EC Defence Equipment Directives

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In December 2005 the European Commission published a number of recommendations for improving efficiency and competition in the EU defence market. The primary intention was to establish guidance on how EC Treaty exceptions and requirements under then Article 296 TEC (now Article 346, TFEU) should be interpreted with respect to defence procurement contracts. Specifically the Commission set out its intention to publish an Interpretative Communication on the application of Article 296, to be followed by a proposal for a legally-binding EU Directive on defence related procurement contracts. As part of these measures to open up the European defence market, the European Commission also published proposals in April 2006 on regulating the intra-Community transfer of defence products.

The Interpretative Communication was published in December 2006 while the draft Directives on intra-community transfers and defence procurement were published as part of a wider package of European defence equipment market measures in December 2007. Both Directives were subsequently adopted in May and July 2009 respectively.

The Directive on defence procurement contracts must be transposed into UK law by 21 August 2011; while the laws or regulations necessary to comply with the Directive on intra-community transfers must be transposed by 30 June 2011, with a view to applying its measures from 30 June 2012.

This note examines the background to these measures and the specific provisions in each Directive.

Contents

1 Background

Historically, most defence and security related products have been purchased by EU Member States on the basis of uncoordinated national contract award procedures and rules. These provisions differed significantly in terms of publication, tendering procedures, selection and award criteria. The European Commission considered that this lack of legal uniformity constituted a major obstacle to the establishment of a European defence equipment market and opened the door to non-compliance of Treaty principles by Member States, in particular the principles of transparency, non-discrimination and equal treatment.

The establishment of an effective European Defence Equipment Market (EDEM) was also regarded as a key factor in the development of a Common Security and Defence Policy.

1.1 Article 296 of the *Treaty Establishing the European Community*

Public procurement contracts currently fall under the scope of Directive 2004/18/EC. However, under Article 296 of the *Treaty Establishing the European Community* (now article 346 of the *Treaty on the Functioning of the EU*, as amended by Lisbon), the procurement of equipment, supplies, works and services intended for military purposes and crucial to national security can be exempted from EU public procurement rules, therefore enabling Member States not to competitively tender contracts in this area. Article 296 (now 346) states:

> 1. The provisions of this Treaty shall not preclude the application of the following rules:
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> (a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

> (b) any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.
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> 2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.[1]

Under the provisions set down in clause 1 (b), civilian goods or those not intended for military purposes, even if purchased by the defence ministry of a Member State, are not covered by the exemption that this Article provides. The products to which clause 1 (b) could apply (the list does not provide automatic exemption) were set down in April 1958 as Council Decision 255/58.

European Court of Justice (ECJ) case law supports this view and states that this Article does not permit automatic exemption for all defence procurement.[2] As the Commission pointed out in 2006:

> Using Article 296 TEC for defence procurement results in the non-application of Directive 2004/18/EC, which is the legal instrument intended to secure respect for the basic provisions of the treaty relating to the free movement of goods and services as well as freedom of establishment in the area of public procurement (Articles 28, 43, 49 TEC). The rules of this Directive are the expression of the fundamental principles and objectives of the Internal Market. Thus, any derogation under Article 296 TEC touches the core of the European Community and is, by its very nature, a legally and politically serious matter.[3]

However Member States have largely adopted a broad interpretation of the provisions of this Article and applied the exemption to the majority of procurement contracts issued by their respective defence ministries, regardless of their nature. As such, defence procurement has been conducted according to national regulations and guidelines on tendering and the award of contracts, all of which differ extensively. Factors such as offset obligations,[4] security of supply and workshare have thus influenced the defence procurement process within each Member State to a varying degree. Some EU Member States have been inherently protectionist in their approach to defence procurement; while others such as the UK have pursued an open market approach and competitiveness as a means to securing best value for money.

1.2 Work of the European Commission

Green Paper – September 2004

EU Member States have the prerogative in defence matters. However, the European Commission has a duty to ensure compliance with the principles of the Treaties and the case law of the European Court of Justice.

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1 Foreign and Commonwealth Office, *Consolidated Texts of the EU Treaties as Amended by the Treaty of Lisbon,* Cm 7310, Session 2007-08

2 European Court of Justice, Case C-222/84, *Johnston,* 15 May 1986; and subsequently Case C-414/97, *Commission v Spain,* 16 September 1999.

3 *Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement* (COM (2006) 779)

4 Offset is also referred to as Industrial Participation.

Therefore, in September 2004 the European Commission Internal Market Commissioner published a consultative *Green Paper on Defence Procurement*.[5] The aim of the paper was to improve efficiency and competition in the EU defence market by establishing guidance on how EC Treaty exceptions and requirements under Article 296 should be interpreted. The initiative was intended to complement harmonisation measures being pursued through the newly established European Defence Agency (EDA), including the Defence Procurement Code of Conduct.[6]

The paper identified two possible options for action by the European Commission: introducing a non-legislative instrument clarifying the existing legal framework; or introducing a new legal instrument aimed at establishing specific rules in defence procurement to supplement the current regulatory framework.

However, support for these stand-alone legislative options was minimal. The introduction of an interpretative communication was regarded by many as potentially useful, although insufficient in the longer term as it would be a non-legislative measure and would do nothing to promote either transparency or competition in the defence market. A new Directive, on the other hand, was viewed by many as a viable option but its impact was considered to be limited, as Member States would have to unanimously decide on when Article 296 applied; while issues such as security of supply would remain subjective and the prerogative of Member States.[7]

Therefore, the consultation paper put forward a third possible option. Under this proposal an interpretative communication, prepared in conjunction with Member States, would be set down to clarify the existing legal framework; while in tandem a voluntary European Defence Agency code of conduct would set down guidelines and broad categories for the procurement of goods under Article 296.[8]

Appearing before European Standing Committee B on 8 February 2005, the then Minister for the Armed Forces, Adam Ingram, set out the previous Government's view on the green paper proposals. He stated:

> We see it as an important lever in opening up thinking and discussions on how we might improve defence equipment procurement in the European Union, and increase the global competitiveness of the European defence industry. We believe that there is a significant need to improve the defence capability of EU member states so that they meet the headline goals of European security and defence policy. We believe that an important step towards that goal is improving the transparency and openness of defence procurement across Europe, potentially providing UK industry with improved access to EU defence markets and providing better value for UK and EU taxpayer […] We agree that such an open market is needed if Europe is to have the opportunity to meet cost-effectively the capability requirements of the ESDP […]
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> The Government believe that an interpretive communication might have some benefit, in that it could clarify the existing framework and particularly the use of article 296.

