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Public Procurement

Defence Procurement

CONTENTS

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Introduction - Notion of Defence Procurement

Defence procurement is the process through which authorities in the field of defence acquire the various goods, services or works they need in order to perform their duties and missions. For example, these authorities acquire stationery and IT equipment in order to perform their administrative duties; they purchase food for their soldiers; they procure cleaning services for their premises; they acquire submarines, fighter jets, armoured vehicles, munitions, missiles and other defence material for protecting national security, territorial integrity or for fulfilling other international commitments, for example, participation in peacekeeping operations abroad; they also procure the relevant maintenance services in order to keep defence material ready for action in a continuous and seamless manner.

Although there is no authoritative definition of the notion of defence procurement, it could arguably be defined in a *wide* and in a *narrow* way.

Defence procurement *widely defined* covers *any* procurement carried out by contracting authorities in the field of defence. In this sense the notion of defence procurement covers *all* the examples referred to above: procurement of stationery, IT equipment, aircraft, submarines, etc.

Defence procurement *narrowly defined* covers only the goods and services *manufactured* or intended to be *used* for *purely military purposes*, namely, using the above examples, submarines, fighter jets, armoured vehicles, munitions, missiles, and associated services. It could be argued that defence procurement narrowly defined also covers also the procurement of "dual-use" technologies, i.e., technologies that could be used, in principle, for both military and non-military purposes, provided that the acquisition was made primarily for military use and that the specifications of these "dual-use" technologies underwent some alterations to meet military requirements.

The distinction between defence procurement narrowly and widely defined reflects the fact that some procurement activity in the field of defence is more closely linked with the core of what could be termed as national defence and national security and is often characterised by the complex nature of the relevant technologies (i.e., the case of defence procurement narrowly defined), whereas other procurement activity in the same sector is clearly, in principle, less sensitive (procurement of non-military equipment and services). This distinction further highlights the fact that more sensitive procurement needs to be subject to a regulatory regime that acknowledges its specificities and tries to strike a balance between openness and transparency of the procurement process, on the one hand, and protection of the core security concerns of the procuring state, on the other.

This Brief focuses on procurement of defence material which, because of its nature and intended use, is closely linked with the notion of defence and security. In other words, it deals with defence procurement *narrowly defined*. The use of the term "defence procurement" in the rest of this Procurement Brief reflects this narrower definition.

Particular Characteristics of Defence Procurement

By its very nature, defence procurement has some distinguishing features.

Firstly, it differs from general public procurement in qualitative terms by the fact that it deals with the main aim of defence procurement, the protection of national security and defence.

Secondly, more often than not, defence equipment tends to be assemblies of complex technologies.

As a result of this combination of strategic and security imperatives and the complexity of the subject matter, many countries around the world have introduced differentiated procurement legislation in the field of defence that departs from the general standards of openness and transparency that are usually required in public procurement.

The degree of departure of defence procurement legislation from the general standards of openness and transparency varies amongst jurisdictions but invariably involves a wider than usual margin of discretion for contracting authorities.

Unfortunately, this environment of secrecy and lessened transparency, together with a wider than usual field of discretion for contracting authorities, lends itself to becoming a fertile ground for protectionism, corruption and inefficient use of public resources.

Defence Procurement in the European Union

Defence procurement constitutes a noticeable segment of public procurement in the EU. The aggregate defence expenditure of the 27 EU member states is approximately EUR 200 billion. This figure includes approximately EUR 90 billion for procurement in general (namely acquisitions, operation and maintenance) and roughly EUR 50 billion for the acquisition of new defence equipment in particular.

Despite the substantial resources allocated to defence procurement by EU member states, defence procurement contracts have for a number of years been subject to different national procurement regimes, with different procurement rules and procedures. These differences across national lines discouraged and in some cases even prevented (*de jure* or *de facto*) cross-border competition. As a result, there has so far never been a genuine pan-European defence procurement market but rather 27 national markets fenced off with regulatory barriers to entry aimed at protecting national defence industries.

Fragmentation across national lines of what could be an EU-wide defence procurement market and national protectionist industrial policies were thought (wrongly, as explained below) to be allowed by Article 346 of the Treaty on the Functioning of the European Union (“TFEU”). In fact this wrong interpretation of Article 346 TFEU was so widespread that often even non-sensitive procurement in the field of defence - for example stationery, cleaning services, food supplies - was wrongly excluded from EU public procurement rules. It is important to mention here that

procurement contracts of non-military equipment or services in the field of defence **have always been covered** by Directive 2004/18/EC - the public sector directive.

