



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.12.2006
SEC(2006) 1554

COMMISSION STAFF WORKING DOCUMENT

Accompanying document to the

INTERPRETATIVE COMMUNICATION

on the application of Article 296 of the Treaty in the field of defence procurement

Impact assessment

{COM(2006) 779 final}
{SEC(2006) 1555}

IMPACT ASSESSMENT

| | | |
|--------|---|----|
| 0. | Procedural issues and consultation of interested parties | 3 |
| 1. | Background information and problem definition..... | 4 |
| 1.1. | Background information | 4 |
| 1.1.1. | Specificities of defence markets..... | 4 |
| 1.1.2. | Market fragmentation..... | 4 |
| 1.1.3. | Defence spending | 5 |
| 1.1.4. | Industrial landscape..... | 8 |
| 1.1.5. | Procurement law..... | 9 |
| 1.2. | Problem definition..... | 9 |
| 1.2.1. | Specific problem: extensive use of Article 296 | 9 |
| 1.2.2. | Causes of the problem..... | 10 |
| 1.2.3. | Consequences of the problem | 10 |
| 2. | Objectives..... | 11 |
| 3. | Subsidiarity | 11 |
| 4. | Policy options..... | 11 |
| 4.1. | Option 1: No action at Community level | 11 |
| 4.2. | Option 2: Revision of the 1958 list | 12 |
| 4.3. | Option 3: Specifying "essential security interests" | 12 |
| 4.4. | Option 4: Clarifying the use of Article 296 by an Interpretative Communication | 13 |
| 4.5. | Conclusion..... | 13 |
| 5. | Analysis of the impact..... | 13 |
| 5.1. | Legal impact..... | 13 |
| 5.2. | Economic and financial impact..... | 13 |
| 5.3. | Impact on competitiveness | 14 |
| 5.4. | Impact on administrative costs..... | 14 |
| 5.5. | Political and institutional impact | 14 |
| 6. | monitoring and evaluation..... | 15 |
| 7. | Conclusion..... | 15 |

INTRODUCTION

The present Impact Assessment accompanies the draft "Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement". The study first recalls the context of the Commission's current initiatives in the field of defence procurement. The analytical part starts with a description of the situation in Europe's defence markets, with a special focus on market fragmentation and its negative consequences. This serves as the background for the identification of the problem and the definition of the Commission's objectives. In the following part, various options for tackling the problem are discussed and the impact of an Interpretative Communication assessed. The focus of this Impact Assessment lies on the problem analysis, the objectives and the policy options. It remains essentially qualitative.

0. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

In 2003, the Commission issued a Communication "European defence – Industrial and market issues – Towards an EU defence equipment policy",¹ which launched a set of seven initiatives aimed at gradually setting up a European Defence Equipment Market (EDEM) in support of the European Security and Defence Policy (ESDP).

In the area of defence procurement, this led to the publication in 2004 of a Green Paper² which invited stakeholders to comment on options for enhancing transparency and openness of defence markets between EU Member States. In parallel a series of meetings and contacts took place. At the end of the consultation period, 40 contributions were received, including from 16 Member States, European institutions (Parliament), bodies (the Economic and Social Committee) and agencies (Institute of Security Studies, European Defence Agency), representative organisations of industries (UNICE, ASD Aeronautic Space and Defence Industries Association of Europe), and experts in the field.

The findings of the Green Paper consultation, published in a Communication in December 2005,³ confirmed that the legal framework for defence procurement at European level is not working properly. This leads in particular to an extensive use of Article 296 TEC, which allows Member states to exempt defence procurement from community rules if this is necessary for the protection of their essential security interests. According to stakeholders, there are mainly two reasons for this:

- 1) the conditions for the use of Article 296 TEC are not clear,
- 2) the current Public Procurement Directive is ill-suited to many defence contracts.

Based on these findings, the Communication announced two further initiatives: an Interpretative Communication to clarify the conditions for the use of Article 296 TEC, and, considering that a clarification may not be sufficient, a possible new sector-specific procurement Directive adapted to the specificities of defence contracts.

According to the principles of better regulation, both initiatives will be accompanied by the relevant Impact Assessments:

¹ COM(2003) 113, 11 March 2003.

² COM(2004) 608, 23 September 2004.

³ COM(2005) 626, 6 December 2005.