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5 A copy of this consultation document is available online at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2004:0608:FIN:EN:PDF

6 Further information on the EDA code of conduct is available in Library Research Paper RP06/32, *European Security and Defence Policy: Developments since 2003,* June 2006

7 See the submission from the EU Institute for Security Studies to the European Commission Green Paper on Defence Procurement, 15 February 2005

8 The EDA code of conduct is examined in Library research paper RP06/32, *European Security and Defence Policy: Developments since 2003,* June 2006

> However, we do not believe that the benefits that might result from introducing a specific defence procurement directive are sufficient to offset the drawbacks. In particular, an additional regulatory burden on top of those already in place is unlikely to support our aim of making defence markets more effective and efficient. We do not, therefore, support the development of a new directive at this time.[9]

European Commission Recommendations – December 2005

In December 2005 the European Commission published its recommendations in response to the results of the consultation. In a Communication to the Council and the European Parliament the Commission highlighted its intention to introduce the following:[10]

1. An Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement. This Communication would recall the principles governing the use of the exemption in line with European Court of Justice (ECJ) case law, and would clarify the criteria on which Member States would have to decide when the conditions for applying the Article 296 exemption apply and when they do not.

   The Commission Communication stated:

   > While providing additional legal certainty and guidance for member States, an Interpretative Communications will not alter the current legal framework. It will simply clarify the existing one, with the objective of making its implementation more uniform.[11]

2. In addition to the Interpretative Communication, the European Commission also considered that a Directive coordinating national procedures for the procurement of defence goods and services, where Article 296 does not apply, would be appropriate. Therefore, impact assessments would be undertaken throughout 2006 with a view to the presentation of a possible proposal for legislation.

Both Commission proposals would be complementary to the EDA Code of Conduct on Article 296 procurement contracts.

Proposal on Intra-Community Arms exports

As part of European Commission initiatives to open up the European defence market to greater competition, the Directorate General for Enterprise and Industry also published a consultation at the beginning of April 2006 on *Intra-Community Transfer of Defence Products.* The aim of the consultation was to facilitate the movement of defence products and services within the EC by laying the groundwork for a future initiative that would overcome the varying national administrative procedures for arms export licensing and establish simplified export procedures based on common criteria for products and services exported between EU Member States. In support of the development of such a framework, the European Commission pointed out that licence applications for intra-Community transfers were hardly ever rejected. By April 2006 approximately 11,500 such licences were being issued annually and, at that point, no request had been formally denied since 2003.[12]

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9 European Standing Committee B, 8 February 2005, c3-5, Session 2004-05

10 The full text of this Communication is available online at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0626:FIN:EN:PDF

11 ibid

12 European Commission, MEMO/07/546

As this proposal focused solely upon intra-Community transfers of defence products, and was not intended to replace national export licensing policies to non-EU countries, it fell within the competence of the European Commission. In its consultation paper the Commission sets out the following legal framework as justification for its proposals:

> According to the case-law of the Court of Justice of the European Communities, Community law applies to defence-related products, as it does to all other products. In particular, the principle of free movement of goods and services and commercial policy (Articles 28, 49 133 TEC) are applicable. By their very nature, export authorisations are one of the measures which create quantitative restrictions or measures having equivalent effect […] which Community law aims to eliminate with regard to intra-Community trade.
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> Nonetheless, Articles 30 or 296 allow Member States to justify restrictive measures by demonstrating on a case-by-case basis that they are needed and proportional to protect national security. However, it is not possible to infer from these articles that there is inherent in the Treaty a general proviso covering all measures taken by Member States for reasons of national security. Thus articles 30 or 296 have no effect on the Community's legislative power to lay down measures concerning the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market (Article 95 (1)).[13]

With a view to the aims of the consultation, the paper set out three options for improving arms export licensing procedures:

- Continued intergovernmental co-operation – The Six Nation Framework Agreement signed in July 1998 and the Farnborough Framework Agreement of July 2000, for example, included undertakings to apply simplified export procedures to transfers carried out as part of multinational procurement programmes. Intergovernmental co-operation could continue on this basis. However the paper acknowledged that the Framework would have to be extended and the other EU Member States would be required to participate if the benefits of the system were to be extended to the EU as a whole. One of the main advantages of this approach would be the utilisation of an instrument that already existed.

- Reinforcing ESDP – this could be achieved by a Common Position of the Council of Ministers. Agreed on the basis of unanimity the Common Position could set out simplified procedures for export licensing for those products being transferred within the EU, while at the same time setting out where exceptions could apply. However, the consultation paper highlighted the inability of the Council to approve similar proposals in the past and suggested that support for this initiative had not increased.

- Establishing a Community Instrument for defence markets – the Instrument would replace the authorisation of each intra-Community transfer with a procedure based on common EU criteria. The paper acknowledged that such an instrument would also be required to lay down measures which were sufficient for ensuring the national security of Member States, including the possibility of Member States

[13] European Commission, *Consultation Paper on the Intra-Community Circulation of Products for the defence of Member States*, 21 March 2006, para. 1.2

> exempting themselves from the principles of this Instrument in certain circumstances. The products covered by this Instrument could be included on a list drawn up on the basis of existing lists, such as the Common list of military goods covered by the EU Code of Conduct.

The consultation paper also acknowledged that any Community-level system would be required to provide guarantees that defence products exported to another EU Member State under this system would not then be re-exported to a country outside the Community. The paper suggested that establishing a list of third countries to which exports could be authorised on the basis of the EU Code of Conduct could be one option for addressing this concern.

