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**INTERPRETATIVE COMMUNICATION**

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

(presented by the Commission)

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## INTERPRETATIVE COMMUNICATION

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(Text with EEA relevance)

#### Introduction

Defence procurement accounts for a large share of public procurement in the European Union. Member States' combined defence budgets are worth about €170 billion, which includes more than €80 billion for procurement.

Most of this expenditure is split into relatively small and closed national markets: Europe's defence sector remains fragmented at national level, with 25 different customers and 25 different regulatory frameworks. This fragmentation is a major obstacle to both intra-European cooperation and competition. It creates extra costs and inefficiencies and thus has a negative impact on the competitiveness of Europe's Defence Industrial and Technological Base as well as on Member States' efforts to equip their armed forces adequately.

Defence procurement law is an important element of this fragmentation. The majority of defence contracts are exempted from Internal Market rules and awarded on the basis of national procurement rules, which have widely differing selection criteria, advertising procedures, etc. At the same time, Defence Ministries' publication rates vary considerably between Member States. All of this can limit market access for non-national suppliers and therefore hampers intra-European competition.

In its Communication of March 2003,<sup>1</sup> the Commission therefore identified procurement law as one area for action towards the establishment of a European Defence Equipment Market (EDEM). This led to the publication, in September 2004, of a Green Paper on defence procurement<sup>2</sup> in which stakeholders were invited to comment on various options for improving transparency and openness of defence markets between EU Member States. The consultation confirmed that the existing legislative framework for defence procurement is not functioning properly:

- Uncertainties persist regarding the scope of Article 296 TEC, which allows Member States to derogate from Internal Market rules when their essential security interests are at stake. Since the dividing line between defence acquisitions which concern essential security interests and those which do not is vague, it is not always clear which rules should apply to which contracts. In consequence, the application of Article 296 TEC remains problematic and varies considerably between Member States.
- The current Public Procurement (PP) Directive, even in its revised version (2004/18/EC), is considered ill-suited to many defence contracts, since it does not take into account some special features of those contracts. As a result, many Member States are reluctant to use the

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<sup>1</sup> COM(2003) 113, 11 March 2003.

<sup>2</sup> COM(2004) 608, 23 September 2004.

PP Directive for defence equipment, even if the conditions for the application of Article 296 are not met.

Based on these findings, in December 2005 the Commission announced two initiatives to improve the situation:<sup>3</sup>

- (1) Adoption of an "Interpretative Communication on the application of Article 296 TEC in the field of defence procurement". This Communication will not modify, but clarify the existing legal framework;
- (2) Preparation of a possible new directive on the procurement of defence equipment to which the derogation in Article 296 TEC does not apply. This directive could offer new, more flexible rules adapted to the specificities of the defence sector.

The objective of the present Communication is to prevent possible misinterpretation and misuse of Article 296 TEC in the field of defence procurement. To achieve this objective, the Commission will set out its views on the principles governing the application of Article 296 TEC and explain its understanding of the conditions for the application of the derogation in the light of the Court's case law. The final word on the determination of the ambit of Article 296 TEC lies with the Court of Justice.

This Communication can neither give an interpretation of Member States' essential security interests nor determine *ex ante* to which procurement contracts the exemption under Article 296 TEC applies or not. It will rather give contract awarding authorities some guidance for their assessment whether the use of the exemption is justified.

Clarification of the existing legal framework is a necessary first step towards greater openness of European defence markets. At the same time, the Commission is also assessing the impact of a possible new defence specific directive. Combining the present Communication with such a directive may in fact be the most appropriate approach at Community level to cope with the difficulties of applying Article 296 TEC. These initiatives are complementary with Member States' efforts to enhance intra-European competition for defence equipment covered by Article 296 TEC via the Code of Conduct administered by the European Defence Agency.

This Communication only concerns defence procurement by national authorities inside the European Internal Market. It does not deal with arms trade with third countries, which continues to be governed by WTO rules, and in particular the Government Procurement Agreement (GPA).<sup>4</sup>

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<sup>3</sup> COM(2005) 626, 6 December 2005.