- the present Impact Assessment accompanies the Interpretative Communication. It analyses in particular how the conditions for the use of Article 296 TEC can be clarified, and whether such clarification can enhance the openness of defence markets.
- a further Impact Assessment will be completed for the beginning of 2007, prior to any decision to undertake the drafting of a specific directive. It will ask in particular whether new, defence specific European procurement rules can improve compliance with the Treaty and enhance intra-European competition for defence contracts not covered by Article 296 TEC. Studies aimed at collecting facts and figures on the administrative costs and economic benefits of a directive have been outsourced and are currently ongoing. The findings of those studies will be integrated into the future Impact Assessment.

The Interpretative Communication on the application of Article 296 TEC will be adopted by the end of 2006. A proposal for a defence specific directive could be drafted by the end of 2007, subject to the outcome of the future Impact Assessment.

1. BACKGROUND INFORMATION AND PROBLEM DEFINITION

Defence procurement law is one element of defence markets. The following section gives an overview of the characteristics and problems of European defence markets, before entering into the main issue of the present Impact assessment, namely the use of Article 296 TEC and its implications for the openness of defence markets in the EU.

1.1. Background information

1.1.1. Specificities of defence markets

Defence markets cover a broad spectrum of products and services, ranging from non-war material, such as office equipment and catering, to complex weapon systems and highly sensitive material, such as nuclear, biological and chemical equipment. The sensitivity of defence equipment for Member States' security interests can vary depending on political and military circumstances. In general, however, its sensitivity is proportional to its technological and strategic importance.

At the upper end of the technological spectrum, weapon systems are often developed for the specific demands of a very small number of customers. These systems normally have long development and life cycles and high non-recurring costs. This, in turn, makes it necessary for governments of producing countries to bear a large share of research and development costs.

Given the importance of military equipment for security, national governments play a predominant role in the organisation and operation of defence markets. As sole clients, they determine the demand for products and thus define both the size of the market and the technological portfolio of the industry. As regulators, they control arms trade via export licences and shape the way companies operate and organise themselves. State control can also include industrial restructuring and ownership. In many cases, States are still shareholders in defence companies and/or hold "golden shares", which provide influence over strategic business decisions.

1.1.2. Market fragmentation

Defence expenditure in the EU is worth about €170 billion (1.7% of GDP),⁴ which includes about €82 billion for defence procurement in general and about €30 billion for the acquisition of new equipment. Most of this expenditure is split into relatively small and closed national markets; fragmentation at national level remains the main feature of Europe's defence sector:

- (1) on the demand side, 25 national customers have great difficulties in harmonising their military requirements and pooling their purchasing power into common procurement projects;
- (2) the regulatory framework consists of 25 different sets of national rules and procedures for all relevant areas (exports, transfers, procurement, etc.), plus specific arrangements for cooperative programmes;
- (3) on the supply side, defence industries remain fragmented along the lines of (national) market structures.

Given the relatively small size of Europe's defence markets, this fragmentation is increasingly problematic. It is generally regarded as a costly and inefficient obstacle to both competition and cooperation. It hinders industry from restructuring and cooperating across national borders, accessing other EU markets and reaching production volumes big enough to remain competitive. This, in turn, makes it difficult for governments to maintain a sound and viable Defence Industrial and Technological Base (DTIB), but also to develop the military capabilities necessary for implementing the ESDP.

The growing awareness of these problems has led to various initiatives under both the first and the second pillar: in March 2003, the Commission launched seven Community initiatives in defence-related areas (standardisation, intra-Community transfers, mapping/monitoring, research, public procurement, export of dual-use goods and competition). All these initiatives are aimed at supporting the gradual establishment of a European Defence Equipment Market. A few months later, at the European Council meeting in Thessaloniki, Member States decided to create an intergovernmental agency to support the development of military capabilities in the framework of the ESDP. This European Defence Agency (EDA) was set up in July 2004, working in particular on military capabilities, armaments cooperation, research and technology, and defence industrial and market issues.

1.1.3. Defence spending

Defence expenditure in the European Union is not only limited, but also unevenly distributed across the EU Member States. The four Member States with the largest defence procurement budget in nominal terms - UK, FR, DE, IT - account for approximately €61 billion, which is around 75% of overall defence procurement in the EU. On the other hand, the combined defence procurement of the ten new Member States amounts to little more than 3.3% of the total for the EU25. The large differences in the nominal values of defence procurement are related to the size of the economy, but also to diverging political priorities.

Figure 1: National defence procurement 2004⁵

⁴ Source: ESTAT and Commission calculations.

⁵ Source: ESTAT; calculations by DG MARKT.