In its July 2007 report on the *Strategic Export Controls: 2007 Review*, the Quadripartite Committee examined the proposals on intra-community transfers of defence products. It concluded:

> If the EU were to acquire a competence in defence manufacturing and to remove the barriers to the free movement of military goods and technology that currently exist within the EU, it would have a profound effect on the UK's system of strategic export controls, potentially such a development could be cause for serious concern, given that EU Member States' export control policies and practice vary. **In our view the Government needs to formulate a policy to respond to any proposals emerging from the European Commission to remove the barriers to the free movement of military goods and technology that currently exist within the EU. The Government's policy needs to address the effect that any changes would have on export controls and to ensure that UK and EU export controls are not weakened. We recommend that the Government set out its policy in responding to our Report.**[14]

In its response to the report the Government noted:

> In essence, the Commission is seeking ways to make intra-Community transfers less cumbersome and to remove unnecessary barriers, rather than removing all control over such transfers. For our part we are seeking to ensure that any proposals would not impact on our ability to use OGELs, nor result in any weakening of the control regime; and the recommendations would offer some tangible benefits for British industry with minimal changes to existing regimes. Commission officials have held a number of discussions with Member States and with representatives from industry on various ideas and continue to refine their thinking. The Government will develop its policy when the extent of the formal proposals is known.[15]

2 EC Interpretative Communication

In December 2006 the European Commission presented its Interpretative Communication on the application of Article 296.[16] The intention of the Communication was to "give contract awarding authorities some guidance for their assessment whether the use of the [article 296] exemption is justified". It does not attempt to either provide an interpretation of Member

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14 Quadripartite Select Committee, *Strategic Export Controls: 2007 Review,* HC 117, Session 2006-07, p.128-9

15 Quadripartite Select Committee, *Response of the Secretaries of State for Defence, Foreign and Commonwealth Affairs, International Development and Business, Enterprise and Regulatory Reform,* Cm 7260, Session 2006-07, p.30

16 COM (2006) 779

States' essential security interests,[17] or determine which procurement contracts the Article 296 exemption should apply to. The communication also only concerns defence procurement by national authorities inside the European internal market and does not apply to defence contracts with third countries. As outlined above, the communication does not alter the existing EC legal framework but merely clarifies existing provisions. As such, it was regarded as very much the first step toward an open and fairer European defence equipment market (EDEM).

The Interpretative Communication made the following observations:

- The nature of the products on the 1958 list[18] and the explicit reference in Article 296 TEC to "specifically military purposes" confirms that only the procurement of equipment which is designed, developed, and produced specifically for military purposes can be exempted from Community rules.

- The interpretation of Article 296 (1) (b) TEC and the definition of its field of applications must take into account the evolving character of technology and procurement policies. With regard to technology, the 1958 list seems sufficiently generic to cover recent and future developments.[19] Similarly, Article 296 (1) (b) TEC can also cover the procurement of services and works directly related to the goods included in that list, as well as modern, capability-focused acquisition methods, provided always that the other conditions for the applicability of Article 296 TEC are met.

- Security is becoming increasingly complex and that new threats blur the traditional dividing line between military and non-military, external and internal security dimensions. However, since the roles of military and non-military security forces still differ, it is normally possible to distinguish between military and non-military procurement. With regard to procurement for non-military security purposes, security interests may justify exemption from Community rules on the basis of Article 14 of the Public Procurement Directive.

- Article 296 (1) (a) TEC can also cover the procurement of dual-use equipment for both military and non-military security purposes, if the application of Community rules would oblige a Member State to disclose information prejudicial to the essential interests of its security.

- Member States have the prerogative to define their own essential security interests and their duty to protect them. However, that discretion is not without limits. The objective justifying the exemption is only the protection of a Member State's essential security interests. Other interests, in particular industrial and economic interests such as indirect non-military offsets, although connected with the production of and trade in arms, munitions and war material, cannot justify by themselves an exemption on the basis of Article 296 (1) (b) TEC. The reference to "essential" security interests also

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[17] Defence policy, and therefore a definition of what constitutes "essential security interests", is not within the Commission's competence.

[18] A copy of that list is available at: http://aof.mod.uk/aofcontent/tactical/toolkit/content/topics/ecannex/ann_c1.htm

[19] A revision of the 1958 list was rejected as an option by the European Commission as it was considered to be "a politically difficult and awkward exercise with a high potential for an unsatisfactory outcome" (*Commission Staff Working Document: Impact Assessment Summary*, COM (2006) 779/SEC (2006) 1555). A fuller explanation is also available in SEC 92006) 1554

makes clear that the specific military nature of a piece of equipment is not by itself sufficient to justify exemption from EU procurement rules and as such possible exemptions are limited to procurements which are of the highest importance for a Member State's military capability.

- Therefore, in determining whether an exemption under Article 296 is justified, Member States should, on a case-by-case basis apply the following questions:
    - Which essential security interest is concerned?
    - What is the connection between this security interest and the specific procurement decision?
    - Why is the non-application of the Public Procurement Directive in this case necessary for the protection of this essential security interest?
- As the guardian of the Treaty, the Commission may verify whether the conditions for exempting procurement contracts on the basis of Article 296 TEC are fulfilled. In such cases the Commission may request information from Member States to prove that exemption is necessary for the protection of their essential security interests. General references to the geographic and political situation, history and Alliance commitments are not sufficient in this context. The Commission may bring a matter directly before the European Court of Justice if it considers that a Member State is making improper use of the powers provided for in Article 296. The burden of proof that an exemption is justified lies with the Member States.

A copy of the EC Interpretative Communication is available online.