<sup>4</sup> Article XXIII paragraph 1 of the GPA states that "*nothing shall be construed to prevent any Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests related to the procurement of arms, ammunition or war material or to procurement indispensable for national security or for national defence purposes*". In accordance with these provisions, Annex 1 Part 3 in Appendix 1 to the GPA contains a list of supplies and equipment purchased by Ministries of Defence that are covered by the Agreement. This list covers only non-warlike material.

## 1. LEGAL BASIS

According to existing EU law, defence contracts fall under Internal Market rules. Directive 2004/18/EC<sup>5</sup> on the procurement of goods, works and services thus applies to "*contracts awarded by contracting authorities in the field of defence, subject to Article 296 of the Treaty*" (Article 10 of the Directive).

Article 296 TEC reads as follows:

- (1) *The provisions of this Treaty shall not preclude the application of the following rules:*
  - (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.*
- (2) *The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on April 1958, of the products to which the provisions of paragraph 1(b) apply.*

The exemption of defence contracts from the rules of the Internal Market is a measure connected with the trade in arms, ammunition and war material. Accordingly, its legal basis is Article 296(1)(b) TEC. Member States can use this exemption for the award of defence contracts, provided that the conditions laid down in the Treaty as interpreted by the Court of Justice are fulfilled. At the same time, the scope of Article 296(1)(b) TEC is limited by the concept of "essential security interests" and the list of military equipment mentioned in paragraph 2 of that Article.

Article 296(1)(a) TEC goes beyond defence, aiming in general at protecting information which Member States cannot disclose to anyone without undermining their essential security interests. This can also concern the public procurement of sensitive equipment, in both the defence and the security sector. In general, however, possible confidentiality needs related to the procurement process for military equipment are covered by Article 296(1)(b) TEC.

## 2. SECURITY INTERESTS AND TREATY OBLIGATIONS

It is Member States' responsibility to define and protect their security interests. Article 296 TEC recognises this prerogative and provides a derogation for cases where compliance with European law would undermine Member States' essential security interests.

However, 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

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<sup>5</sup> Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts.

provisions of the Treaty relating to 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.

The Treaty therefore contains strict conditions for the use of this derogation, balancing Member States' interests in the field of defence and security against the fundamental principles and objectives of the Community. The aim of these conditions is to prevent possible misuse and to ensure that the derogation remains an exception limited to cases where Member States have no other choice than to protect their security interests nationally.

The Court of Justice has consistently made it clear that any derogation from the rules intended to ensure the effectiveness of the rights conferred by the Treaty must be interpreted strictly.<sup>6</sup> Moreover, it has confirmed that this is also the case for derogations applicable "*in situations which may involve public safety*". In *Commission v Spain*, the Court ruled that articles in which the Treaty provides for such derogations (including Article 296 TEC) "*deal with exceptional and clearly defined cases. Because of their limited character, those articles do not lend themselves to a wide interpretation*".<sup>7</sup>

Therefore, both the field and the conditions of application of Article 296 TEC must be interpreted in a restrictive way.

### 3. FIELD OF APPLICATION

Article 296(1)(b) TEC allows for measures "*connected with the production of or trade in arms, munitions and war material*", specified in the list mentioned in paragraph 2. The latter was adopted on 15 April 1958 as Council Decision 255/58. According to the Court, it is clear that Article 296(1)(b) TEC "*is not intended to apply to activities relating to products other than the military products identified on [that] list*".<sup>8</sup>

At the same time, the interpretation of Article 296 (1)(b) TEC and the definition of its field of application must also 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. Similarly, Article 296(1)(b) TEC can also cover the procurement of services and works directly related to the goods included in the list, as well as modern, capability-focused acquisition methods, provided always that the other conditions for the applicability of Article 296 TEC are met.

On the other hand, the 1958 list includes only equipment which is of purely military nature and purpose. It is true that security has become an increasingly complex concept, with new threats blurring the traditional dividing line between military and non-military, external and internal security dimensions. However, since the roles of military and non-military security

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<sup>6</sup> Judgment of 4 October 1991, Case C-367/89 *Richardt and Les Accessoires Scientifiques*, par. 20; for public procurement in particular: judgment of 3 May 1994, Case C-328/92 *Commission v Spain*, par. 15; judgment of 28 March 1995, Case C-324/93 *Evans Medical and Macfarlan Smith*, par. 48.

