

Analysis

Towards a European Defence Equipment Market

COMMUNICATION, DIRECTIVE OR CODE? THE COMMISSION'S GREEN PAPER ON DEFENCE PROCUREMENT HAS OPENED A NEW DEBATE ON HOW TO REACH THE AIM OF AN EDEM

In September 2004, the European Commission (EC) issued a Green Paper on Defence Procurement, proposing various options to improve transparency and openness of defence markets between EU member states. It is part of a global Commission initiative on the creation of a European Defence Equipment Market (EDEM).¹

Introduction

According to Article 296 TEC, member states have the possibility to derogate from the rules of the Internal Market for the procurement of “arms, munitions and war material”, if the latter are included in the list attached to that Article and concern their essential security interests. With regard to defence contracts which do not fulfil these criteria, the normal public procurement Directive of the Internal Market applies. The latter, however, have been developed for civil public procurement markets and do not take into account the specificities of most warlike materiel.

In its Case Law, the European Court of Justice has made it clear that exemption under Article 296 is subject to certain conditions and by no means an automatism. De facto, however, most governments have considered Article 296 as a blank cheque, using national procedures for (almost) all defence contracts.

These national procedures, in turn, differ greatly between member states in terms of publication of contract notice, specifications, tendering procedures, selection and award criteria, etc. The result is a regulatory patchwork which lacks transparency, hinders fair intra-European competition and represents a major obstacle towards an EDEM.

In its Green Paper, the EC identifies two options for Community action to improve the situation:

- an interpretative Communication, which would clarify existing Community law and specify the conditions for the use of Article 296;

¹ See COM(2003) 113 final, 11 March 2003.

- a new Procurement Directive adapted to the specificities of defence markets for those defence contracts which are not covered by the exemption under Article 296, and for which the existing civil Directive may be ill-suited.

In addition, during the debate opened by the Green Paper, several member states suggested an intergovernmental Code of Conduct on arms procurement as a third option. Such a Code would aim at fostering intra-European competition for sensitive defence contracts which fall within the scope of Article 296.

An Interpretative Communication

Given the quasi-systematic use of Article 296 for defence procurement, the EC is considering issuing an Interpretative Communication to clarify the existing legal framework. Explaining the principles defined by the ECJ for the interpretation of Article 296, the Communication would specify the conditions that member states have to fulfil when they invoke an exemption:

- derogation from Internal Market rules 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 or not;
- 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 national courts or, where appropriate, the ECJ.

At the same time, the Communication would commit the EC to fully assume its responsibilities as Guardian of the Treaties and to ensure that Member states use Article 296 according to the interpretation given in that document.

A clarification of existing Community law could probably contribute to change member states' current procurement practice, in particular if it was flanked by a less lenient EC Policy. However, an Interpretative Communication would have a number of important weaknesses and shortfalls:

- A Communication would clarify *how* to use Article 296, but not for *which* contracts. It can neither render the list attached to Article 296 more precise nor clarify the concept of essential security interests (which justify exemptions), because both are member states' prerogatives. It seems therefore doubtful that the Communication would facilitate the application of existing Community legislation.
- A Communication is a non-legislative measure which, by definition, would neither change current Community law nor harmonise national defence procurement rules for contracts covered by Article 296. It would thus not contribute to rationalising Europe's fragmented regulatory framework.

- A Communication would enhance transparency and competition, but mainly for non-warlike items (such as boots). Since this segment lies at the periphery of defence markets and clearly outside the scope of Article 296, a less lenient EC could certainly ensure that the use of the civil Directive becomes the rule. This would create better value for money, but it is unclear how great cost-savings would actually be.
- For less sensitive warlike items, which do not concern essential security interests (such as rifles), competition may increase as well, but only to a limited extent and with potentially problematic side effects. In this market segment, implementation of European law would probably be difficult, since the concept of essential security interests remains vague. Facing the choice between the use of Article 296 or the civil Directive, which is generally considered ill-suited for defence contracts, member states may well try to interpret Article 296 as broadly as possible. In this case, a more proactive EC policy would certainly increase the number of legal disputes.
- The impact on high-value market segments (sensitive items and complex systems) would be close to zero. Member states may be more often obliged to justify the use of Article 296, but it is difficult to conceive many cases where the EC or the ECJ would not accept such justification.
- 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).

For all 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 defence specific procurement Directive. Such a Directive would not replace Article 296, nor limit member states' right to invoke exemption for defence contracts which concern their essential security interests. Highly sensitive items and complex weapon systems, in particular, would still be covered by Article 296.

The focus of the Directive would rather be on defence contracts which do not concern Member states' essential security interests. In certain cases, it may be possible to use the civil Directive for this category. In general, however, the procurement of warlike equipment needs a Directive adapted to the specificities of defence, including in particular flexible procedures and specific provisions on security of supply and confidentiality.