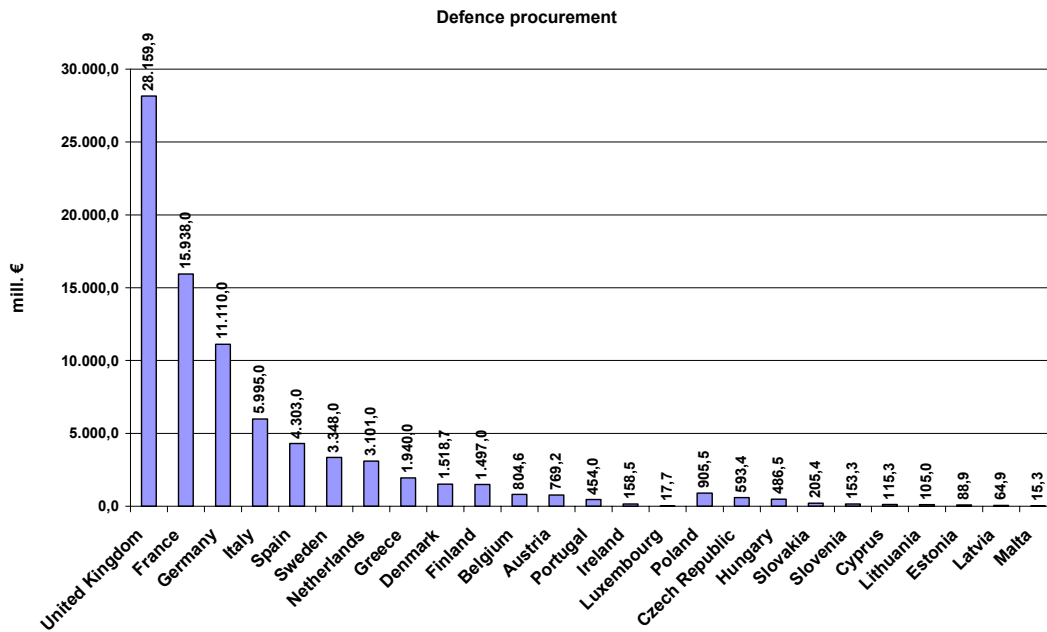


Table 1 shows that most EU Member States spend less than 1% of GDP on defence procurement. Only in the UK, SE and HE is the share higher (ranging from 1.2% to 1.6% of GDP). Moreover, considerable differences exist between the four largest countries, the share being three times higher in the UK and two times higher in FR than in DE or IT. Last but not least, the ratio between defence procurement expenditure and GDP does not change much over time. Even in those countries where the absolute value of defence procurement increased considerably between 2001 and 2004 (like the UK), the defence expenditure/GDP ratio remained fairly constant. Thus the development of defence procurement appears to be closely connected to changes in GDP.