<sup>7</sup> Judgment of 16 September 1999, Case C-414/97 *Commission v Spain*, par. 21; judgment of 15 May 1986, Case C-222/84 *Johnston*, par. 26.

<sup>8</sup> Judgment of 30 September 2003, Case T-26/01 *Fiocchi Munizioni v Commission*, par. 61; see also Opinion of Advocate General Jacobs of 8 May 1991, Case C-367/89 *Richardt and Les Accessoires Scientifiques*, par. 30.

forces still differ, it is normally possible to distinguish between military and non-military procurement.

The nature of the products on the 1958 list 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 for specifically military purposes can be exempted from Community rules on the basis of Article 296(1)(b) TEC.<sup>9</sup>

Procurement for non-military security purposes, by contrast, is excluded from the field of application of Article 296(1)(b) TEC. For these procurements, security interests may justify the exemption from Community rules on the basis of Article 14 of the PP Directive, provided that the conditions for its application are met.<sup>10</sup>

In contrast to Article 296(1)(b), 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.

#### 4. CONDITIONS OF APPLICATION

Military items included in the 1958 list are not automatically exempted from the rules of the Internal Market. Council Decision 255/58 itself states that the list includes equipment for which Member States have a legitimate interest in being able to take the measures provided for in Article 296(1)(b) TEC. In other words, the Council decision itself does not provide for automatic application of the exemption. In addition, the Court has confirmed, on several occasions, that Article 296 TEC does not introduce an automatic exemption in the field of defence.<sup>11</sup> On the contrary, an exemption is legally based on Article 296 TEC, which means that items on this list can be exempted, if, and only if, the conditions for the use of Article 296 TEC are fulfilled.<sup>12</sup>

According to Article 296 TEC, Member States can take measures they consider necessary for the protection of their essential security interests. This provision has been acknowledged to grant to Member States a broad degree of discretion in deciding how to protect their essential security interests<sup>13</sup>: However, the text ("necessary for the protection ...") also demonstrates that this discretion is not unfettered. The very existence of Article 298 TEC, which lays down a special procedure to be followed in the event of possible improper use of Article 296 TEC, confirms that Member States do not have absolute freedom in their decision to exempt a specific procurement contract from the rules of the Internal Market. On the contrary, "*it is for the Member State which seeks to rely on [Article 296 TEC] to furnish evidence that the exemptions in question do not go beyond the limits of such [clearly defined] cases*" and to

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<sup>9</sup> Case T-26/01 *Fiocchi Munizioni v Commission*, par. 59 and 61.

<sup>10</sup> Article 14 of Directive 2004/18/EC stipulates: "*This Directive shall not apply to public contracts when they are declared to be secret, when their performance must be accompanied by special measures in accordance with the laws, regulations or administrative provisions in force in the Member State concerned, or when the protection of the essential interests of the Member State so requires.*"

<sup>11</sup> Judgment of 26 October 1999, Case C-273/97 *Sirdar*, par. 15-16; judgment of 11 January 2000, Case 285/98 *Kreil*, par. 16; judgment of 11 March 2003, Case C-186/01 *Dory*, par. 30-31.

<sup>12</sup> See also response of 3 October 1985 from the Council to MEP Mrs Van Hemeldonck (1985)0574/F; by analogy: judgment of 13 July 2000, Case C-423/98 *Albore*, par. 22-23.

<sup>13</sup> Case T-26/01 *Fiocchi Munizioni v Commission*, par. 58

demonstrate "*that the exemptions ... are necessary for the protection of the essential interests of its security*".<sup>14</sup>

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, 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. Indirect non-military offsets, for example, which do not serve specific security interests but general economic interests, are not covered by Article 296 TEC, even if they are related to a defence procurement contract exempted on the basis of that Article.<sup>15</sup>

At the same time, Member States' security interests should also be considered from a European perspective. They may vary, e.g. for geographical or historical reasons. On the other hand, European integration has led to an ever-growing convergence of national interests among Member States. The development of the CFSP and the ESDP illustrate that this is increasingly the case in the field of security and defence as well. Member States share in particular the objective of developing a common Defence Equipment Market and a competitive Defence Industrial and Technological Base. They should take this into account when assessing whether the application of EU procurement rules, which are aimed at fostering intra-European competition, would undermine the essential interests of their security.

