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Accompanying document to the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

**on the coordination of procedures for the award of certain public works contracts,
public supply contracts and public service contracts in the fields of defence and security**

SUMMARY OF THE IMPACT ASSESSMENT

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EXECUTIVE SUMMARY

1. INTRODUCTION

For more than 40 years, defence and security matters were excluded from European integration. As a consequence, defence markets have remained de facto outside the single market and fragmented along national lines.

Since the end of the Cold War, this fragmentation has become increasingly problematic. With severe budget constraints, on the one hand, and rising costs for military equipment, on the other, national defence markets in Europe have often become too small to produce and procure high-quality equipment at affordable prices. Far-reaching reforms have become indispensable if Europe is to maintain a viable defence industry and equip its armed forces adequately.

In this context, the establishment of a European Defence Equipment Market (EDEM) is particularly important. To this end, in its Communication "Towards a European Defence Equipment Policy" of March 2003 the Commission presented proposals for action in areas related to defence industries and markets, notably in the field of defence procurement.

2. PROCEDURAL ISSUES AND CONSULTATION

The Commission then organised workshops with governments and industry to identify their expectations vis-à-vis possible Community action in this field. This prepared the ground for the Green Paper on defence procurement, adopted in September 2004.

The Green Paper consultation confirmed that the legislative framework for defence procurement in Europe is deficient:

1. Uncertainties persist regarding the use of Article 296 of the Treaty (TEC), which allows Member States to derogate from European Community (EC) rules if this is necessary for the protection of their essential security interests.
2. The Public Procurement (PP) Directive, even in its revised version (2004/18/EC), is generally considered ill-suited to many defence contracts.

To tackle these problems, in December 2005 the Commission announced two initiatives: the adoption of an "interpretative communication on the application of Article 296 TEC in the field of defence procurement"; and the preparation of a possible defence procurement directive.

The Interpretative Communication, which gives guidance to contracting authorities for assessing whether or not procurement contracts can be exempted, was adopted in December 2006. In parallel, the Commission continued to prepare a possible defence procurement directive. Stakeholders were closely involved via the Advisory Committee on Public Procurement, the European Defence Agency (EDA) and bilateral meetings. Moreover, governments and industry were consulted in the framework of the Impact Assessment.

The present report addresses both defence procurement (arms, munitions and war material procured for armed forces) and sensitive security procurement (equipment with similar features to military equipment procured for non-military security forces). The latter came up at a later stage in the debate at Member States' request.

The main argument for broadening the debate was the evolution of the strategic environment, in which the dividing line between external and internal, military and non-military security has blurred. However, the focus of the Commission's initiative remains on defence. With regard to non-military security, the question is "merely" whether an EC instrument for defence should also be made applicable to certain particularly sensitive procurements.

3. PROBLEM DEFINITION

Many Member States use Article 296(1)(b) TEC extensively to exempt the procurement of defence equipment from EC rules. The same problem, albeit less prominent, exists for sensitive security procurement, where Member States use either Article 296(1)(a) TEC or Article 14 of the PP Directive to evade EC rules. This practice is at variance with the Court's case law, which stipulates that such exemptions should be limited to exceptional cases.

The cause of the problem lies in the lack of EC rules suited to the specific features of defence and sensitive security contracts, in particular complexity (which calls for flexibility) and special requirements for security of supply and security of information. Since the existing EC rules have been developed for non-military and non-sensitive procurement, they do not sufficiently take these features into account.

As a consequence, most defence and sensitive security equipment is procured on the basis of uncoordinated national rules, which differ greatly in terms of publication, tendering procedures, selection and award criteria, offsets, etc. This regulatory patchwork is a major obstacle on the way towards an EDEM and opens the door to non-compliance with the Treaty principles. Lack of transparency and discrimination of suppliers from other Member States lead to lack of openness of defence markets, with negative effects for all stakeholders.

This is less visible for sensitive security than for defence, mainly because non-military security is more diverse, with a great variety of customers, users and budgets at national, regional and local levels. However, the problem (widespread exemption from EC rules), its cause (specific contract features to which EC rules are ill-suited), and its consequences (lack of openness) are the same for both defence and sensitive security procurement.

The specific problem is thus a mismatch between the Treaty and the ECJ case law, on the one hand, and Member States' procurement practice, on the other. The Commission, as guardian of the Treaty, has the duty to act to solve the problem.