Similar to a Communication, a Defence Directive could not clarify the notion of "essential security interests" either. The vagueness of the latter would thus persist and continue to create problems for the interpretation and

implementation of European law in this market segment. However, a Defence Directive could help to cope with the negative effects: in questionable cases, it would become easier for member states not to invoke Article 296 (and thus to avoid legal disputes) if they had at their disposal a Directive with rules adapted to the specificities of defence procurement.

At the same time, the very existence of a “credible alternative” could make it more difficult for Member states to justify the use of Article 296. However, member states would be fully involved (and have the final word) in the drafting of a Directive and could therefore make sure that its procedures become flexible enough to introduce the appropriate degree of competition for each contract. The Directive could then serve as a “parachute” to bear the “shock” of competition in cases where the use of Article 296 is not justified.

A defence Directive would have to tackle a large set of thorny questions, such as offsets and security of supply, which can only be resolved if member states reach consensus among themselves. The time it would take to draft a Directive therefore depends mainly on member states’ political will. Moreover, accompanying measures in related areas, such as transfer, transit or state aid would be necessary to allow the Directive to be fully effective. However, solutions in these areas should not be preconditions for a Directive. The preparation of the Directive should rather be considered as an opportunity to tackle problems that must be resolved anyway, if an EDEM is to become reality.

A Code of Conduct on Defence Procurement

During the debate raised by the Green Paper, some member states have put forward the proposal of a Code of Conduct to foster intra-European competition. In early March, the EDA received the mandate to prepare, by the end of 2005, the grounds for the decision on whether or not to proceed with such a Code to move on with the project or not.

A Code would be a politically – not legally – binding intergovernmental agreement. In contrast to the Directive, it would apply only to contracts falling within the scope of Article 296. A Code would therefore not be an alternative, but a complement to Community action.

The content of a Code is still unclear. However, taking the Code of Conduct on Arms Exports as a model, a Code of Conduct on Defence Procurement would probably consist of a set of common principles, plus a notification and consultation system to ensure the respect of the agreed principles. The EDA would be in charge of administering the Code.

Given the poor record of previous intergovernmental arrangements in this field, there are good reasons to be sceptical with regard to the Code’s impact. Optimists point out that participation of the EDA could make a difference, thanks to its political visibility and direct link to defence ministers. Pessimists, by contrast, stress the difficulty of seeking with non-binding instruments openness and transparency in market segments where industrial, technological and political stakes are particularly high and therefore

particularly strong (and often legitimate) counterweights to competition concerns.

This makes it unlikely, for example, that the Code would apply to cooperative projects and highly sensitive programmes. Exemption of these high-technology and high-value contracts, however, would dramatically reduce the Code's impact and potential to generate cost-savings

Moreover, a Code may be easy to draft, but would probably be difficult to implement. To be effective, it would have to be translated into national regulations, which could take up as much time as the definition of a Directive. A less ambitious Code would not pose that problem, but would probably change very little. On top of that, the Code, similar to the Directive, would only lead to more (and fair) competition, if it were accompanied by a series of measures in other areas (see above).

Conclusion

Five remarks may be expressed at this point.

- The fragmentation of Defence procurement law in Europe is generally acknowledged as a major source of inefficiency. However, the current debate opened by the Green Paper illustrates that reforms in this field remain highly controversial, since they would have major financial and political implications and touch on national interests and sensitivities.
- At the same time, there are widespread misinterpretations of the various options at hand. In this context, the lack of knowledge of most defence establishments on Community rules, mechanisms and processes is a major problem for objective decision-making.
- However, after decades of ignoring possible misuse, the EC seems now determined to ensure that member states respect the Treaty and the Case Law of the Court when they invoke Article 296. In other words: the EC will accept the use of national procedures only if member states can justify that their essential security interests are concerned. This change is in line with the EC's declared policy to move towards an EDEM in support of ESDP.
- There seems little doubt today that the EC will take further action. As a non-legislative instrument, an Interpretative Communication is the easiest solution at hand: the EC would "officially" declare the end of its (too) lenient policy in this area and explain what it expects member states to do when they invoke 296. Such a Communication would have only a limited impact and seems therefore insufficient. It could probably prevent the worst cases of misuse of Article 296 and ensure that non-warlike items come under civil Directives. In other market segments, however, a grey zone persists where the use of Article 296 would remain controversial, and where a more rigid EC policy could easily clash with member states' reluctance to apply civil Community rules.
- It is generally accepted that the existing civil Directive is ill-suited for most defence contracts. Member states should therefore consider a new

Directive adapted to the specificities of defence as an opportunity rather than a threat. It would not call into question the possibility of invoking Article 296, but help to 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 have the possibility to ensure, during the drafting process, that their concerns are taken into account.

- A Code would not be an alternative but a complement to a defence Directive. Both instruments would pursue the same objectives – openness and transparency – in different market segments. As a legally non-binding instrument which aims at fostering competition within the scope of Article 296, the Code would be both weaker and more ambitious than the Directive. Due to its intergovernmental nature, the implementation of a “strong” Code may become awkward and time-consuming. A “light” Code, in contrast, would probably make no difference to existing WEAG arrangements.