Table 1: Defence procurement in the EU⁶

| | Defence procurement (mill. of current EUR) | | | | | Defence procurement (percentage of GDP) | | | | |
|-----------------------|---|-----------------|-----------------|-----------------|-----------------|--|-------------|-------------|-------------|-------------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2000 | 2001 | 2002 | 2003 | 2004 |
| United Kingdom | 27.909,1 | 25.268,8 | 26.670,1 | 27.803,7 | 28.159,9 | 1,8% | 1,6% | 1,6% | 1,7% | 1,6% |
| France | 13.190,0 | 14.284,0 | 15.039,0 | 14.657,0 | 15.938,0 | 0,9% | 1,0% | 1,0% | 0,9% | 1,0% |
| Germany | 11.050,0 | 11.160,0 | 11.440,0 | 11.250,0 | 11.110,0 | 0,5% | 0,5% | 0,5% | 0,5% | 0,5% |
| Italy | 5.616,0 | 5.871,0 | 6.036,0 | 7.601,0 | 5.995,0 | 0,5% | 0,5% | 0,5% | 0,6% | 0,4% |
| Spain | 2.633,0 | 2.887,0 | 3.419,0 | 3.700,0 | 4.303,0 | 0,4% | 0,4% | 0,5% | 0,5% | 0,5% |
| Sweden | 4.079,6 | 3.645,1 | 3.545,2 | 3.457,6 | 3.348,0 | 1,6% | 1,5% | 1,4% | 1,3% | 1,2% |
| Netherlands | 3.189,0 | 3.136,0 | 3.027,0 | 3.086,0 | 3.101,0 | 0,8% | 0,7% | 0,7% | 0,6% | 0,6% |
| Greece | 4.308,1 | 3.204,0 | 3.727,0 | 3.115,0 | 1.940,0 | 3,4% | 2,4% | 2,6% | 2,0% | 1,2% |
| Denmark | 1.281,5 | 1.457,3 | 1.403,4 | 1.423,7 | 1.518,7 | 0,7% | 0,8% | 0,8% | 0,8% | 0,8% |
| Finland | 1.162,0 | 1.087,0 | 1.196,0 | 1.315,0 | 1.497,0 | 0,9% | 0,8% | 0,8% | 0,9% | 1,0% |
| Belgium | 931,7 | 952,8 | 899,4 | 804,6 | 804,6 | 0,4% | 0,4% | 0,3% | 0,3% | 0,3% |
| Austria | 706,7 | 635,0 | 649,5 | 711,3 | 769,2 | 0,3% | 0,3% | 0,3% | 0,3% | 0,3% |
| Portugal | 749,4 | 584,0 | 443,1 | 423,5 | 454,0 | 0,6% | 0,5% | 0,3% | 0,3% | 0,3% |
| Ireland | 158,2 | 229,0 | 170,8 | 152,9 | 158,5 | 0,2% | 0,2% | 0,1% | 0,1% | 0,1% |
| Luxembourg | 15,1 | 14,1 | 17,9 | 19,1 | 17,7 | 0,1% | 0,1% | 0,1% | 0,1% | 0,1% |
| EU-15 Total | 76.979,4 | 74.415,1 | 77.683,4 | 79.520,4 | 79.114,6 | | | | | |
| EU-15 Average | | | | | | 0,9% | 0,8% | 0,8% | 0,8% | 0,8% |
| Poland | | | | 1.042,4 | 905,5 | | | | 0,5% | 0,4% |
| Czech Republic | | | | 856,1 | 593,4 | | | | 1,1% | 0,7% |
| Hungary | | | | 474,4 | 486,5 | | | | 0,6% | 0,6% |
| Slovakia | | | | 284,1 | 205,4 | | | | 1,0% | 0,6% |
| Slovenia | | | | 133,5 | 153,3 | | | | 0,5% | 0,6% |
| Cyprus | | | | 218,1 | 115,3 | | | | 1,9% | 0,9% |
| Lithuania | | | | 111,9 | 105,0 | | | | 0,7% | 0,6% |
| Estonia | | | | 89,7 | 88,9 | | | | 1,1% | 1,0% |
| Latvia | | | | 50,1 | 64,9 | | | | 0,5% | 0,6% |
| Malta | | | | 9,4 | 15,3 | | | | 0,2% | 0,4% |
| NMS-10 Total | | | | 3.269,7 | 2.733,5 | | | | | |
| NMS-10 Average | | | | | | | | | 0,7% | 0,6% |
| EU-25 Total | | | | 82.790,1 | 81.848,1 | | | | | |
| EU-25 Average | | | | | | | | | 0,8% | 0,8% |

Differences between countries are even more striking when it comes to military R&D spending (see Table 2). In 2001, the combined R&D budget in DE, FR and UK accounted for more than 90% of overall R&D expenditure in the EU15; for the six signatories of the Letter-

⁶ Source: ESTAT; calculations by DG MARKT.* For Belgium, no data was available for 2004. However, the values for the previous year (2003) can serve as a conservative estimate for procurement in 2004.

of-Intent (LoI)⁷ Framework Agreement – FR, DE, IT, ES, SE and UK – the share is almost 99%.