Moreover, Article 296 TEC refers not to the protection of security interests in general, but to the protection of essential security interests. This specification underlines the exceptional character of the derogation and makes it clear that the specific military nature of the equipment included in the 1958 list is, by itself, not sufficient to justify exemption from EU procurement rules. On the contrary, the particularly strong wording ("essential") limits possible exemptions to procurements which are of the highest importance for Member States' military capabilities.

The wording of Article 298 TEC and the relevant case law, which refer to Article 296 in general, confirm that this reasoning should apply to the use of both paragraph 1(a) and paragraph 1(b) of Article 296 TEC.

## **5. HOW TO APPLY ARTICLE 296 TEC**

It is the Member States' prerogative to define their essential security interests and their duty to protect them. The concept of essential security interests gives them flexibility in the choice of measures to protect those interests, but also a special responsibility to respect their Treaty obligations and not to abuse this flexibility. Member States must in particular keep in mind that the derogation under Article 296 TEC is only applicable in clearly defined cases and make sure that it does "*not go beyond the limits of such cases*".<sup>16</sup>

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<sup>14</sup> Case C-414/97 *Commission v Spain*, par. 22.

<sup>15</sup> Offsets are compensations that many governments require from non-national defence contractors as a condition for purchasing military equipment. These compensations can cover a wide range of activities: direct offsets are directly related to the object of the procurement contract; indirect offsets are not and can be military or civil in nature.

<sup>16</sup> Case C-414/97 *Commission v Spain*, par. 22.

In the area of defence procurement, the only way for Member States to reconcile their prerogatives in the field of security with their Treaty obligations is to assess with great care for each procurement contract whether an exemption from Community rules is justified or not. Such case-by-case assessment must be particularly rigorous at the borderline of Article 296 TEC where the use of the exemption may be controversial.

This means in particular that contracting authorities have to evaluate:

- 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 specific case necessary for the protection of this essential security interest?

At the same time, Article 296(1)(b) TEC stipulates that measures taken under this Article "*shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes*". In the area of defence procurement, this can be the case for offsets, in particular for indirect, non-military offsets. Member States must therefore make sure that offset arrangements related to defence contracts covered by Article 296(1)(b) TEC do respect this provision.

## **6. THE ROLE OF THE COMMISSION**

It is not for the Commission to assess Member States' essential security interests, nor which military equipment they procure to protect those interests. However, as 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, it is for Member States to provide, at the Commission's request, the necessary information and prove that exemption is necessary for the protection of their essential security interests. The Court of Justice has repeatedly stated that "*Article 10 EC makes it clear that the Member States are required to cooperate in good faith with the enquiries of the Commission pursuant to Article 226 EC, and to provide the Commission with all the information requested for that purpose*".<sup>17</sup> This concerns all investigations carried out by the Commission as guardian of the Treaty, including possible verifications of the applicability of Article 296 TEC to defence contracts.

Therefore, when the Commission investigates a defence procurement case, it is for the Member State concerned to furnish evidence that, under the specific conditions of the procurement at issue, application of the Community Directive would undermine the essential interests of its security. General references to the geographical and political situation, history and Alliance commitments are not sufficient in this context.

By means of Article 287 TEC it is guaranteed that the Commission will grant Member States absolute confidentiality of the information received.

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<sup>17</sup> Judgment of 13 July 2004, Case 82/03 *Commission v Italy*, par.15.



According to Article 298 TEC, if measures taken under Article 296 TEC have the effect of distorting the conditions of competition in the common market, the Commission can, together with the Member State concerned, examine how these measures can be adjusted to the rules laid down in the Treaty.

The Commission may also bring the matter directly before the Court if it considers that a Member State is making improper use of the powers provided for in Article 296 TEC. In this case, the burden of proof that an exemption is justified lies with Member States.

In evaluating possible infringements, the Commission will take into account the specific sensitivity of the defence sector. In parallel, the Commission will continue its preparatory work on a possible procurement directive for military equipment to which Article 296 TEC does not apply.