4. OBJECTIVES

The Commission's general objective is to establish an open and competitive EDEM. Ideally, such an EDEM would allow suppliers established in one Member State to serve without restriction public customers in all Member States. In the field of public procurement, this requires a properly functioning regulatory framework at EU level for the award of contracts in the field of defence and security.

The operational objective of the Commission is to limit the use of the exemptions provided for in Article 296 TEC and Article 14 of the PP Directive to exceptional cases, in accordance with ECJ case law. The majority of contracts in the field of defence and security, including those for the procurement of arms, munitions and war material, should thus be awarded on the basis of EC rules in order to enhance

equality of treatment, transparency and non-discrimination. At the same time, Member States' security interests must be ensured.

5. POLICY OPTIONS

To achieve this objective, three options are possible: not taking any action, proposing a non-legislative measure, or a legislative measure.

Without further action, the current PP Directive, the Code of Conduct for defence contracts covered by Article 296 TEC, which is administered by the EDA, and the Interpretative Communication on the use of Article 296 would remain the only instruments in the field of defence procurement.

Non-legislative measures could include an interpretative communication on the use of Article 14 of the PP Directive in the field of security; a more proactive infringement policy; and training for national contracting authorities and Commission staff for their assessment of possible exemptions.

Possible **legislative measures** include a regulation, a sector-specific directive applying to all contracts awarded by contracting authorities operating in the field of defence and security, and a directive introducing into EC law new rules tailored to the specificities of defence and sensitive security contracts, by way of either an amendment to the PP Directive or a stand-alone directive.

Options discarded and retained for further consideration

Non-legislative measures are useful, but by themselves would be unlikely to achieve the objective of reducing use of the exemptions. This can be achieved only if EC procurement law contains rules which take into account the specificities of defence and sensitive security contracts. Since such rules currently do not exist, they must be set in place via a legislative measure.

Two options were thus retained for further consideration:

1. Doing nothing;
2. Taking a legislative measure to introduce into EC law new rules tailored to the specificities of defence and sensitive security contracts. Given its greater flexibility, a directive seems better suited to this end than a regulation.

For option 2, sub-options exist at three levels:

- *Type of legal instrument.* A sector-specific directive was discarded as incompatible with the principles of better regulation. Retained options were thus an amending directive and a stand-alone directive.
- *Field of application.* This could be determined either by a list or by a general definition; it could explicitly exclude certain contracts or simply refer to the exemptions allowed under the Treaty; and it could either contain new thresholds or maintain those set in the current PP Directive.
- *Content.* Different options are possible regarding security of supply, security of information, offsets and awarding procedures.

6. ASSESSMENT OF IMPACTS

Choice of options

Option 1. Without further EU action, the widespread exemption of military and sensitive security procurement from EC rules would certainly continue. The Interpretative Communication can curb the use of Article 296 TEC for the procurement of non-military equipment, but is likely to have little effect on the procurement of military equipment and no effect on the procurement of sensitive security equipment. The EDA's Code of Conduct can, at best, limit the negative consequences of the exemption provided for in Article 296 TEC, but not its misuse. The market for military and sensitive security equipment would not gain greater transparency and openness as a result. The negative consequences for costs, efficiency and competitiveness would persist.

Option 2. Before assessing the impacts of a possible directive, decisions on its key features must be made.

(a) Stand-alone vs. amending directive

The choice of instrument is mainly a question of legislative technique and was made on the basis of four criteria: enhancement of the *acquis*, conformity with better regulation principles, legal certainty and visibility.

A stand-alone directive would be a more visible, clearer, more reader-friendly and therefore easier-to-use instrument for contracting authorities. Moreover, it would make it easier to preserve the *acquis* (i.e. the provisions of the current PP Directive) and offer greater flexibility for drafting tailor-made provisions. Last but not least, the vast majority of Member States prefer a stand-alone directive.

(b) Field of application

The field of application must be delineated against the main objective, i.e. reducing the use of exemptions to exceptional cases. Consequently, the potential field of application of the new rules should be kept as wide as possible. At the same time, Member States' Treaty-based rights not to apply EC law for essential security reasons must be respected. On the basis of these criteria, the best options are:

- determining the field of application by a general definition rather than a list;
- limiting the number of explicit exclusions and rather referring to the derogations mentioned in the Treaty;
- maintaining current EC thresholds.