The European Scrutiny Committee examined the Interpretative Communication in the first half of 2007. Noting the comments of the MOD in February 2005 (see above) the Committee sought to clarify the government's position following the publication of the Communication on Article 296 and the possible creation of a directive concerning the procurement of defence goods and services where Article 296 does not apply. In its report of May 2007 the Committee noted:

> In response to our question as to whether he [the Minister] continues to subscribe to the position set out by the Minister for the Armed Forces in the debate two years ago, the Minister said that the Government's position remained consistent; it remained to be seen whether the potential benefits of a Defence Directive would outweigh the disadvantages; meanwhile he was "working constructively with the Commission, UK industry and other Member States to identify what benefits to defence procurement might be derived from a Directive, and without commitment to support the adoption of a Directive at Council, whether a balance of advantage can be achieved which would allow us to support the introduction of Commission proposals".
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> We noted that, despite his view as to its consistency, it seemed to us that the Government's position had shifted, from not supporting the development of a new Directive, to seeking to identify what benefits to defence procurement might be derived from one; that alternative interpretation might be that, with the Commission intent on pursuing this matter, he had concluded that damage limitation was the right approach; and that though he said that UK involvement was without commitment to supporting

> the adoption of a Directive, it seemed to us unlikely that, once produced, it would not in due course become law.[20]

The Committee subsequently concluded:

> We understand the purpose of the IC and the [EDA] code of conduct in relation to Article 296 EC […] our concern, however, is that no case has been made for fresh regulation of those areas of procurement in which Article 296 EC is not invoked […]
>
> We have seen nothing so far to justify the apparent change in the Government's position. Perhaps this will become clearer as and when the commission concludes its consultations and proposals are put forward. If that transpires […] they will need to be able to demonstrate clearly and persuasively why further legislation is the right way of making defence markets more effective and efficient and that it is not "an additional regulatory burden on top of those already in place".[21]

3 EU Package of Defence Measures

In December 2007 the European Commission published a package of measures entitled *A Strategy for a Stronger and more Competitive European Defence Industry*. The measures contained three elements:

1. A Communication entitled *A Strategy for a Stronger and more Competitive European Defence Industry,* which set out recommendations for fostering competitiveness in the European defence sector, including the promotion of common standards, the sharing and pooling of resources and abandoning the practice of defence offsetting.

2. A proposal for a Directive on defence procurement to enhance openness and competition in the defence sector.

3. A proposal for a Directive on intra-EU transfers of defence products designed to alleviate obstacles to intra-Community trade.

Announcing the measures, then EU Internal Market and Services Commissioner Charlie McCreevy commented:

> Introducing transparent and competitive procurement rules applicable throughout the Union is crucial for the establishment of a common defence market. This will lead to greater openness of defence markets between Member States to the benefit of all: armed forces, taxpayers and industries.[22]

The European Defence Agency also welcomed the efforts of the Commission to develop an effective European Defence Equipment Market, an initiative complementary to the EDA's own harmonisation agenda. In a press release issued on 5 December 2007 it went on to note, however, that:

> The Agency believes that competition is one key tool in a larger set that includes other important initiatives such as agreements on security of supply and security of information, issues on which the EDA is currently working. Competition is not a cure-all

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[20] European Scrutiny Committee, *Twentieth Report of Session 2006-07,* HC 41-xx, p.30-31
[21] European Scrutiny Committee, *Twentieth Report of Session 2006-07,* HC 41-xx, p.32
[22] "Commission proposes new competitive measures for defence industries and markets". IP/07/1860

and cooperation is in some instances more appropriate to shape the EDTIB [European defence technological and industrial base] of the future.[23]

3.1 EU Directive on Defence and Sensitive Security Procurement

Full Title: Directive 2009/81/EC of the European Parliament and of the Council on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security.

This proposal was made under Articles 47(2), 55 and 95 TEC, and was subject to the co-decision procedure with Qualified Majority Voting.[24] It was adopted in July 2009.

The Directive amends Directive 2004/18/EC which relates to public procurement contracts, and introduces harmonised EC rules on the procurement of defence and sensitive non-military security equipment where exemptions under Article 346 TFEU do not apply. The express aim of this new Directive is to encourage EU Member States to limit the use of Article 346 to exceptional circumstances, by providing a procurement framework unique to the defence and security sector which takes into consideration issues which will not contravene a state's essential security interests during the procurement process. Security of supply and the security of information have been highlighted as two such issues.

In principle, the procurement of all military equipment on the 1958 list, and related works and services, will come under the remit of this new Directive. Only where it is deemed that the protections provided in this new Directive are insufficient to safeguard a Member State's essential security interests, will the State in question be able to invoke the procurement exemptions provided under Article 346. Any decision to exempt a contract on the basis of Article 346 must be taken on a case-by-case basis and against the guidance set down in the Interpretative Communication and the principles set down in previous ECJ case law. What constitutes "essential security interests" will be the sole responsibility of Member States.

For the most part this Directive is based on the design and rationale of Directive 2004/18/EC, in particular with respect to the value thresholds for the application of the Directive's provisions (no less than €412,000 for supply and service contracts and €5.15m for works contracts),[25] and the rules on technical specifications, advertising, award procedures and criteria. An outline of the procurement tendering process under Directive 2004/18/EC is set out at: http://www.ogc.gov.uk/documents/Intro_to_EU.pdf. However, this new directive will also introduce a number of specific features which reflect the unique characteristics of public defence and security contracts. Specifically:

- **Scope** – the new Directive will apply to the procurement of arms, munitions and war material and related works and services. Procurement of non-sensitive and non-military equipment will remain covered by Directive 2004/18/EC even if those goods are procured by awarding authorities in the field of defence and security. Government-to-Government purchases, contracts arising from co-operative programmes between Member States and co-financed research and development

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23 "EDA welcomes Commission Communication on EU defence industry and market", 5 December 2007

24 Co-decision is now referred to as the Ordinary Legislative Procedure, which involves a legislative proposal from the Commission passing through the Council of Ministers and the European Parliament at the same time, with a conciliation procedure after second reading if there is still no agreement. For further information see Library briefing SN03689, *The European Union: a guide to terminology, procedures and sources*.

25 Directive 2009/81/EC, article 8

programmes[26] are excluded from the scope of this Directive; as is the award of contracts for all types of intelligence activities, including counter-intelligence, contracts for border protection or combating terrorism and organised crime (article 13). The Directive will not impact on defence trade with third countries which will continue to be governed by WTO rules and in particular the Government Procurement Agreement.[27]

- **Procedure** – Awarding authorities may use the 'negotiated procedure' with publication of a contract notice as standard which will give them the flexibility to negotiate all details of a contract with suppliers. However the Directive recognises that this may be impossible or inappropriate in certain exceptional circumstances. Therefore in very specific cases the use of the negotiated procedure without publication can be used, for example contracts for additional deliveries or the modernisation of technically complex existing systems. The restricted procedure may also be used if desired; while in the case of particularly complex contracts where the default procedures are considered insufficient, Member States may make use of Competitive Dialogue. However, the open procedure is not considered appropriate given the confidentiality and security requirements attached to such contracts (articles 25-28).

