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Annex to the

**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE
EUROPEAN PARLIAMENT**

**on the results of the consultation launched by the Green Paper on Defence Procurement
and on the future Commission initiatives**

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PRELIMINARY IMPACT ASSESSMENT ACCOMPANYING THE COMMUNICATION ON THE RESULTS OF THE CONSULTATION ON DEFENCE PROCUREMENT

1. INTRODUCTION

In March 2003, the Commission launched a set of initiatives with a view to the creation of a European Defence Equipment Market (EDEM). One of these initiatives concerned defence procurement.

The aim was to achieve an improvement in the current EU legal framework on defence procurement, or at least an improvement in the way the rules are applied in practice, in order to reduce the current fragmentation and introduce some transparency and competition into the defence market. The objective of the initiative was to open up defence markets, in order to improve the efficiency of public spending and Member States' military capabilities and, ultimately, to increase the growth and the competitiveness of Europe's Defence Industrial and Technological Base (EDITB).

The Green Paper issued by the Commission in September 2004 opened a public consultation on the issue, inviting all interested parties to comment on how to improve the EU defence procurement regulation and/or its application.

The level of participation in the debate was satisfactory. Written contributions were received from 40 stakeholders (Member States and third countries, companies and industrial organisations, experts, institutions and agencies of the European Union) and several meetings, seminars and public hearings were held during the consultation period.

The Communication to the Council and to the European Parliament published in parallel to the present document consists of two parts. First, it presents the results of the public debate (the contributions are also published in their original language on the Web). Secondly, it sets out the Commission's assessment and announces the future initiatives that the Commission considers at this stage to be the most appropriate in order to tackle the issue, namely:

- An "Interpretative Communication" aimed at clarifying the principles governing the use of Article 296 of the Treaty ("Art. 296"). This provision allows Member States to derogate from Internal Market rules, including procurement rules, when their essential security interests are at stake. The public debate showed that there is a great deal of uncertainty about how this derogation can be used and that, in any event, its implementation varies substantially from one Member State to another. It therefore seems appropriate, as a first step, to provide guidance on the criteria for the use of this provision, in light of the case law of the Court of Justice.
- Considering that mere clarification of the existing law is likely to be insufficient, the Commission believes that, in the medium term, a new directive coordinating national

procedures for the procurement of defence goods and services would also be a useful tool. In fact, the consultation also confirmed that the current Public Procurement Directive (2004/18), even in its revised version, may be ill-suited for some defence contracts, since it does not take into account certain special features of those contracts. A new defence directive could offer more flexible rules, and possibly regulate a number of specific defence procurement needs.

Of course, according to the principle of better regulation, both of these initiatives would only be taken further subject to the results of the proportionate impact assessments which will be carried out beforehand. These impact assessments are already ongoing, but some of the data needed to complete the picture are still missing and final results will not be available before 2006. This document therefore simply sets out the broad lines along which the further impact assessments to accompany the envisaged actions will be conducted, based on the preliminary conclusions which can be drawn from the data currently available and on the opinions expressed by the stakeholders during the consultation process.

2. DESCRIPTION OF THE PROBLEM

A detailed description of the problem will be the starting point. In particular, the description will focus on the lack of a precise definition of the scope of the abovementioned Art. 296. Since the concept of “essential security interests” is rather vague, it is not always clear which rules should apply to which defence contracts. Some Member States use the derogation almost automatically, without conducting the necessary case-by-case evaluation of the existence of an “essential security interest” justifying the exemption from the application of the internal market rules. As a consequence, contracts which should be concluded according to the rules of the existing EU Public Procurement Directive are in fact concluded on the basis of national procurement rules alone, or even without any form of competition.

Statistical data on the rate of publication for invitations to tender in the area of defence will be presented in support of this conclusion. The data available at this stage already show a low rate of publication in the area of defence, equivalent to only half the average publication rate for central governments in the area of “civil” procurement. While the overall publication rate for central governments for other goods, services and works amounts to around 20%, for defence only about 10% of contracts are published,

In addition to the low average rate of publication, special attention will be also given to the transparency rates across countries. According to the data already available, among the four largest countries, for example, the publication rate for defence procurement varies between 1 and 21%. Although there may well be other reasons, this suggests that the interpretation of Art. 296, and thus the decision on whether or not to publish procurement projects, differ significantly from one Member State to another.

While some Member States seem to resort to derogation almost automatically, others seem to interpret Art. 296 rather strictly, which then results in higher rates of publication. Although these discrepancies might (in part) be caused by differences in the goods and services procured, they nevertheless appear to bear out the argument

that interpretation of Art. 296 differs considerably from one Member State to another.

The impact assessment will also identify categories of market behaviour based on the industrial capacity of various Member States. Some of them have the industrial capabilities within their territory to develop and produce weapons systems, while others have less industrial capability or none at all. It will be interesting to assess how this difference between “producing” and “non-producing” countries impacts on the way they acquire defence items and technology. As a preliminary result, it can be already noted that “producing countries” tend to have a preference for their own national manufacturers, while “non-producing countries” tend to buy complex and sensitive systems in a more open manner, from foreign suppliers.

