDA could make a difference and help to ensure the Code's actual implementation. However, this places a huge responsibility for the success of the Code on the EDA. Problems may arise at both practical and political levels:

- Preparation and implementation of a Code are thorny administrative tasks. Information provided by member states needs to be standardised, processed and analysed; common criteria must be established (and applied) for the justification of non-application of the Code's competition principles; standardised procedures and forms must be defined for the publication of contract opportunities, etc. This may appear to be purely technical, but, as usual, the devil is in the detail. The centralised publication system, for example, will only fulfil its purpose if it is understandable for potential bidders in all European countries. This, in turn, raises the politically sensitive question of translation: must contract opportunities be published in all EU languages? Only in the national language of the respective country and in English? Only in English or French (the existing CFSP/ESDP language regime)? If there is translation, who would be in charge of it and bear the related costs? Such apparently minor issues could easily become serious obstacles to the project.

32. Another way to strengthen the Code's notification system would be to invite suppliers to notify the EDA if they find that a member state is not applying the Code's principles faithfully.

- With its current resources, the EDA would probably have great difficulties in coping with the workload that the Code implies (collect, process and analyse procurement data from all member states, organise the publication system and report to the Steering Board). In particular EDA's market and industry division would have to be enlarged considerably in order to meet that challenge.
- Even more importantly, a critical analysis of national procurement decisions is a politically tricky task. Playing the role of watchdog for member states is an enormous challenge for an institution that is not only very recent and still a fledgling, but also purely intergovernmental and, as such, highly dependent on the support of member states. Criticising individual governments and procurement decisions would be particularly delicate in a system that is based on peer pressure but in which all (or most) peers are potential (or actual) 'sinners'. The risk is thus that member states would prefer not to blame others for their procurement practice, knowing that they will sooner or later take questionable decisions as well.

Given all of this, a Code of Conduct might be relatively simple to design but its actual implementation would certainly not be easy. This is particularly true since the Code would be more ambitious than the two Community instruments. In contrast to the Communication and the Directive, the Code would try to foster competition for items for which Art. 296 is invoked. In this market segment, however, the industrial, technological and political stakes are particularly high and therefore particularly strong (and often legitimate) counterweights to competition concerns.

This makes it also unlikely that the Code will be applied to cooperative projects. Since the latter are mostly high-value and high-technology systems, which are also developed with the objective of strengthening specific industrial capabilities, it is difficult to imagine that participants would open up competition to companies of non-participating nations, i.e. invest scarce R&D resources abroad and sponsor other countries' technology base. At the current stage, where there is still no common defence industrial policy, such openness seems possible, at best, at the subcontracting level and for maintenance and in-service support contracts. However, even if member states were ready to go beyond that, thorny administrative and political problems would arise: OCCAR in particular would have to verify and possibly adapt its procurement regulations to make

them compatible with the Code's principles. Moreover, to make sure that OCCAR was not discriminated against NATO agencies, for example, member states would have to ensure that all international management bodies apply the provisions of the Code.

Implementing the Code's guiding rules on competition within the scope of Art. 296 would be one challenge, respecting its principle of using Art. 296 restrictively another. Exhaustive notification of exemptions from Internal Market rules would indeed greatly enhance transparency on member states' procurement practice, in particular if the EDA published the complete list of exemptions. This would give high visibility to member states' application of the Treaty and allow the European Commission to fully assume its responsibilities as guardian of the Treaty.

In this respect, EDA's role would depend on whether member states notified the *actual use* or the *intention to use* Art. 296. If decisions had already been taken, EDA could do little more than publish them (or inform only the Commission) and, if necessary, point to cases of obvious misuse in order to mobilise the Steering Board to influence member states' behaviour during the following reporting period. If member states notified their intention to use Art. 296, EDA could act as a clearing house, discussing with national authorities cases which should come under Community rules. Such prior decision consultation, however, is conceivable – at best – for a limited number of particularly dubious Art. 296 borderline cases, and would necessitate close cooperation between the EDA and the Commission (which has the necessary expertise to evaluate such cases).

Whether member states will actually allow EDA and the Commission to police the Art. 296 borderline together remains to be seen. Moreover, a self-imposed notification system organised by customers would be a new approach to which Commission services are not accustomed. However, transparency between EDA and the Commission on the use of exemption from Community law would constitute a perfect example of effective trans-pillar cooperation and could contribute considerably to limiting misuse of Art. 296.