The awarding authority may also oblige contractors to specify, in its tender, any share of the contract it may intend to subcontract to third parties, on a fully or partly competitive basis, and may also oblige them to subcontract to third parties up to 30% of the value of the contract (article 21). Given the choice of language in this article, these particular provisions on subcontracting are regarded as options for contracting authorities, rather than mandatory requirements.

An awarding authority may also oblige companies to make specific contractual provision for the security of information (article 22) and security of supply, particularly in times of crisis and armed conflict (article 23). Both provisions can also be used in the criteria for selecting suppliers. Contracts will be awarded on the basis of two criteria: the lowest cost or the most economically advantageous tender, which will include criteria such as quality, price, technical merit, functional characteristics, environmental characteristics, running and lifecycle costs, after-sales service and technical assistance, delivery dates, security of supply, interoperability and other operational characteristics (article 47).

Member States will be required to take necessary measures to ensure that decisions taken by contracting authorities may be reviewed effectively and in a timely manner,[28] thereby introducing the ability of suppliers or contractors to take individual purchasers, i.e. the MOD, to the High Court if they considered them to be in breach of the regulations set down under this Directive. However, under the Directive (article 60) the review body may not consider a contract ineffective, even if it has been awarded in breach of the procedures under this Directive, if it finds that there are defence or security interests, of other overriding reasons, for confirming the award of the contract. The European Commission would also have the

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[26] R&D contracts should only cover activities up to the stage where the maturity of new technologies can be reasonably assessed and de-risked, in order to avoid precluding fair competition in the latter phases of any programme (Directive 2009/81/EC, para 55).

[27] Further information is available at: http://www.wto.org/english/tratop_e/gproc_e/gproc_e.htm

[28] This review procedure largely mirrors that process established in the Remedies Directive for the award of public contracts (Directive 89/665/EEC and 92/13/EEC, as amended by 2007/66/EC).

right to take the UK to the European Court of Justice over defence procurement matters that related to the implementation of this Directive.

In order to assess the application of this Directive, Member States are obliged to forward to the European Commission, an annual statistical report which addresses supply, services and works contracts awarded by contracting authorities, by no later than 31 October each year (article 65). In the longer term, a review of the implementation of this Directive, followed by a report to the European Parliament, will be concluded by 21 August 2016.

When the Directive was first introduced, the Commission made clear that the Directive does not allow for, or regulate, offset agreements. However, it has also stated:

> Offset practices differ so much that any attempt to forbid them explicitly in the Directive would face serious definition problems. It is therefore preferable to leave it up to Member States to make sure that possible offset requirements stay in line with the rules of the Directive and the Treaty.[29]

That position was also supported by the British Government which commented that "the text should neither explicitly authorise nor prohibit offsets, because this is a complex issue which ought to be resolved gradually, including through ongoing work in the European Defence Agency".[30]

The Directive will also have an impact on the Community's budget. Financing will be needed for the daily publication of notices in the *Official Journal of the European Union*; annual monitoring of the Directive's implementation; medium-term assessment of the administrative impact of the Directive, and a longer term assessment of the economic impact of the Directive. However, the European Commission's impact assessment concluded that there would be limited cost implications for contracting authorities and businesses themselves. Any increase in costs would be tied to the initial introduction of the new rules, while in the medium or longer term administrative costs for business, and SMEs in particular, would be lower.[31]

The Directive is intended to be entirely complementary to the EDA Code of Conduct on defence procurement.

Comments

When the draft Directive was first published, concerns largely centred focused on the notion that the Directive would lead to the indirect adoption of a "buy European" policy on the part of the EU Member States. In response the Commission sought to reassure that:

> The objective of the Commission's initiative is not to introduce a "Buy European" policy, but to foster transparency and openness of defence markets between Member States […] The Directive will set rules on how to procure defence equipment, but not determine which equipment should be procured. This is the decision of the customer, i.e. Member States.[32]

The Commission also stated:

> This proposal does not in any way interfere with the right of member States to cooperate on defence procurement […]

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29 European Commission, MEMO/07/547
30 European Scrutiny Committee, *Thirty Ninth Report,* HC 16-xxxv, Session 2007-08
31 European Commission, Explanatory Memorandum
32 European Commission, MEMO/07/547

> The Directive does not in any way interfere with Member State sovereignty on security and defence issues: it does not seek to determine what they should procure, or how much they will spend on defence. It merely offers them a more flexible tool which allows them to protect their security interests during the procurement process without violating their Treaty obligations.[33]

While expressing its support for the overall package of defence measures presented by the Commission, the Aerospace and Defence Industries Association of Europe also voiced concern that "regulating the EU market in a non-regulated world market could cause competitive disadvantage, especially in a sector where political, military and diplomatic involvement is sometimes called upon to support sales to governments".[34]

The European Scrutiny Committee examined the draft Directive on several occasions throughout 2008.[35] In its final report on this issue, the Committee recommended the draft Directive for debate in European Standing Committee and noted:

> It is apparent from the material supplied to us by the Minister that a number of improvements have been made to the proposal to meet the UK's concerns. This is notably the case in relation to ensuring that a Member State's ability to rely on the exemption under Article 296 EC [346 TFEU] is not radically curtailed. We also note that the legal difficulty we identified arising from the use of the EC treaty to adopt definitions of terrorism and criminal organisation has now been resolved by the deletion of those provisions.
>
> It is also clear from the Minister's account that a number of difficult issues remain, notably in relation to subcontracting and the question of the threshold for the application of the Directive. There is also the risk of amendments being made, such as provisions requiring reciprocity, which would affect the ability of UK industry to compete in world markets. Above all is the key question identified by the Minister of whether the market-opening advantages of the Directive continue to outweigh the potential drawbacks.[36]

The European Standing Committee debate took place on 24 November 2008. The Question:

> That the Committee takes note of European Union Document No.16488/07 and Addenda 1 and 2, draft Directive on the co-ordination procedures for the award of public contract in the fields of defence and security; and endorses the Government's approach to the negotiations and its view that if, following European Council agreement on a text and negotiations with the European Parliament, the documents remains within the UK's negotiating position, the Commission draft Directive could be supported.

was accordingly agreed to following a vote in the Committee (Ayes 8, Noes 4).