(c) Content

- The new rules must aim to implement the single market principles on defence markets. On the other hand, they must also offer sufficient safeguards and flexibility to ensure Member States' security interests. On the basis of these two criteria, the best options are:
- For security of supply, allowing contracting authorities to (1) request evidence from suppliers of their ability to meet export, transfer and transit obligations; (2) use security of supply as a selection criterion for assessing the technical capacity of suppliers, as well as request an undertaking from suppliers to meet security of supply imperatives in the future.

- For security of information, allowing contracting authorities to (1) not disclose confidential information during the tender procedure; (2) use the ability to ensure security of information as a selection criterion for assessing the technical capacity of suppliers.
- For offsets, not mentioning them. Since offsets usually entail discrimination by their very nature, they stand in direct contrast to the Treaty. Consequently, EC procurement rules can neither allow nor regulate them. On the other hand, explicitly forbidding offsets in the directive could create the impression that they would automatically be allowed for defence procurement contracts which are exempted under Article 296 TEC. This, however, is wrong. It seems therefore advisable to leave it up to Member States to keep possible offset requirements compatible with EU law.
- Allowing the negotiated procedure with prior publication as standard procedure, but limiting the use of the negotiated procedure without publication to strictly necessary cases.

Impacts of the chosen options

- Legal impacts. A directive should considerably improve the current fragmented regulatory framework for defence procurement. It would also significantly improve legal clarity. Awarding authorities would be able to assess which legislation to apply and justify their decision if necessary. This would improve legal certainty for all parties.
- Administrative costs. Possible negative impacts would be low both for industry and for awarding authorities. In the medium to long term, greater transparency will certainly reduce administrative costs for companies, in particular SMEs.
- Economic impacts. These depend considerably on the directive's acceptance by awarding authorities. This acceptance will certainly evolve over time. Initially, the directive may impact mainly on off-the-shelf procurement and technologically less sophisticated equipment. Greater openness of markets should enhance companies' chances to win cross-border contracts, thereby allowing the most competitive European companies to achieve economies of scale. The reduction of unit costs will then make their products more competitive on the global market. On the other hand, contracting authorities will obtain better value for money.
- International aspects. The introduction of EC procurement rules for defence and sensitive security would not change the situation regarding arms trade with third countries. The latter would remain governed by WTO rules, and more specifically the Government Procurement Agreement. Awarding authorities would still be free to invite to tender only EU companies or non-EU firms as well.

7. MONITORING AND EVALUATION ARRANGEMENTS

The Commission will continue to calculate year by year the main economic indicators allowing the assessment of transparency and competition on defence markets. It will also continue its political dialogue with Member States. A first assessment of the impacts of the directive on administrative costs should be scheduled five years after adoption. An evaluation of the economic impact should be contemplated in the longer term.

8. CONCLUSION

Introducing rules tailored to the specificities of defence and sensitive security contracts into EC procurement law seems indispensable to limit the use of the exemption provided for by Article 296 TEC and Article 14 of the PP Directive to exceptional cases, as stipulated by the ECJ. A stand-alone directive seems the best-suited legal instrument to do so.

Adoption of a procurement directive on defence and sensitive security is the logical follow-up to the Interpretative Communication of December 2006, which explains the conditions for the use of Article 296 TEC in the field of defence procurement. At the same time, it is a natural pendant to the Code of Conduct of the EDA, which is aimed at fostering transparency for defence contracts that fulfil the criteria for the application of Article 296 TEC.

Given the multitude of factors which shape defence markets, it is difficult to quantify the expected economic impact of such a directive. In general, however, it has the potential to make a difference. Bringing arms, munitions and war material as well as sensitive security equipment into the single market is by itself a strong political signal for the EU's readiness to build an EDEM. Coordinating national procedures, the directive will reduce the current regulatory patchwork. It will make it easier for Member States to use EC rules, but also more difficult for them to justify possible exemptions. This, in turn, will reduce the number of exemptions and hence improve transparency, non-discrimination and openness of defence markets in the EU.

To make the new rules as effective as possible, the Commission should envisage a series of accompanying measures. Special training courses for Commission staff and the allocation of additional resources for active monitoring of defence and security markets seem particularly important. The Commission should also pursue ongoing initiatives in related areas, namely security of supply and standardisation, and envisage new actions, particularly in the field of security of information and offsets.

The preparation of EC procurement rules for defence and sensitive equipment is only one step, but an important one, towards the establishment of a European Defence (and Security) Equipment Market.