Impact

Whether the Code would fulfil its objective to of fostering intra-European competition would depend in particular on how its principles were implemented and whether member states could agree on accompanying measures in related areas.

Covering the Art. 296 exemption area of the market, the Code would in principle have the potential to generate important cost savings and provide better value for money. At the same time, however, highly sensitive items (segment 1) would certainly be exempt, and the same would probably be the case for cooperative projects. This means that the Code's provisions on competition would not apply to important high-value parts of the upper end of the market, which, in turn, would reduce its impact considerably. This makes it even more critical to make notification of such programmes mandatory in order to limit possible misuse.

The Code's provisions would apply neither to warlike items not concerning essential security interests (market segment 3) nor to non-warlike items (market segment 4). However, if all exemptions from Community rules were notified and published, the Code would certainly have an impact on these market segments as well. A combination of peer pressure and proactive Commission policy could then lead to a more restrictive use of Art. 296. At the same time, interpretation of the scope of Art. 296 would probably remain controversial, especially in market segment 3. Member states could still try to invoke Art. 296 for these items, particularly if the only alternative was use of the civil Directive (i.e. if a Directive on defence procurement was still lacking). The transparency the Code would generate could then – similar to the Interpretative Communication – multiply disputes on whether contracts were covered by the exemption or not. Market segment 5 (security market), finally, would not fall within the scope of the Code.

Following the traditional intergovernmental approach to establish an EDEM via political arrangements and voluntary self-commitment, the Code would not coordinate national procurement regulations and therefore not contribute to a more coherent regulatory framework. Nor would processes for legal complaints change. Consequently, foreign industries would not be able to reduce their overhead costs. Coherence could even be negatively affected if not all EU member states subscribed to it and/or not all Code members commenced application at the same time.

The Code would probably have no direct influence on European armaments cooperation, nor would it improve the efficiency of cooperation mechanisms. However, were it to increase competition, it could create more market pressure to establish new industrial partnerships.

The impact on transatlantic armaments relations would also be limited, since member states would remain free in their decision to buy in the United States. Problems could arise if member states dis-

criminate against US-owned firms established in the EU. However, these problems would then be political, not legal in nature, and would certainly not be compelling enough to influence member states' procurement decisions.

To sum up:

- A Code of Conduct should by all accounts go beyond what the current WEAG system encompasses. This implies ambitious and precise principles and guidelines, an effective publication system and comprehensive notification. Transparency will be crucial, both to ensure member states' compliance and to help non-national suppliers to gain market access.
- If the provisions of a Code were both ambitious and effectively implemented, they could increase intra-European competition in crucial segments of the defence market (segments 2 and 3). At the same time, exemption of cooperative and highly sensitive projects would considerably reduce the Code's scope and thus its potential to provide better value for money and enhance the competitiveness of Europe's defence industry.
- The difficulties of establishing a 'strong' Code must not be underestimated. The preparation of the Code of Conduct on Arms Exports and, even more clearly, the LoI process illustrated that intergovernmental decision-making can be awkward and time-consuming. Moreover, there is a real risk that member states can only agree on a 'light' Code, with vague principles, weak supporting mechanisms and limited scope. Implementation of the Code's provisions will be even more difficult, depending mainly on member states' willingness to stick to their declared intentions with regard to both a competitive EDEM and a strong EDA.
- Even a 'strong' Code would lead to more competition only if a series of accompanying measures were taken. As with the Directive, a Code would need to be complemented by arrangements covering security of supply, transfers, transits and exports so as to give non-national suppliers a fair chance to compete with their national counterparts.
- A Code would not contribute to a more coherent regulatory framework. It would concern only certain parts of the defence market and have little influence on European armaments cooperation. It should therefore be considered not as the solution for Europe's defence market, but – at best – as *one* element of a more comprehensive and multipronged strategy.

Conclusions

Strengths, weaknesses and complementarities

It is generally accepted that the progressive establishment of an EDEM is necessary if Europe is to maintain a competitive EDITB in the long term and equip its armed forces adequately. The three instruments discussed in this report must therefore be seen and evaluated to the extent that they contribute to achieving the overall objective of an EDEM and add value as compared to today's reality.

All three instruments deal with procurement law as a central element of defence markets and aim at changing member states' current procurement practice:

- An Interpretative Communication would clarify existing law with the objective of putting an end to the frequent misuse of the exemption from Community rules under Art. 296.
- A defence Directive would coordinate national procedures for the procurement of warlike items subject to Art. 296.
- A Code would be a legally non-binding agreement between member states to open their defence markets in the area covered by Art. 296.