A copy of that debate is available at: General Committee Debates, 24 November 2008

Since the Directive was adopted in 2009 concerns have continued to be raised particularly over the impact of shrinking defence budgets and markets in Europe as a result of the current economic climate. A number of commentators have questioned whether the Directive will truly have an impact on opening up the European defence market to competition, or

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33 European Commission, DG for Internal Market and Services, press conference, 5 December 2007

34 "ASD broadly welcomes the European Commission's defence directives", 5 December 2007

35 European Scrutiny Committee, HC16-xi, HC 16-xiv, HC16-Xvii, HC16-xxii, HC16-xxv and HC16-xxxv (session 2007-08)

36 European Scrutiny Committee, *Thirty Ninth Report,* HC16-xxxv, Session 2007-08

whether Member States will fail to limit protectionism by continuing to invoke article 346 wherever possible, or by choosing not to apply the optional provisions in the Directive relating to subcontracting, in order to safeguard their respective domestic defence industrial bases.[37] In October 2010, for example, Greek defence Minister Evangelos Venizelos, was reported to have commented, in relation to the implementation of the Directive, that "countries must have the right to nourish their own industries".[38]

Clara O'Donnell at the Centre for European Reform has also argued that the impact of the Directive will depend "on the willingness of defence companies and the European Commission to contest decisions by member states, and take them to the European Court of Justice".[39] Other commentators have also expressed concern over the potential damage the Directive may inflict on research and development investment, given that production contracts would still be competed. The law firm DLA Piper noted the possibility that "companies will no longer invest in expensive R&D if there is no guarantee that they will get a return on their investment because production contracts will be open to tender".[40]

The Aerospace and Defence Industries Association has also continued to argue that the Directive will only address half of the issues facing the European defence industry and that an overwhelming need to consolidate demand via harmonised military procurement, still remains. A spokesman for the Association commented:

> When markets are forced open without consolidating demand, nations seeking the cheapest deal will go after off-the-shelf purchases from foreign suppliers who have the OTS products to sell. If you don't consolidate demand, then you don't achieve the economies of scale necessary to maintain capabilities in Europe.[41]

Transposition into UK Law

Directive 2009/81/EC must be transposed into UK law by 21 August 2011.

Under the *European Communities Act 1972*, a Statutory Instrument (SI) implementing EU law can be approved using the affirmative procedure, requiring a vote in each House; or be subject to annulment using the negative procedure. The vast majority of EU legislation is adopted using the negative procedure: i.e. if there is no motion of either House within the specified time (40 days), the instrument becomes law. The reasoning behind the overwhelming use of the negative procedure for EU law appears to be a matter of parliamentary time, and the fact that EU regulations and directives will already have been examined in their draft form under parliamentary scrutiny procedures (see above for the European Scrutiny Committee's comments on this Directive).

In their second Report in 1972-73 the Joint Committee on Delegated Legislation[42] acknowledged the difficulties in defining precise criteria for the method of implementation, but suggested the affirmative procedure would normally be appropriate for:

- powers substantially affecting provisions of Acts of Parliament;

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37 See "EU procurement directive prompts industry concern", *Jane's Defence Weekly,* 9 February 2011
38 "Greece to boost industry with contentious contracts", *Jane's Defence Weekly,* 4 May 2011
39 "The EU takes on defence procurement", Centre for European Reform, November 2008
40 DLA Piper, *Defence procurement: the emergence of a single market,* February 2009
41 "Industry steps up rhetoric as directive deadline looms", *Jane's Defence Weekly,* 4 May 2011
42 HL 204, HC 468

- powers to impose or increase taxation or other financial burdens, or to raise statutory limits on amounts which may be borrowed by, or lent, or granted to public bodies;

- powers involving considerations of special importance not falling under the above (e.g. powers to create new varieties of criminal offence of a serious nature).

As such, the *Defence and Security Public Contracts Regulations 2011* are likely to be implemented using the negative procedure, which does not require a vote in each House.

MOD Consultation on the Implementation of this Directive
While implementation of the Directive is mandatory, there are some elements of it, such as the various provisions on subcontracting, which are optional. Therefore, the MOD held two consultations with stakeholders on the Directive's implementation during 2010 and early 2011. The first consultation (held between December 2009 and March 2010) sought to elicit views on the optional elements in the Directive over which Member States had discretion.

The MOD's Second Consultation Document provided a summary of the results of the first consultation and the text of the draft regulations, the *Defence and Security Public Contracts Regulations 2011*. That document is available online at:

2009/81/EC Second Consultation Document

With regard to some of the optional elements of the Directive, the document made the following observations and policy decisions:

- **Subcontracting** – the MOD will transpose, as an option for contracting authorities, the obligation on successful contractors to compete all, or a certain proportion, of proposed sub-contracts to third parties. This will be done on a case by case basis, and will consider whether such measures will deliver value for money and create opportunities for SMEs across the EU.

  The MOD has opted, however, not to transpose article 21 (4) of this Directive which would oblige contractors to subcontract at least 30% of the contract value. The MOD noted that:

  > If used, it is likely to affect each tenderer differently, as they are likely to have different in-house and supply chain arrangements. This might result in difficulties for the contracting authorities/entities to comply with the legal duty to ensure equal treatment and non-discrimination for all tenderers. Some suppliers might find it difficult to sub-contract 30% of contracts if they do not have significant procurement departments. Other suppliers might find it difficult to maintain the critical mass necessary to sustain their business operations if they have to sub-contract 30% of contracts. Article 21(4) would also have a disproportionate effect on certain sectors, in some cases obliging SMEs to sub-contract to third parties up to 30% of the work which they would otherwise have won. SMEs may also struggle to cope with the bureaucracy required to use this Article 21(4).

- **Security of Information** – Providing contracting authorities with the option to require tenderers to comply with the UK's national provisions on security clearance, in accordance with existing government-to-government bilateral arrangements, will be transposed as a non-exhaustive series of options to be used on a case by case basis by the contracting authorities.