The impact of the current situation on the industry will also be evaluated. In particular, the difference between the impact on the few big producers which operate in the market and the many small and medium-sized enterprises (SMEs), which often act as sub-contractors to big system integrators located in producing countries, will be taken into account.

Lastly, an evaluation of the implications of these problems will be carried out. A preliminary conclusion confirms a high level of fragmentation of the defence market. It is also commonly acknowledged that this fragmentation has hampered the efficiency of procurement processes and the functioning of the Internal Market and that this reduces competition and, in turn, the choice of procuring agency, which may ultimately lead to reduced value for money.

2. OBJECTIVES

The ultimate objectives of the possible EU initiatives will be precisely defined. At this stage, the preliminary objective is to reduce or even abolish the fragmentation of defence procurement, especially in the area of war material which do not concern essential security interests according to Art. 296. This should allow both companies and the contracting authorities to take full advantage of the positive effects of transparency and competitive tendering. More transparency and EU-wide tendering would lead to a broader and better choice for the contracting authorities and thereby improve the efficiency and effectiveness of defence. Ultimately, this should result in overall savings for the taxpayer and the improvement of the global competitiveness of this sector. On the one hand, defence purchases would be closer to the optimal requirements and, on the other, suppliers could also improve their tendering at lower costs. Higher efficiency should put suppliers in a better position to tender effectively in third countries.

3. SUBSIDIARITY AND PROPORTIONALITY

The further impact assessments will confirm whether the objectives to be pursued can be achieved by the actions identified to date. At this stage the Commission, as guardian of the Treaty, appears to be best placed to provide legal guidance and to ensure, through an Interpretative Communication, that the procurement rules are being respected and correctly applied. Also, it seems that the elaboration of a new

proposal aimed at adapting the legal framework to the specific needs of a market sector is a possible remedy. As can be seen from the Communication, stakeholders replying to the consultation would welcome action by the Commission to overcome market fragmentation and increase competition in the defence markets. Also, special attention will be paid to the proportionality of the action by the Commission.

For contracts falling under the derogation of Art. 296, i.e. for those contracts where the conditions for the application of the derogation are met, Member States seem to have the intention to foster competition and transparency via a voluntary, inter-governmental agreement (“Code of Conduct”), to be concluded within the European Defence Agency (“EDA”). The development of such instruments will be monitored closely. Improving defence procurement in a complementary way, both at Community and inter-governmental level, seems to present a promising way forward. However, an intergovernmental initiative alone would not solve the problem identified, since it would have to be limited to procurements falling outside the EU rules.

4. OPTIONS FOR THE WAY FORWARD

On the basis of the preliminary analysis of the problem set out above, the Commission will focus on the description of the policy options for the way ahead. At this stage, the policy options which have been identified are the following:

4.1. No Specific Action by the Commission

Without specific action by the Commission, defence contracts not covered by Art. 296 will still fall under the Public Procurement Directive. The new directive on procurement will become effective in the near future and will provide some additional flexibility, which could (possibly also) have an impact on defence procurement. However, the majority of stakeholders still maintain that the impact would be limited. It remains to be seen whether the “no action” option would bring benefits to the situation described.

4.2. Interpretative Communication

For the reasons mentioned above, the adoption of an interpretative communication aimed at clarifying the existing law, and in particular the principles governing the use of the derogation in Art. 296, appears already at this stage to be a useful tool. The vast majority of the stakeholders also share this view. The results of the further proportionate impact assessment will show whether this preliminary conclusion is correct.

As a non-legislative measure, the communication would not develop the Treaty nor change Community law. Nor would it aim at harmonising national defence procurement rules for those defence contracts covered by Art. 296 or define the concept of essential security interests. The interpretative communication would focus on providing administrative guidelines on how to use Art. 296. The aim would be to agree on a common application of existing rules and to achieve a common interpretation. The interpretative communication would be intended to provide increased legal certainty on the application of the derogation.

4.3. New Directive on Defence Procurement

The further, extensive impact assessment could also conclude that a new directive on the procurement of defence items is required. A sector-specific directive could, in this case, take into account the particularities of defence contracts, e.g. the special needs for classified information, security of supply and urgency; or the need to strike a balance between transparency and competition on one side, and flexibility on the other. Such a new directive would apply to defence procurement only in cases where a derogation on the basis of Art. 296 is not justified.

A directive, as a binding Community instrument, would ensure transparency, non-discrimination and equal treatment in order to establish a level playing field. The aim of the new directive would be to offer new, more flexible rules for defence procurement, taking into account all the specific features of the defence sector.

4.4. Gradual Approach

As an alternative to the last two options, the Commission could also decide to choose a more gradual, progressive approach. If this option were confirmed by an extended impact assessment, an interpretative communication could be prepared in order to solve the more pressing and already identified problems concerning the application of Art. 296. A further, extensive impact assessment might also identify a need for a specific new directive on public procurement.