The emergence of the Common Security and Defence Policy (CSDP)[1], which aims to make the EU a global actor in the defence and security fields, requires a competitive and vibrant European defence industrial base. Fragmentation across national lines and protectionist national policies, combined with budgetary constraints, create inefficiencies and duplication of resources that harm competitiveness and ultimately could undermine the CSDP's credibility.

For these reasons, the European Parliament invited the European Commission to make concrete proposals for reforms in the field of defence industries, markets and procurement. The most tangible result of this process is the enactment of Directive 2009/81/EC (the "Defence and Security Directive") which aims, among other things, to open up national defence procurement to intra-union competition and thus create a genuine pan-European defence procurement market.

Regulatory Framework: Primary EU Law

- General Rules and Principles

From a legal point of view, defence procurement is an integral part of the internal market and as such is subject to the general rules enshrined in the European Treaties. In particular, defence procurement is subject to the fundamental rules and principles of:

- non-discrimination on grounds of nationality;
- free movement of goods;
- free movement of services;
- free movement of establishment.

In addition, it is subject to the general principles of law recognised by the Court of Justice of the EU ("CJEU"). These principles include:

- equal treatment;
- mutual recognition;
- transparency;
- proportionality;

It is important to note that these rules and principles apply to the award of procurement contracts even when these contracts fall outside the field of application of the various procurement directives (public sector, utilities, and defence and security). For example, they apply to procurement contracts whose value is below the relevant procurement thresholds (with the excep-

[1] The CSDP was established in 1999 in its original form as the European Security and Defence Policy (ESDP) - it was renamed CSDP by the Treaty of Lisbon.

tion, perhaps, of procurement contracts of very small value that do not attract cross-border interest) or service concession contracts (which in the case of the public sector are excluded from the scope of the public sector directive 2004/18/EC). This means that these rules and principles applied in defence procurement contracts even before the enactment of the Defence and Security Directive.

- The Security Exemption of Article 346 TFEU

Article 346 TFEU establishes that member states may derogate from the rules and principles of EU law and adopt extraordinary measures in the field of trade and production of munitions and other war material if these measures are necessary for the protection of their *essential security* interests. In addition, these measures should not adversely affect intra-union trade in non-defence related products.

As mentioned above, this provision has been interpreted wrongly by most member states as establishing an *en bloc, automatic* exclusion of defence procurement from the rules and principles of EU law. A number of cases brought to the CJEU have clearly demonstrated that such a wide interpretation of this provision is unlawful.

In December 2006, the European Commission issued an interpretative communication (COM (2006) 779 Final, *Interpretative Communication on the Application of Article 296 of the Treaty in the Field of Defence Procurement)* in which it explained its views regarding the proper interpretation of Article 346 TFEU. Although this interpretative communication is not legally binding, it is important because it explains how the Commission will perform its role as the watchdog of EU law when confronted with national measures in the field of defence procurement that appear to be contrary to EU law.

According to the interpretative communication, when member states choose to derogate from EU rules in the field of defence procurement can only do so on an ad-hoc basis and by invoking Article 346 TFEU. In other words, member states cannot exempt defence procurement from the field of application of EU law in general terms. In addition, when invoking this article, member states need to demonstrate that the conditions of application of this provision have been met. In particular, member states need to show that:

- The national measures cover defence goods included in the drafted in 1958 by the Council;
- There are relevant, essential security interests at stake;
- The extraordinary national measures are necessary to protect essential security interests.

More precisely, following the entry into force of the Defence and Security Directive, a member state has to demonstrate why the new "tailor-made" rules of the Defence and Security Directive does not suitably protect its essential security interests.

Although the exact margin of discretion of member states in defining the link between the derogation and the protection of an essential security interest is still to be clarified by the CJEU, the European Commission has recently shown its willingness to adopt a more proactive stance (see, for example, the investigations against Greece and the Czech Republic for failing to adequately justify the use of Article 346 TFEU in the context of two defence procurement award processes).