The objective of all three instruments would be to foster transparency and intra-European competition. Competition in defence is not an end in itself, nor is it always possible or even desirable. Member states may decide, for example, to maintain certain industrial capabilities for purely strategic reasons (for instance nuclear deterrence), even if they are not commercially competitive. At the same time, European monopolies – by definition the opposite of intra-European competition – may become necessary in specific areas (as is the case for civil aircraft) in order to be competitive on world markets. In many parts of the European defence markets, however, greater competition would be both possible and desirable as a way of reducing costly overcapacities and unnecessary duplication.

In principle, all governments recognise that the opening up of national defence markets is indispensable if they are to maintain a competitive EDITB and strengthen ESDP. In practice, however, national traditions, bureaucratic inertia, short-term employment interests, but also political mistrust and rivalries among member states, still prevail over common sense and financial imperatives.

Furthermore, member states' traditional reluctance to introduce the Community approach in defence persists. Granted, during the debate on the Green Paper, governments and industry demonstrated a remarkable readiness to consider the Commission as a serious interlocutor, but the general reluctance to apply Community instruments to defence markets remains intact. This is (in part rightly) justified on the grounds of the Commission's lack of experience in security and defence matters. However, it also covers a lack of knowledge in most defence establishments on Community rules, mechanisms and processes. This, in turn, has led to a considerable confusion and widespread misinterpretations of the various options for action at hand.

The most important conclusion that can be drawn at this stage is that the three instruments currently discussed are not alternatives to one another, but complementary in the way they impact on different segments of the market. Moreover, each of them has its specific strengths and weaknesses:

- An Interpretative Communication could probably limit the worst cases of misuse of Art. 296 and enhance competition on the periphery of defence markets. However, it would not contribute to a more homogenous regulatory framework and would leave Art. 296 as the only alternative to the civil Directive.
- A defence Directive could de-dramatise the choice between Community rules and Art. 296, and introduce a measured dose of competition into the market of those warlike items for which member states do not invoke Art. 296 (and possibly sensitive security items). However, leaving Art. 296 in place, it would probably not apply to most high-value contracts.
- Covering the upper end of the market, a Code would in principle have the potential to generate considerable cost-savings. However, important categories are likely to be exempt, which would greatly reduce its impact on the Art. 296 area of the market. Moreover, the effectiveness of a Code would depend completely on member states' political will to change their behaviour and accept the EDA as a watchdog over their procurement practice.

On top of that, none of the three instruments would resolve the fundamental question: for which contracts is the use of Art. 296 justified. At both ends of the market spectrum, the answer is – or should be – incontrovertible ('no' for non-warlike items, at the one end, 'yes' for highly sensitive items, at the other). For 'normal' warlike items, however, a large grey zone exists where it is less evident whether essential security interests are concerned or not. Neither a Communication, nor a Directive or a Code will be able to resolve this problem, since the definition of 'essential security interests' is purely political and evolves together with member states' defence and security policies. The more these policies converge, the less controversial the Art. 296 borderline will become. At the current stage, however, the vagueness of essential national security interests will continue to create problems for the interpretation and implementation of European law in defence markets. Each of the three instruments would cope differently with this problem:

- An Interpretative Communication would lead to a less lenient Commission policy within the existing legal framework. Thus, member states would still face the choice between the use of Art. 296 or the civil Directive, which they consider ill-suited to the procurement of much warlike material. They may therefore try to interpret Art. 296 as broadly as possible. In this case, a more proactive Commission policy would certainly increase the number of legal disputes.
- A flexible Directive could be a 'credible' Community alternative to national procedures. This would make it easier for member states not to invoke Art. 296 for questionable cases (and thus to avoid legal disputes). It could also become more difficult for member states to justify the use of Art. 296. This effect would be desirable as it would foster intra-European competition.
- The impact of a Code of Conduct on the Art. 296 borderline problem depends on its content and whether it was combined with a defence Directive or not: if the Code established full transparency vis-à-vis the Commission for all exemptions from Community rules, it would probably 'convince' member states to evaluate (more) carefully whether the use of Art. 296 was justified. However, if there were no defence Directive, the temptation to invoke the exemption to avoid the civil Directive would remain strong. Member states would, if they did so, then have to apply the Code's competition provisions and could face peer pressure to use (national) competitive procedures.