Table 2: Military R&D spending⁸

| | Military R&D Spending (mill of current national currency) | | | | Military R&D Spending (mill of current EUR) | | | | Military R&D (in % of GDP) | | | |
|----------------|--|-------|-------|-------|--|-------|-------|-------|-------------------------------|------|------|------|
| | 1998 | 1999 | 2000 | 2001 | 1998 | 1999 | 2000 | 2001 | 1998 | 1999 | 2000 | 2001 |
| United Kingdom | 2,619 | 2,488 | 2,197 | 2,158 | 4,165 | 3,595 | 3,237 | 3,184 | 3.27 | 2.62 | 2.07 | 1.99 |
| France | 3,580 | 2,674 | 2,454 | 2,512 | 3,580 | 2,674 | 2,454 | 2,512 | 2.72 | 1.96 | 1.70 | 1.68 |
| Germany | 1,551 | 1,161 | 1,044 | 1,027 | 1,551 | 1,161 | 1,044 | 1,027 | 0.79 | 0.58 | 0.51 | 0.49 |
| Italy | 587 | 274 | 175 | 232 | 587 | 274 | 175 | 232 | 0.55 | 0.25 | 0.15 | 0.19 |
| Spain | 218 | 156 | 141 | 139 | 218 | 156 | 141 | 139 | 0.41 | 0.28 | 0.22 | 0.20 |
| Sweden | 1,618 | 790 | 763 | 757 | 177 | 87 | 84 | 82 | 0.80 | 0.37 | 0.32 | 0.34 |
| Netherlands | 109 | 58 | 53 | 52 | 109 | 58 | 53 | 52 | 0.31 | 0.16 | 0.13 | 0.12 |
| Greece | 25 | 19 | 19 | 21 | 25 | 19 | 19 | 21 | 0.18 | 0.13 | 0.12 | 0.12 |
| Austria | 11 | 9 | 8 | 8 | 11 | 9 | 8 | 8 | 0.06 | 0.04 | 0.04 | 0.04 |
| Finland | 11 | 12 | 6 | 6 | 11 | 12 | 6 | 6 | 0.09 | 0.10 | 0.05 | 0.05 |
| Portugal | 4 | 4 | 3 | 3 | 4 | 4 | 3 | 3 | 0.04 | 0.03 | 0.03 | 0.03 |
| Belgium | 1 | 2 | 1 | 1 | 1 | 2 | 1 | 1 | 0.00 | 0.01 | 0.00 | 0.00 |
| Denmark | 39 | 33 | 6 | 6 | 5 | 4 | 1 | 1 | 0.03 | 0.03 | 0.00 | 0.00 |
| Ireland | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.00 | 0.00 | 0.00 | 0.00 |
| Luxembourg | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.00 | 0.00 | 0.00 | 0.00 |
| EU-15 Total | | | | | 10,443 | 8,056 | 7,226 | 7,268 | | | | |
| EU-15 Average | | | | | 696 | 537 | 482 | 485 | 0.09 | 0.07 | 0.06 | 0.05 |

1.1.4. Industrial landscape

The high concentration of R&D spending is directly related to the distribution of defence industrial capabilities, with the six LoI countries representing more than 90% of European production. In particular, research-intensive high-technology and system integration capabilities are concentrated in the LoI countries, whereas many other Member States have only some small and technologically less sophisticated industrial capabilities.

Driven by rising costs for complex weapon systems, on the one hand, and shrinking – or at best stagnating – defence budgets on the other, defence industries in Europe have gone through a major consolidation process over the last 10 years. All sectors have witnessed downsizing and restructuring, but only in aerospace and electronics have companies merged across national borders (BAE Systems, Thales and EADS, plus a dense network of joint ventures). However, the fragmentation of the market makes it difficult for these companies to optimise their internal processes and to function as truly transnational companies. In naval and land armaments, consolidation is less advanced and cross-border industrial ties remain an exception.

The "right" balance between consolidation (necessary to reach the critical mass to become competitive on a global scale) and competition (desirable to avoid the negative effects of oligopolies or monopolies) varies between the sectors and depends on the specific market situation. It is generally agreed, however, that Member States' defence budgets are too small for them individually to maintain a viable industrial base. Access to other markets is therefore crucial for most producers, through either cooperation (joint programmes, subcontracting,

⁷ The Framework Agreement was signed in July 2000 between the six main arms producing countries in Europe. It is an international Treaty outside the EU context and is aimed at facilitating cross-border cooperation and restructuring of defence industries.

⁸ Source: International Institute for Strategic Studies (IISS); calculations by DG MARKT. Data was available for EU15 and until 2001 only. For Euro zone countries, "national currency" refers to "euro fixed" series.

etc.) or competition (participation in foreign tenders). Here again, market fragmentation becomes the major obstacle.

The existence and importance of defence industrial capabilities are also key determining factors for Member States' procurement policies. If Member States have the industrial capabilities within their territory to develop and produce weapon systems they need, they normally give preference to local manufacturers (which can also be in foreign ownership). For low-tech products, many Member States have national capabilities and often pursue a policy of national preference. For complex systems, the situation is different: only the LoI countries have the necessary assets to develop (individually or collectively) these systems. The other Member States buy them off-the-shelf and on a competitive basis from non-national suppliers, often from the United States. However, this does not mean that competition is necessarily transparent and fair, since procurement rules differ considerably between Member States, and procurement decisions are often influenced by political considerations with offsets playing a crucial role.⁹

1.1.5. Procurement law

At Community level, there is – in contrast to other sectors such as energy or transport – no specific directive coordinating national procurement rules in the defence sector. It is thus Directive 2004/18/EC on the procurement of goods, works and services which applies to public contracts awarded by authorities in the field of defence, subject to Article 296 of the Treaty.

Article 296 TEC allows Member States to exempt the procurement of arms, ammunition and war material from Community rules, if this is necessary for the protection of their essential security interests.