Regulatory Framework: Secondary EU Law - Defence and Security Directive

The Defence and Security Directive[2] entered into force on 21 August 2009. The implementation period by the end of which member states must have transposed the Defence and Security Directive in their national legislation ended on 21 August 2011. The new instrument forms part of the Union *acquis* and therefore, is also relevant to all EU membership (potential) candidates.

The Defence and Security Directive provides a regulatory framework that is flexible and takes into account the special characteristics of defence procurement. The aim of the new instrument is to open up national defence procurement market to cross-border competition by reducing the instances of unjustified evocation of Article 346 TFEU by member states. Article 346 TFEU remains unchanged. However, as mentioned above, member states will from now on have to justify more clearly why derogation from EU law is necessary for the protection of their essential security interests, since the Defence and Security Directive was designed precisely to respond to the specificities and sensitive characteristics of defence procurement.

- Field of Application and Applicable Thresholds

In principle, the Defence and Security Directive covers two major areas:

- Military equipment, associated services and works contracts;

- Sensitive procurement for security purposes (not only defence or national security) or procurement involving classified information.

It is important to note that before the enactment of the Defence and Security Directive, procurement of sensitive (but non-military) equipment or services was in principle covered by the other procurement directives (public sector or utilities directive). This means that it is important for contracting authorities to be aware of the precise field of application of the Defence and Se-

[2] Directive 2009/81/EC of the European Parliament and of the Council of 13 July 2009 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, and amending Directives 2004/17/EC and 2004/18/EC

curity Directive with regard to procurement contracts that were previously covered by the other public procurement directives.

The rationale for the wide scope of the Defence and Security Directive is twofold: on the one hand, modern technology renders the distinction between defence and civilian technology increasingly difficult (often, the determining factor is the use of a particular technology rather than the nature of that technology). On the other hand, the distinction between internal security and external security is also more difficult. For example, the procurement of security equipment and services by a civilian airport nowadays raises security concerns comparable to those of traditional defence procurement. For this reason this bespoke, flexible procurement regime also covers these security procurement contracts.

As with other procurement directives, the value of the relevant contracts must be above certain thresholds in order for the Defence and Security Directive to apply. The applicable thresholds are currently as follows:

- EUR 412 000 for supply and service contracts;
- EUR 5 150 000 for works contracts.

Moreover, as is the case with the other public procurement directives, these thresholds will be updated periodically. See *Procurement Brief 5 - Understanding the Thresholds* for further information.

Contracts whose value is below these thresholds are not covered by the Defence and Security Directive. However, if they are likely to attract cross-border interest, these contracts are covered by the general rules and principles of EU Law, for example the principles of non-discrimination and of transparency. See *Procurement Brief 15 – Below Threshold Contracts* for further information on the general rules and principles applying to contracts below the threshold.

- Procurement Procedures

Arguably one of the most significant innovations of the Defence and Security Directive is that contracting authorities in the field of defence are free to choose the *negotiated procedure with prior notice* (together with the restricted procedure) as a standard procurement procedure. This provides greater flexibility to contracting authorities and more freedom to discuss available solutions with economic operators. It should be remembered that the European Legislator has chosen a similar approach for the Utilities Directive but not for the public sector one.

In addition, contracting authorities can use the competitive dialogue and the negotiated procedure without prior notice on specific grounds. The grounds for the use of competitive dialogue are the same as those in the Public Sector Directive.

The grounds for the use of the negotiated procedure without prior notice include two additional circumstances that do not have any equivalent in the public sector directive.

The first ground refers to procurement contracts that deal with the provision of air and maritime transport services for the armed or security forces deployed (or to be deployed) abroad when the contracting authority has to procure these services from economic operators that guarantee the validity of their tenders only for such short periods that the time limit for the restricted procedure or the negotiated procedure with prior notice (including their versions with shortened time limits) cannot be complied with.

The second ground refers to the urgency that ensues from a crisis. In such cases, the negotiated procedure without prior notice can be used if compliance with the restricted procedure or the negotiated procedure with prior notice (even with the shortened time limits) would be incompatible with the urgency of the crisis.

See *Procurement Brief - 10 What are the Public Procurement Procedures and When Can They Be Used*, for general information on the procedures referred to above.