5. POTENTIAL IMPACTS

5.1. Possible Impacts

The assessment and comparison of the different policy options, ultimately leading to the identification of a preferred option, will be conducted by focusing on the following possible impacts (where possible, a preliminary evaluation of those impacts is already made):

– **Legal Certainty:**

Any action taken to better define when certain conditions apply or what legal arrangements should be followed should lead to improved clarity. An EU-wide set of rules will make it easier for firms to participate, as they will only have to “learn” one set of procedures. This could also encourage firms to tender in other countries of the Union, thereby improving cross-border procurement.

– **Increased Transparency in the Public Procurement Market:**

At present, the general view is that Art. 296 TEC is being used to restrict the amount of open public procurement occurring at EU level. With a better definition and enforcement of Art. 296, awarding authorities should be operating on a “level playing field” in terms of the kind of contracts they put out to tender. There may even be a kind of “domino effect”, as authorities are influenced by the projects they see published by other contracting authorities. This is expected to increase the level of defence procurement being published in the Official Journal of the EU, making the sector more transparent. It might also act to reduce the extent of the dispersion currently seen in defence contract publication rates across Member States.

- **More Competitive Defence Markets:**

With proper application of the public procurement rules and open and transparent procedures, competition should increase and firms should become more efficient and effective. At the same time, tendering agencies should receive more offers and therefore have more, and better, choice in their procurement decisions, thus making actual purchases that correspond more closely their needs. Greater access to markets and competition can also help create a virtuous circle, as firms would be able to fund the development of new products which gain them access to wider markets. As markets open up, and publication rates increase, firms are better able to balance their workload and resources, as they have more opportunities to bid for work, thereby keeping the workforce more continuously active.
- **Value for Money for Awarding Authorities:**

Opening up contract award procedures to wider competition through tendering is expected to improve value for money (VFM) either by reducing prices and/or by improving the quality of the product purchased. Obviously, the ultimate beneficiary of improved VFM would be the taxpayer, as the allocation of resources in governments would be improved.
- **Friction and Litigation:**

These may increase or decrease depending on the interaction of several effects. By having clearer definitions of when procurement falls under a given set of rules, it is easier for a party to bring a challenge if it believes that the rules have not been followed; so the number of complaints may increase. In the current situation, parties can bring actions because they feel that the rules have not been followed; with greater visibility of contracts, on the other hand, some of the reasons to complain are actually removed.
- **Lessening of Administrative Burdens:**

Any changes in the current situation would lead to requirements for training, changes in current procedures etc, which will give rise (initially at least) to an administrative cost, although this will generally be of a “one-off” nature. However, it is expected that any changes will actually reduce the overall time taken to comply with or to complete a procedure.
- **Employment in the Defence Industry:**

Opening up the market, bringing in more firms, developing capabilities in new countries – all these factors could have an effect on employment. At the very least, stabilising effects resulting from market integration are to be expected. Effects both in the short and on the long runs have to be evaluated, taking into account possible regional dimension.
- **Environmental:**

It would appear that no significant impact on the environment is to be expected. However, the possible impact resulting from the application of environmental public procurement should be taken into account.

5.2. Other Contributing Factors

Other factors which could have an impact on defence procurement will also be taken into account. Attention will be paid in particular to the following:

5.2.1. *The Code of Conduct*

The possible adoption by the EDA of the Code of Conduct mentioned above will be an interesting development to follow. Such a Code of Conduct could usefully complement the actions taken at Community level, since it aims at increasing competition and transparency also in the segment of the market which is not covered by EC rules. It will also be very interesting to see the results of the work the EDA is doing in connection with the preparation of such a Code.

5.2.2. *The Global Market*

The initiative launched by the Commission with the Green Paper concerns essentially the rules to be applied within the Internal Market. However, many stakeholders, particularly the industry, supported the idea of creating a more open and transparent defence procurement market, not just in the European context, but as part of the wider, global market. The relationships with third countries, the degree of reciprocity in the opening of markets to competition; the use of certain practices (such as offsets) and the overall transparency of the procurement process will have to be also taken into account.

5.2.3. *Technological Advances*

Defence procurement and the defence industry are both strongly affected by technological developments, which can quickly create new situations that require new legislation. The potential impact of these changes must be borne in mind when considering any actions to improve the application of the defence procurement rules. Solutions must be adaptable to change, or processes need to be agreed to allow major technological changes to be catered for in a consistent manner. The impact of possible future initiatives on technology and innovation have also to be taken into account.

5.2.4. *Implementation of Directive 2004/18*

It remains to be seen whether the new procurement package (Directive 2004/18), which will only start to function in 2006 (deadline for implementation) and which introduces a degree of flexibility for the conclusion of particularly complex contracts, will have an impact on the opening up of defence procurement. Whilst acknowledging potential improvements, many stakeholders are of the view that most of the current problems will remain.

6. CONCLUSIONS

This preliminary impact assessment, together with the results of the stakeholder consultation presented in the Communication, illustrates that there is scope for further action by the Commission. In particular, it identifies the factors to be analysed in detail with a view to the decision to be taken on the possible ways forward envisaged at this stage, namely an Interpretative Communication and a possible defence directive. The preparatory work done so far should provide a good basis for the elaboration of the impact assessments which are required by those policy options. It also provides all stakeholders and interested parties with an overview of the status of the Commission's thinking.