- **Security of Supply** - Providing contracting authorities with the option to require tenderers to provide certain documentation and/or commitments that provide assurance that there will be security of supply, will be transposed as a non-exhaustive series of options to be used on a case by case basis by the contracting authorities. This will allow each contracting authority/entity to draw up appropriate security of supply requirements which are tailored to specific procurements.

- **Transitional Policy** – The Directive requires the new rules to be implemented by 21 August 2011, but it does not explicitly address transitional issues. Therefore the MOD has decided to apply the new rules only to new procurement processes beginning on or after 21 August 2011.

The second consultation document also provided an opportunity to comment on a number of outstanding issues, such as the text of the draft Statutory Instrument.

The outcome of the second consultation and the final text of the implementing regulations have yet to be published, although both are expected before the summer recess.

Accompanying guidance on the implementation of these regulations is also available at: DSD Government Awareness Guide

The European Commission will report on the measures taken by Member States on the transposition of this Directive by 21 August 2012.

3.2 EU Directive on Intra-Community Defence Transfers

Full Title: Directive 2009/43/EC of the European Parliament and of the Council on simplifying terms and conditions of transfers of defence-related products within the Community

The directive was based on Treaty Article 95 TEC and was subject to the co-decision procedure using Qualified Majority Voting (QMV). It was adopted in May 2009.

Following on from the 2006 consultation on intra-community defence exports (see above), the Commission introduced a Directive simplifying national licensing procedures governing the movement of defence products and services within the EU. The Commission argued that the introduction of such legislation would increase the competitiveness of the defence industry; facilitate participation in prime contractor's supply chains, particularly by SMEs; benefit large industrial groups with subsidiaries in several Member States and enable those States to meet military needs at lower cost and enhance security of supply. Facilitating intra-community transfers was also regarded as essential for making the defence Directive more effective by eradicating the theoretical risk that sourcing from a European competitor instead of a national producer would carry an administrative burden thereby persuading a Member State to procure from the latter.

The Directive does not abolish licensing requirements for intra-community transfers.[43] Indeed the right to issue or reject an export licence will remain at the discretion of the Member State in line with its export control policies. Instead it introduces a streamlined framework of general and global licences for intra-community transfers teamed with confidence building measures for the protection of national security such as certification of defence companies and guarantees to prevent the re-export of goods to third countries. Individual licensing will

[43] This option was considered as part of the Impact Assessment (see SEC (2007) 1593).

remain an option in exceptional circumstances in line with the prerogative of Member States with respect to safeguarding its essential national interests and the determination of its defence and export policies and obligations under international arms control agreements and other treaties.

Specifically the Directive will:

- Apply to all defence–related products covered by the Common Military List of the European Union,[44] including sub-systems, components, technology transfer, maintenance and repair which is reflected in the Annex to this Directive (article 2). This Directive is also subject to the provisions of article 346 TFEU.

- Establish a system of general licences for two types of transfer: government-to-government transfers and transfers to certified recipients in another Member State (article 5). Suppliers in the territory of the Member State issuing a general licence and who meet the terms and conditions of that licence will thus be able to transfer defence-related products without the need for an individual licence every time.

- Establish global licences which may be granted to an individual supplier, at its request, for the transfer of one or several defence-related products to one or more recipients in another Member State (article 6). A global licence will be valid for a minimum of three years.

- Place a requirement on Member States to authorise and determine the terms and conditions of each licence, including the defence products that the licence covers, the possible uses of those products and the reporting obligations of companies using those licences (articles 4 and 6 (2)).

- Require Member States to certify companies who wish to source goods under general licences issued in other Member States (article 9). This article also sets out a number of criteria against which eligibility will be assessed including proven experience in defence activities, relevant industrial activity, a written commitment to observe and enforce all conditions related to end-use and the appointment of a senior executive personally responsible for transfers and exports. Competent authorities will be obliged to monitor the compliance of the recipient against these criteria at least every three years. The duration of a certificate will not exceed five years. A central register of certified recipients will be published by the European Commission.

- Include a safeguard clause whereby a Member State may revoke or limit the use of such licences at any time for the protection of essential security interests (article 4 (9)). Where a Member State issuing a licence has reason to doubt whether a certified company would respect any conditions attached to its general licence it will be able to suspend those licences with the company concerned. Such action will be reported to both the Commission and the other Member States (article 15). Certification may also be revoked (article 9 (7)).

- Oblige companies to guarantee respect for the export limitations which may be imposed by the originating Member State (article 10).

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[44] See Official Journal L 88, 29 March 2007, p.58

- Include a safeguard clause whereby Member States, in the interests of safeguarding essential security interests or compliance with its arms export control obligations, or where a member state has serious reason to believe that the supplier will not be able to comply with the terms and conditions necessary for the granting of a global licence, could choose to alternatively grant an individual export licence. Those individual transfer licences would authorise *one* transfer of a specified quantity of a specified defence-related product, to be transmitted in one or several shipments, to one recipient (article 7).

- Oblige Member States to lay down rules on penalties applicable to infringements of the provisions in this Directive, in particular in the event of false or incomplete information being provided as regards compliance with export limitations attached to a transfer licence (article 16).

Member States will still be entitled to pursue other intergovernmental arrangements such as the Six Nation Framework Agreement.

As a result of these provisions the Directive will subsequently have implications for the Community budget as the Commission will be required to co-operate in work with the Council on Updates to the Common Military List; report on the measures being taken by Member States to implement this Directive; report on the functioning of the Directive and its impact on the development of the EDEM; to organise the work of the Cooperation Group and monitor compliance.

In November 2010 one such update to the Common Military list was published (Directive 2010/80/EU).

Comments

Like the defence and security procurement directive, the European Scrutiny Committee examined this Directive several times over the course of 2008, prior to its adoption in 2009.[45] Having raised a number of concerns with the Government, the Committee noted in its final report on this issue in January 2009 that:

> The concerns we raised have been substantially addressed. We think that there could be some doubt over the scope of the power delegated to the Commission under Article 13(2) and that ideally this could have been more closely confined to amendments to the list mentioned in Article 13(1), but we do not consider this point to be sufficiently important to withhold clearance of the document.[46]

The document was therefore cleared from scrutiny.