- Security of Information

Another important innovation of the Defence and Security Directive is the inclusion of specific provisions linked with the security of information. Because of the sensitive subject matter of defence and security procurement contracts, the handling of classified information is extremely important. The Defence and Security Directive includes bespoke provisions that try to tackle this issue. For example, the contracting authority may require from economic operators the following:

- A commitment from the tenderer and the sub-contractors already identified to appropriately safeguard the confidentiality of all classified information in their possession or coming to their notice, in accordance with the relevant member state's provisions on security clearance;
- A commitment from the tenderer to obtain the commitment outlined above from other sub-contractors it will sub-contract to during the execution of the contract;
- Sufficient information on the sub-contractors already identified to enable the contracting authority to determine that each of them possesses the capabilities required to appropriately safeguard the confidentiality of the classified information to which they have access or which they are required to produce when carrying out their sub-contracting activities; and
- A commitment from the tenderer to provide the information outlined above from other sub-contractors it will sub-contract to during the execution of the contract.

It is important to note at this point that member states must recognise equivalent security clearances issued by other member states. The decision regarding the existence of such equivalence resides with the procuring member state.

- Security of Supply

Security of supply in the context of defence and security procurement is of fundamental importance. Member states have often tried to justify departure from EU procurement rules on this very ground. In fact, the lack of specific provisions for security of supply was one of the reasons why the public sector directive was considered ill-suited for defence procurement contracts.

The Defence and Security Directive includes specific provision that try to respond to member states' concerns. In particular, the Defence and Security Directive provides that contracting authorities must specify any security of supply requirements in the contract documents and may require the following from economic operators:

- Certification or documentation demonstrating (to the satisfaction of the contracting authority) that the tenderer will be able to honour its obligations regarding the export, transfer and transit of goods associated with the contract;
- The indication of any restriction on the contracting authority regarding disclosure, transfer or use of the products and services or any result of those products or services, which would result from export control or security arrangements;
- Certification or documentation demonstrating that the organisation and location of the tenderer's supply chain will allow it to comply with the requirements of the contracting authority/entity concerning the security of supply, and a commitment to ensure that possible changes in its supply chain during the execution of the contract will not adversely affect compliance with these requirements;
- A commitment from the tenderer to establish and/or maintain the capacity required to meet additional needs of the contracting authority as a result of a crisis and any supporting documentation received from the tenderer's national authorities regarding the fulfillment of additional needs of the contracting authority/entity as a result of a crisis;
- A commitment from the tenderer to carry out the maintenance, modernisation or adaption of the supplies covered by the contract;
- A commitment from the tenderer to inform the contracting authority in due time of any change in its organisation, supply chain or industrial strategy that may affect its obligations to that authority;
- A commitment from the tenderer to provide the contracting authority/entity, according to terms and conditions to be agreed, with all the specified means necessary for the production of spare parts, components, assemblies and special testing equipment, including technical drawings, licenses and instructions for use, in the event that it is no longer able to provide these supplies.

It is noteworthy that contracting authorities cannot oblige a tenderer to obtain a commitment from a member state that the latter would refrain from applying its national export, transfer or transit criteria, provided that these are in accordance with international or Union law.

- Remedies

Another important feature of the Defence and Security Directive is that in addition to the substantive provisions, it also includes specific provisions on remedies. The provisions on remedies are in line with those of the Remedies Directive (Directive 89/665/EC as amended by Directive 2007/66/EC). See *Procurement Brief 12 – Remedies*, for information on the requirements of the remedies directive.

There are some variations that correspond to the specificities of defence and security procurement. For example, ineffectiveness of a contract may not be available if the consequences of this ineffectiveness would endanger a wider defence or security contract.

In line with the specific nature of defence and security procurement, member states are also free to establish a specific body that has sole jurisdiction for reviewing defence and security procurement cases, provided that it maintains all the safeguards of due process in judicial review and that the relevant procurement decision is ultimately reviewable by a body considered as a court or tribunal for the purposes of EU Law (namely a body that may refer preliminary questions to the CJEU).

Other issues:

- **Offsets**

Offsets are practices followed by contracting authorities in the field of defence procurement with the aim of safeguarding for their domestic industry some kind of return of their "investment" - i.e., the payment given to a foreign defence contractor for the acquisition of defence equipment or related services.. For example, offsets may take the form of the participation of the defence industry of the procuring state in the production phase of a defence contract - through *co-production* or through *subcontracting* -, or the involvement of the domestic industry as a subcontractor in the foreign supplier's future contracts. Offsets may appear as a condition for the participation of foreign contractors in a specific procurement process or as award criterion. Offsets constitute a common feature of defence procurement regimes of countries with small or medium size defence industrial bases.