Last but not least, none of the three instruments would by itself be sufficient to create the level playing field for national and non-national suppliers which is necessary for an effective European marketplace. To create the conditions for fair intra-European competition, they would need to be accompanied by measures in related areas, in particular the establishment of common regimes for security of supply and transfers. This is true in particular for the Directive and the Code as the two instruments covering the procurement of warlike material.

Towards a comprehensive strategy

Following the consultation period of the Green Paper, the EDA has started to work on a Code with the aim of preparing a Steering Board decision at the end of 2005 on whether or not to proceed with the project. At the same time, the Commission is evaluating stakeholders' contributions to the Green Paper's consultation and will present a final report by the end of the year.[33] Based on this report, it will decide on how best to proceed: prepare an Interpretative Communication, start to work on a Directive or take no action at all. In other words, by the end of 2005, crucial decisions on the organisation of Europe's defence markets will be taken.

Bearing this in mind, we recommend that one instrument should not be played off against another, but rather that advantage should be taken of their complementarities and potential for mutual reinforcement. Communication, Code and Directive should thus be developed concurrently. In order to optimise their effectiveness, the Commission and EDA should work out solutions in related areas. All these initiatives should be launched in parallel as parts of a comprehensive strategy for the establishment of an EDEM.

An interpretative Communication could be prepared within a few months, that is to say long before the other two instruments become fully applicable. However, if a Directive were developed, a Communication would in principle be unnecessary, as the former could state in its preamble the same principles as the latter. Moreover, one could argue that it would be contradictory to adopt a Communication to insist on strict implementation of existing Community law and at the same time to admit that the civil Directive was ill-suited to defence. On the

33. Contributions are available on-line at: http://europa.eu.int/comm/internal_market/publicprocurement/dpp_en.htm#consultation (viewed 1 May 2005).

other hand, the Commission will probably not be able to ignore the fact that, during the consultation process, several member states expressed their preference for the Communication. It should therefore adopt a Communication as a political signal of its readiness to prevent misuse of Art. 296, but draft and implement it differently, depending on the decision on the Directive. If there were an agreement to develop a defence Directive, it would be sufficient to recall, in the Communication, the principles defined by the Court, make reference to the Directive and encourage member states to use the time until the latter becomes applicable to prepare themselves for strict implementation of Community law. If, in contrast, the project of a Directive were dropped or postponed, the Commission should draft a more rigorous Communication and fully apply its principles. This would probably demonstrate the utility of a Community instrument adapted to defence and rapidly revitalise the project of a defence Directive.

Given the poor record of intergovernmental arrangements in this area, there are good reasons to be sceptical about the prospects of a Code of Conduct. However, as long as member states cling to Art. 296, there is simply no alternative. From a purely technical point of view, one could imagine a Community defence Directive flexible enough to replace Art. 296 altogether; from a political point of view, however, such a step is still out of reach. In consequence, a voluntary arrangement of member states is at this stage the only way forward that will foster transparency and competition for complex and sensitive defence systems. Whether member states can reach consensus on an ambitious Code and implement it faithfully remains to be seen. However, they should not forget that the stakes are high, in particular for the credibility of the EDA, which will take charge of developing and administrating the Code.

Many member states still have misgivings vis-à-vis a Directive. However, they should view on a new Directive adapted to the specificities of defence as an opportunity rather than as a threat. It would not call into question the possibility of invoking Art. 296, but help smooth the effects of competition in areas not covered by the exemption. It would in particular reduce the risk of legal disputes and keep the bulk of defence contracts outside the scope of the civil Directive. Moreover, member states would be able to ensure, during the drafting process, that their concerns were taken into account. There are admittedly numerous obstacles and problems, but they are neither insurmountable nor exclusively related to the Directive:

- ***Feasibility***. The preparation (and even more so the implementation) of a Directive would certainly be politically difficult. Member states would have to reach consensus on thorny questions, such as offsets and security of supply. However, to become a serious endeavour a Code would have to cope with exactly the same issues.
- ***Preconditions***. Accompanying measures in related areas such as transfer, transit or state aid would be necessary to allow the Directive to be fully effective and to ensure fair cross-border competition. However, this is, again, true for the Code as well. Solutions in these areas should therefore not be preconditions for a Directive. The preparation of the latter should rather be seen as an opportunity to tackle problems that must be resolved anyway if an EDEM is to become reality.
- ***Timeliness***. Granted, member states still find it difficult to overcome their mistrust of the Community method in defence markets. However, if work does not start now, the next opportunity for a defence Directive will probably not arise for a long time. In particular a decision to wait and see whether a Code is sufficient would mean losing many years (and miss the point, because the two instruments are tailored for different market segments).
- ***Timing***. A Directive could easily take up to five years to become effective. However, a long preparation phase should not be an argument for dropping the Directive, but for starting as soon as possible. Moreover, the time it actually takes would depend mainly on member states' political will and, related to this, EDA's capacity to play the role of a constructive interface between member states and the Commission. Last but not least, one should not forget that it would also take a considerable time to make the Code operational, in particular if this implied changes to national legislation.
- ***Effectiveness***. In civil markets, the Community method has, in spite of all difficulties and problems, enhanced competition and improved industries' competitiveness. There is no reason why this should not work in the defence sector if the rules of a Directive are adapted to the specificities of the sector. Even with Art. 296 remaining in place, it has the potential to generate cost-savings if member states do not overstretch their definition of 'essential security interests'. Of course governments could always try to delay and

obstruct implementation of the Directive, but they could even more easily do so with a voluntary Code.

The challenges are considerable: in the case of an Interpretative Communication, the Commission must be politically courageous enough to stick to its commitments and to apply the principles defined in that document – if necessary in the face of resistance from member states; for a Code, member states must have the political will to radically change their behaviour; for a Directive, member states must overcome their traditional anti-Community instincts and accept the loss of a certain measure of national sovereignty over some elements of the defence market. In other words, political will once again will be essential.

Bringing together all relevant stakeholders and establishing a serious dialogue between member states and the Commission, the Green Paper has opened a useful and necessary debate. It has in particular opened the path to reforms that are indispensable for the establishment of an EDEM. Whether member states are ready to go down that path remains to be seen. As with all reforms, the risk is that everyone agrees in principle on the necessity to do 'something', but shies away when it comes to the crunch, threatening vested interests and old habits. The question is simply how often Europe can afford to postpone what is generally accepted as unavoidable.

Abbreviations

CFSP	Common Foreign and Security Policy
CPD	Coherent Policy Document
CPV	Common Procurement Vocabulary
EDA	European Defence Agency
EDEM	European Defence Equipment Market
(E)DITB	(European) Defence Industrial and Technology Base
ECJ	European Court of Justice
ESDP	European Security and Defence Policy
EU	European Union
EUISS	European Union Institute for Security Studies
LoI	Letter of Intent
NBC	Nuclear, Biological and Chemical
NATO	North Atlantic Treaty Organisation
OCCAR	Organisation for Joint Armaments Cooperation (*Organisation Conjointe pour la Coopération en matière d'armament*)
R&D	Research and Development
SME	Small and Medium-sized Enterprises
TEC	Treaty establishing the European Community
UK	United Kingdom
US	United States of America
WEAG	Western European Armaments Group
WEAO	Western European Armaments Organisation

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In September 2004, the European Commission issued a Green Paper on defence procurement, proposing various options to improve transparency and openness of defence markets between EU member states. The Green Paper opened a discussion on procurement law which rapidly widened into a general debate on how to move towards a common Defence Equipment Market.

The starting point of the debate is the use of Art. 296 TEC, which gives member states the possibility to derogate from the rules of the Internal Market for the procurement of arms, munitions and war material. Although this exemption is subject to certain conditions, most governments have interpreted Art. 296 as a blank cheque, excluding defence procurement almost completely from Community rules. This practice has led to inefficient market fragmentation and a lack of intra-European competition.

The Green Paper identifies two options for action to improve the situation: an Interpretative Communication, which would specify the conditions governing the use of Art. 296 on the basis of existing Community law; and a new Directive adapted to the specificities of defence for procurement contracts which are not covered by Art. 296 but for which the civil Directive may be ill-suited. In addition, member states tasked the European Defence Agency to explore possibilities of a Code of Conduct to foster competition within the scope of Art. 296. By the end of 2005, both the Commission and member states will decide on how to proceed and which elements to develop.

Given the importance of these issues the EUISS established a Task Force to assess the various options for action. The present report is the fruit of that work. It concludes that Communication, Directive and Code are not alternatives to one another, but complementary. It therefore recommends that all three of them should be developed concurrently. In order to optimise their effectiveness, the Commission and the Defence Agency should work out solutions in related areas. All of these initiatives should be launched in parallel as part of a comprehensive strategy for the establishment of a common European Defence Equipment Market.

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