Defence contracts exempted under Article 296 TEC are awarded on the basis of national legislation. For defence procurement, most national legislation provides for exemptions from the application of public procurement rules, with differing degrees of transparency. Defence specific procurement rules, however, differ greatly between Member States with regard to publication systems, standards for technical specifications, selection criteria, tendering procedures and award criteria. On top of that come special procedures for cooperative programmes. This diversity of regulatory frameworks is an important factor in Europe's market fragmentation.

1.2. Problem definition

The previous section has shown that fragmentation of defence markets in the EU creates problems with major financial and economic consequences in a variety of areas. The following sections will focus on one area – defence procurement – and one specific problem, namely the extensive use of Article 296 TEC.

1.2.1. Specific problem: extensive use of Article 296

⁹ Offsets are compensations that governments require from non-national contractors as a condition for purchasing defence articles or services. These compensations can cover a wide range of activities directly or indirectly related to the object of the procurement contract. Indirect offsets, in turn, can be defence related or non-defence related.

According to the Court, the exemption provided under Article 296 TEC is limited to exceptional cases and does not lend itself to a wide interpretation. In practice, however, many Member States have used Article 296 TEC extensively, exempting from Community rules also defence contracts which do not fulfil the conditions for the use of Article 296 TEC, namely non-war material and equipment which does not concern essential security interests.

One indicator for the extensive use of Article 296 TEC is the low publication rate for defence procurement (an average ratio of 10 between the value of defence contracts published in the OJEU and the total amount of defence procurement expenditure). Even more telling, however, are the great differences in publication rates between Member States, ranging from 1% to 20%. This clearly illustrates that (a) Member States have very different views on how to interpret the possibility of exempting defence contracts from Community rules, and (b) many of them could probably use the exemption more restrictively without putting their essential security interests at risk.

1.2.2. Causes of the problem

According to the findings of the Green Paper consultation, application of Article 296 TEC is problematic mainly for two reasons:

- (1) **The conditions for the use of Article 296 TEC are not clear. There are several reasons for this:**
 - (a) The concept of "essential security interests" is vague and can lead to different judgments on the strategic and military importance of equipment;
 - (b) Paragraph 2 of Article 296 TEC mentions a list of war material which can be exempted. However, this list is not very precise and has never been published or revised since it was established in 1958;
 - © New threats and technologies have blurred the dividing line between military and non-military security. This makes the decision on what is "defence" and what is "essential for security" even more complex.

As a result of all this, there is an important grey zone in defence markets where it is not clear whether procurement contracts fulfil the conditions for the use of Article 296 TEC or not.

- (2) The **current Public Procurement Directive**, even in its revised version (2004/18/EC), is **considered ill-suited to many defence contracts**, since it does not take into account defence specific features. This concerns in particular the publication system, award procedures and selection criteria. Consequently, many Member States are reluctant to use the PP Directive for defence equipment. In order to be able to incorporate those special features in defence contracts, they declare them exempt from public procurement rules on the basis of Article 296 TEC, even if the conditions for the application of that provision are in fact not met.

1.2.3. Consequences of the problem

As a result of the excessive application of Article 296, the majority of defence contracts in the EU are awarded on the basis of national procurement rules, which differ greatly between Member States. This hampers transparency and creates extra transaction costs for foreign

bidders (identification of calls for tender, adaptation to local contracting conditions). The result is less openness than there should (and could) be in those defence market segments which are *de jure* not covered by the exemption provided for in Article 296 TEC.

This has a negative impact for both the supply and the demand side: production volumes remain limited, which reduces economies of scale and has a negative impact on industries' competitiveness. For Member States, the lack of competition causes overspending in defence procurement. Higher prices for specific procurements, in turn, can lead to reductions of orders and, consequently, further reduction of production (either under the programme concerned or under other procurement programmes). Last but not least, lack of competition can also lead to lower quality, which means that Europe's armed forces risk not getting the best value for money.

2. OBJECTIVES

The Commission's overall objective is gradually to establish a common European Defence Equipment Market (EDEM).

The Commission's activities in the area of defence procurement are part of this wider initiative. Their objective is to ensure compliance with the principles of the Treaty and foster transparency, equality of treatment and non-discrimination in those parts of the defence markets where Community rules (should) apply.

To achieve this objective, the Commission's policy is to make sure that the legal framework for defence procurement at Community level works properly. This makes it necessary to tackle the two causes of the problem, i.e. the lack of certainty regarding the scope of Article 296 TEC and the lack of Community rules suited to defence procurement.

As a first step, the Commission will therefore clarify the conditions for the use of the exemption provided for by Article 296 TEC. The present Impact Assessment focuses on this initiative.