The Committee on Arms Export Controls (formerly known as the Quadripartite Committee) has also followed the adoption of this Directive through its annual reports scrutinising UK arms export controls. In its 2008 report the Committee noted:

> On the basis of the evidence given by the Secretary of State for Defence and by the Foreign and Commonwealth Office we conclude that the Government has reached the view that neither the Defence and Security Procurement Directive nor the Intra-Community Transfers Directive as published on 5 December 2007 will lead to a

[45] European Scrutiny Committee, HC16-xi and HC-16xv, Session 2007-08, and HC 19-ii, Session 2008-09
[46] European Scrutiny Committee, *Second Report,* HC19-ii, Session 2008-09

> weakening of the UK's export control system. This is an issue that we shall keep under review.[47]

The Committee also raised the new Directive during the evidence session for it 2009 report:

> **Q185 Richard Burden:** In December of last year the EU agreed its Directive for the simplification of defence product transfers within the EU. That is due to come in this year. Do you see problems for the UK in the implementation of that harmonised licensing regime?
>
> ***Bill Rammell:*** No. I think it has been a very positive outcome. There were concerns, and certainly the European Scrutiny Committee flagged this up to us and we took on board those concerns about potential loss for national discretion, the extension of Community competence and potential for limitations of inter-governmental co-operation through the negotiations that took place particularly in December. We managed to resolve those and the European Parliament adopted the directive on 16 December, and that will proceed for adoption at a future Council of Ministers meeting very shortly.
>
> **Q186 Richard Burden:** For it to work from now on, though, it will obviously require all EU states involved to handle the regulations in a consistent way. Are you confident that that will be the case? Are there any areas of concern, and how will that be monitored?
>
> ***Bill Rammell:*** It will certainly be monitored by the Commission and nationally by individual governments. The Directive certainly permits us to operate the regime very close to the current one because, for example, we have long moved towards a simplified licensing system within our operations, so I do not think we have anything to fear from this. We need to ensure—and the Commission will take a role in that—that that is the way it is applied across the European Union.[48]

In written evidence to that Committee report, the UK Working Group on Arms raised concerns, however, over the lack of a mechanism in the Directive to ensure that the certification process adopted by each Member State was equally rigorous. It argued:

> The Directive stipulates that Member States are responsible for certifying companies within their territory, on the basis of certain criteria. It seems, however, that there is no mechanism to ensure that all Member States' certification processes are equally rigorous. Where concerns exist about the conduct of a certified company a Member State of origin may suspend transfer licences to that company or the receiving state may suspend exports from its territory for up to 30 days, however the expectation is that certification should be respected by all Member States. Moreover, the Directive does not provide for any systematic means whereby receiving Member States are routinely informed about relevant re-export conditions; it is up to the certified recipient company to abide by and to alert its government to any export restrictions associated with the original transfer licence. There would thus appear to be a significant risk of unauthorised export in cases where companies either wilfully or inadvertently neglect to inform their authorities of any re-export restrictions that apply to particular defence-related products.[49]

The group therefore called for Member States to:

> adopt a system of peer review to make sure that the certification process is working correctly and to a common high standard. This would help build trust and confidence on the part of the Member States in the operation of the new regime.

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47 Committee on Arms Export Controls, *Scrutiny of Arms Export Controls 2008,* HC 254, Session 2007-08
48 Committee on Arms Export Controls, *Scrutiny of Arms Export Controls 2009,* HC 178, Session 2008-09
49 Committee on Arms Export Controls, *Scrutiny of Arms Export Controls 2009,* HC 178, Session 2008-09

> In addition certified recipients should be required to keep detailed information about transfers received and any relevant restrictions; these records should be inspected annually by the certified recipients' national authorities. Another option could be to create a searchable on-line licence-information database in order to collate the details (including export restrictions) of relevant licences for each Member State. This would allow those dealing with export licence applications to easily verify the nature of any restrictions that apply to exports of defence products that have originated in other Member States.
>
> At some point (as yet undetermined) the Directive is to be reviewed, which could provide the opportunity to introduce the measures suggested above. However the stated purpose of the review is to examine whether the Directive has lowered barriers to intra-community defence trade, not its impact on effective transfer controls.
>
> The UK Government should insist that the eventual review of the Directive should include an analysis of its impact on transfer controls, with particular attention paid to the consequences of the certification process on the unauthorised export of defence equipment.[50]

In a July 2010 briefing, Clara O'Donnell of the Centre for European Reform suggested that in the longer term:

> For the initiative to be effective, EU countries will have to trust their neighbours to ensure that their defence equipment is not re-exported to undesirable destinations. That trust does not yet exist across the whole of the union. Some states, such as Germany and the UK, are known to have very reliable export controls. But others suffer from lower standards, in particular some of the new member states such as Romania and Bulgaria. All governments have promised to develop thorough controls before the new system comes into force. They must deliver on that commitment. Otherwise national export control authorities will use general and global licences for only a limited range of defence goods – or perhaps none at all.[51]

On the attitude of the United States, she went on to comment that:

> Currently the Pentagon fears that the EU's new system will lower the effectiveness of European export controls. US officials are concerned that looser controls amongst EU member states will increase the risk of technology leaking out of the EU into the wrong hands. If Europeans want the US to take part – and if they want it to take more ambitious steps in dismantling barriers to transatlantic defence co-operation in the future – they must address existing trust issues.
>
> The best way to reassure the US about the inadequate technical standards of export controls within some European countries is for EU governments to implement thoroughly the EU's new streamlined system of controls. If efficient pan-EU controls are proven to be effective, the US will feel more confident about exploring possible synergies.[52]

Transposition into UK Law

The laws or regulations necessary to comply with the Directive on intra-community transfers must be transposed by 30 June 2011, with a view to applying its measures from 30 June 2012.

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50 ibid

51 *A Transatlantic defence market, forever elusive?* Centre for European Reform Policy Brief, July 2010

52 ibid

The European Commission will report on the measures taken by Member States with regard to the transposition of this Directive by 30 June 2012. In the longer term the Commission will review, and report to the European Parliament and the Council of Ministers, on the implementation of this Directive by 30 June 2016.