The Defence and Security Directive does not deal explicitly with the important issue of offsets. However, the position of the European Commission as expressed in the Interpretative Communication of Article 296 EC (now Article 346 TFEU) and the Guidance Note on Offsets is that offsets are, by their very nature, discriminatory, since they aim to promote the domestic industry of the procuring state. This means that, in principle, offsets are contrary to EU law.

Nevertheless, specific offset practices may be justified on the basis of one of the exemptions available in the EU Treaties. The most relevant is, of course, Article 346 TFEU. In other words, member states could justify certain offsets if these practices meet the conditions of Article 346 TFEU as discussed above. It is important to note at this point that the European Commission

finds that it would be very difficult to justify so called non-military offsets, i.e., offset obligations imposed on a foreign contractor that are not linked with the defence sector. For example, if a foreign defence contractor is obliged to buy a certain number of photocopying machines from the procuring state's industry - on the basis of Article 346 TFEU because they do not have an obvious link with the essential security concerns of the procuring Member State.

A recent initiative of the European Defence Agency (EDA), the Code of Conduct on Offsets (which came into effect on 1 July 2009), tries to minimise the adverse effects of offsets.

As mentioned above, the Defence and Security Directive does not include provisions on offsets. However, it includes a set of provisions on "subcontracting" that aim to address some of the concerns that led member states to adopt offsets - for example, protection of small and medium sized enterprises (SMEs) -, but in manner that complies with EU Law. In particular, the Defence and Security Directive allows member states to request that the prime contractor subcontracts parts of the contract to third parties. It is important to note, however, that potential subcontractors shall not be discriminated on the basis of nationality. This is the major difference between the "subcontracting" provisions of the Defence and Security Directive and offset practices.

- **Parallel regimes:**

EDA's Code of Conduct on Defence Procurement

Another relevant regime in the field of EU Defence procurement is the Code of Conduct on Defence Procurement of the European Defence Agency (launched on 1 July 2006).

This is a voluntary, non-legally binding, non-legally enforceable regime applicable in the cases of procurement contracts *where the conditions of article 346 TFEU are met,* in other words, in cases not covered by the Defence and Security Directive.

The Code of Conduct is applicable to defence – but not security - procurement contracts whose value exceeds EUR 1 million. Contracts subject to this regime should fulfil some publication requirements that are much more relaxed than those established by the Defence and Security Directive. In particular, contracting authorities are free to choose any procurement procedure provided that they comply with the principles of transparency, non-discrimination and equal treatment. In other words, the regime has the same aims as the Defence and Security Directive but it covers a seemingly different field (i.e. procurement contracts where conditions of Article 346 TFEU are met) and is much less prescriptive. Contract opportunities are published in a central electronic portal accessible to anyone.

It is submitted that the significance of the Code of Conduct will diminish after the entry into force of the Defence and Security Directive, since the goal is that member states will resort less frequently to Article 346 TFEU, given the bespoke nature of the Defence and Security Directive.

Defence Procurement: EU-Third Countries

As mentioned above, the Defence and Security Directive now forms part of the Union *acquis*, meaning that all current or future candidate countries will have to incorporate it in their national legislation.

With regard to existing commitments undertaken by the EU and its member states towards third countries under the plurilateral Government Procurement Agreement (GPA), it can be said that Article XXIII (1) of the GPA allows any signatory Party to take "…any action … which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defence purposes." Furthermore, Part (3) of Annex I of the Appendix of the GPA shows clearly that signatory Parties exempted hard-defence procurement from the field of application of the GPA. This is also clearly mentioned in the Preamble of the Defence and Security Directive in recital 18.

It should be noted at this point that the scope of Article XXIII (1) of the GPA is wider than the scope of Article 346 TFEU as it refers not only to "arms, ammunition or war materials" but also to "procurement indispensable for national security". This means that member states may invoke Article XXIII (1) of the GPA also in cases of sensitive procurements of non-military equipment.

Further Reading:

European Commission website on Defence Procurement which includes the interpretative communications and guidance notes including those referred to in this Procurement Brief:http://ec.europa.eu/internal_market/publicprocurement/rules/defence_procurement/

European Defence Agency website for Codes of Conduct referred to in this Procurement Brief:http://www.eda.europa.eu