3. SUBSIDIARITY

As guardian of the Treaty, it is the Commission's duty to ensure compliance with European law. This is also the case for Article 296 TEC and its application in the field of defence procurement. It is thus for the Commission to examine, if necessary, in specific procurement cases whether the conditions for the use of Article 296 TEC are met, but also to ensure that the provisions of that Article are applied throughout the Union.

It is the Member States' prerogative to define their security interests and their duty to protect them. However, the differences in their way of using the exemption from Community rules show the need to clarify the legal framework at EU level and give some guidance on how to interpret Article 296 TEC. Given its role as guardian of the Treaty, only the Commission can do this.

4. POLICY OPTIONS

4.1. Option 1: No action at Community level

Without an initiative from the Commission, the only remaining initiatives to foster openness of defence markets in Europe would be the "Code of Conduct" (CoC) of the European

Defence Agency (EDA), which entered into force on 1 July 2006. The CoC is a non-legally binding instrument aimed at securing greater transparency (through publication on the so-called Electronic Bulletin Board) and accountability (through an obligation of reporting to the Steering Board of the Agency) for certain national procurement contracts covered by Article 296 TEC.

However, the scope of the CoC is limited to certain defence equipment covered by Article 296 TEC. In other words, it applies only to contracts which are exempted from Community rules and does not clarify the conditions for the use of Article 296 TEC.

Without action at Community level, the current uncertainty and all its negative consequences would thus persist. It therefore comes as no surprise that, in the Green Paper consultation, all stakeholders ruled out "no Community action" as an option.

4.2. Option 2: Revision of the 1958 list

The list mentioned in Article 296(2) TEC includes military equipment to which the exemption can apply if the conditions for the use of that Article are met. Although the list has never been officially published, it is available in the public domain. It is generally acknowledged that this list is not very precise. Moreover, being established in 1958, it has never been adapted to technological developments and is therefore often considered somewhat outdated.

In principle, the Commission could present a proposal for a more precise and possibly more exhaustive list in order to better define the scope of Article 296 TEC. However, the stakeholder consultation confirmed that this approach is not advisable:

- First, the Council would have to approve the Commission's proposal by unanimity, which seems unlikely, since many Member States see no need for a revision.
- An updated and more precise list on which all 25 Member States could agree could become very comprehensive, since each Member State would probably try to include as many (of its national industrial) products as possible in order to keep at least the option of exempting them from Community rules. A modification of the list could thus turn out to be counter-productive, potentially leading to even less intra-European competition.
- The more technological details a list contains, the sooner it would be outdated again. From that point of view, the vagueness of the current list is an advantage, since it allows for a flexible interpretation covering new technological developments.
- The current list may be rather generic, but it clearly includes only equipment of specific military nature and purpose. This appears sufficient to limit the type of equipment which can be exempted on the basis of Article 296 TEC. The question is then whether an exemption is necessary to protect essential security interests.

To sum up: revision of the 1958 list would be a politically difficult and awkward exercise with high potential for an unsatisfactory outcome.

4.3. Option 3: Specifying "essential security interests"

Another possibility to clarify the conditions for the use of Article 296 TEC would be to establish a commonly agreed and precise definition of "essential security interests". However,

since defence policy is not a Community policy, it is the Member States' prerogative to define their essential security interests. It is therefore not within the Commission's remit to propose such specification.

4.4. Option 4: Clarifying the use of Article 296 by an Interpretative Communication

Recalling the principles of the Treaty and the relevant case law of the Court, an Interpretative Communication can explain the conditions for the use of Article 296 TEC and give guidance to awarding authorities for assessing the applicability of the exemption. It can make clear, in particular, that:

- the use of Article 296 TEC for the exemption of defence contracts from Community rules should be limited to exceptional cases;
- Article 296 TEC allows exemption from Community rules only for purely military items included in the 1958 list and only if the exemption is necessary for the protection of a Member State's essential security interests;
- it is within the competence of Member States to define and protect their security interests. To reconcile this prerogative with their Treaty obligations, they must assess carefully case by case whether the exemption is necessary;
- as guardian of the Treaty, the Commission may verify whether the conditions for the use of Article 296 TEC are fulfilled. In this case, Member States have to demonstrate that the exception from Community rules is necessary for the protection of their essential security interests.

4.5. Conclusion

The Interpretative Communication is thus the only available instrument to shed some light on the conditions for the use of Article 296 TEC. It could be adopted by the Commission on its own. Naturally, consultation of the Member States is politically desirable, albeit not mandatory.

5. ANALYSIS OF THE IMPACT

5.1. Legal impact

The Interpretative Communication clarifies the conditions for the use of the derogation under Article 296 TEC, as defined by the relevant case law.

As a non-legislative measure, the Interpretative Communication does not modify existing law. It does not coordinate national procurement rules and thus does not contribute to rationalising Europe's fragmented regulatory framework.

5.2. Economic and financial impact

The impact of the Interpretative Communication on the openness of defence markets probably varies between the various market segments:

- **for non-warlike products**, the Interpretative Communication may have a significant impact. Since this market segment lies at the periphery of defence markets and

clearly outside the scope of Article 296 TEC, the Communication can give sufficient guidance to make sure that contract awarding authorities systematically use the existing PP Directive for such contracts. This can enhance transparency and openness of markets. More competition certainly results in better value for money, since this market segment covers a broad spectrum of goods and services, ranging from catering and cleaning to uniforms and construction. However, actual cost savings also depend on a more rigorous enforcement policy being pursued by the Commission.

- for **warlike items not concerning essential security interests**, the impact is probably limited. Faced with the choice between the use of Article 296 TEC or the PP Directive, which they consider ill-suited to the procurement of most military equipment, Member States may well try to interpret Article 296 TEC as broadly as possible to cover all warlike items. In this market segment, the impact on transparency and openness will therefore be modest.
- for **warlike products concerning essential security interests**, the impact is zero, because they fall within the scope of application of Article 296 TEC.

5.3. Impact on competitiveness

The Interpretative Communication would have an impact mainly on non-warlike items, which represent normally the lower end of the technological spectrum. In consequence, it would contribute little to the competitiveness of defence industries.

5.4. Impact on administrative costs

A more rigorous implementation of existing law should not involve organisational or structural changes for national administrations. Moreover, a case-by-case assessment of the applicability of Article 296 TEC is probably very similar to verification of the applicability of the CoC, on which Member States have already agreed. Administrative costs should consequently be close to zero. The same is true for industry, which will be only indirectly concerned and will therefore not face additional administrative burdens.

5.5. Political and institutional impact

Explaining how to use Article 296 TEC, the Interpretative Communication is a useful adjunct both to the EDA's attempt via the CoC to increase transparency for defence market segments covered by Article 296 TEC, and to possible Commission measures to improve the suitability of Community rules to defence contracts not covered by Article 296 TEC.

As such, the Interpretative Communication contributes to better functioning of the legal framework surrounding defence procurement in Europe and constitutes an important step on the way towards a future European Defence Equipment Market.

From an institutional point of view, the Interpretative Communication is also useful for establishing a clear distribution of responsibilities between the two pillars (EDA for defence contracts to which Article 296 TEC applies, and the Commission for those to which community rules apply). Furthermore, the Communication demonstrates that the Commission plays its role as guardian of the Treaty, ensuring compliance with the provisions of Article 296 TEC.

6. MONITORING AND EVALUATION

The Commission, assisted by the Advisory Committee for Public Procurement, will monitor the implementation of the recommendations set out in the Interpretative Communication. It will in particular:

- pay attention to developments in case law related to defence procurement,
- follow the evolution of the rate of publication as an indicator of transparency,
- continue its dialogue with the relevant stakeholders,
- verify, in the case of complaints, whether the use of the exemption is justified for specific procurement contracts.

Moreover, possible exchange of information on the use of Article 296 TEC between the Commission and the EDA, which has established a monitoring system in support of the CoC, may also be useful for actively monitoring compliance with the recommendations in the Communication.

7. CONCLUSION

Clarification of the use of Article 296 TEC is a necessary first step towards a functioning legal framework for defence procurement at EU level.

In particular, since the concept of essential security interests remains vague, the Interpretative Communication cannot clarify *ex ante* to which procurement contracts Article 296 TEC applies. However, it reduces the uncertainty concerning the conditions for the use of the exemption and gives guidance to awarding authorities on how to use the possibility to exempt. As such, it is a useful contribution to ensuring better compliance with EU law.

A Communication should be able to limit the worst cases of misuse of Article 296 TEC, namely the exemption of non-warlike material. However, it might not resolve the problem of equipment which is of military nature, but which does not (necessarily) concern essential security interests. As long as the use of the current PP Directive is the only alternative, Member States might continue to exploit the flexibility which lies in the concept of essential security interests and stick to an extensive interpretation of Article 296 TEC for this equipment. A new Directive adapted to the specificities of defence seems an appropriate instrument to tackle this problem. The Commission will therefore continue its work on an Impact Assessment for such a Directive and, subject to the results of this Assessment, take further initiatives in 2007.