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The Commission's Interpretative Communication on the Application of Article 296 EC in the field of Defence Procurement.

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Introduction

On December 7 2006 the European Commission issued the long awaited interpretative Communication on the application of the controversial Article 296 EC in the area of defence procurement.[1] It is reminded that the European Commission commenced anew its initiatives towards harmonisation and liberalisation of defence market at the European level with its Communication *COM (2003) 113*[2]. The current

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[1] COM (2006) 779 final, Interpretative Communication on the Application of Article 296 of the Treaty in the field of Defence Procurement, Brussels, 7 December, 2006.

[2] For an analysis see Georgopoulos, Aris, "Industrial and Market Issues in European defence: the Commission Communication of 2003 on Harmonisation and Liberalisation of Defence Markets", *Public Procurement Law Review* PPLR (2003) 12 NA 82-89

interpretative Communication constitutes the first initiative announced by the *Green Paper on Defence Procurement.*[3]

The aim of the interpretative Communication is first to articulate explicitly the European Commission's position on the interpretation of Article 296 EC and as a result reduce the possibility or prevent altogether the misinterpretation and abuse of the exemption established by Article 296 EC. The Commission clarifies that the Communication cannot provide an interpretation of the notion of Member States *essential security concerns* or determine precisely in advance which contract may fall under article 296 EC.[4] Instead it provides some guidance to Member States when deciding whether the use of the exemption is justified or not.

The Communication

Introduction

The Interpretative Communication begins by highlighting the significance of defence procurement as an economic activity within the EU. In particular the Communication specifies that the aggregate defence spending within the EU is € 170 billion of which more than € 80 billion is spent on procurement.

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[3] For an analysis see Georgopoulos, Aris "The Commission's Green Paper on Defence Procurement" *Public Procurement Law Review* [PPLR (2005) 14 Issue 2 NA 34-38.

[4] According to the European Commission it is the European Court of justice that will ultimately determine the ambit of Article 296 EC. COM (2006) 779 final p.3

The Communication then refers to the regulatory discrepancies that arise from the 25 five different regulatory frameworks that govern defence procurement within the EU. According to the Commission this regulatory plurality leads to extra costs and insufficiencies and as a result has a negative impact on the competitiveness of the European Defence Industrial and Technological Base and can be detrimental to the efforts of Member States to achieve value for money when purchasing equipment for their armed forces.

The Commission informs that at the same time it continues its preparation for carrying out an impact assessment for the possible adoption of a defence procurement directive which would cover the procurement of defence equipment which does not fall under the derogation of Article 296.[5] Moreover the Commission states explicitly that both initiatives are *complementary* with the Code of Conduct[6] for armament procurement, the intergovernmental non-binding regime administered by the European Defence Agency[7] and intended to enhance competition in the field of defence material covered by Article 296 EC.

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[5] *Ibid* p. 3.

[6] For an analysis of the Code of Conduct see Georgopoulos, Aris "The European Defence Agency's Code of Conduct for Armament Acquisitions: A Case of Paramnesia" *Public Procurement Law Review* PPLR (2006) 15 Issue 2 pp 51-61.

[7] For an analysis of the European Defence Agency see Georgopoulos, Aris "The New European Defence Agency: Major Development or Fig Leaf?" *Public Procurement Law Review* PPLR (2005) 14 Issue 2 pp. 103-112.

Field of Application

The communication refers only to the interpretation of Article 296 EC in the context defence procurement contracts carried out by procurement authorities of the EU Member States. Thus the communication does not address the issue of arms trade with third countries covered by WTO rules and the Government Procurement Agreement (GPA).

In particular the field of application of Article 296 (1b) EC[8] refers to national measures *connected with the production and trade in arms, munitions and war material* specified in the list of 1958[9] (mentioned in Article 296 (2) EC). According to the Commission this list includes only material of *purely military nature and purpose.*[10] The communication argues that on the basis of the previous observation Article 296 (1b) EC can only justify an exemption for procurement of equipment which is designed for specifically military purposes. As a result procurement for *non-military security* purposes

[8] Article 296 1(b) EC provides that: "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.

9 Council Decision 298/58 of 15 April 1958. The list was never officially published although it was available in the public domain. The most "official" of these communications of the list came as a result of a written parliamentary question, see Response to Written Question E-1324/01 by Bart Staes (Verts/ALE) to the Council, O.J. C-364 E, 20th December 2001, at 85-86.

[10] COM (2006) 779 *op. cit.* p. 5.

can only be justified under Article 14[11] of the Public Procurement Directive 2004/18/EC[12] but not Article 296 (1b) EC.

More importantly the communication argues that in contrast to Article 296 (1b) EC, Article 296 (1a) EC[13] may justify the refusal of disclosure of sensitive information linked with the procurement of both military and non-military procurement including procurement of 'dual use'[14] goods.[15] This is so because according to the communication Article 296 (1a) EC transcends the area of 'defence' strictly speaking and aims at protecting the disclosure of any information which could be detrimental to the essential security interests.[16]

Conditions for Application of Article 296

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[11] Article 14 reads: "This Directive shall not apply to public contracts when they are declared to be secret, when their performance must be accompanied by special security 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 that Member State so requires."

[12] Directive 2004/18/EC of the European Parliament and 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 [2004] OJ L134/114.

[13] Article 296 (1a) EC stipulates that: "No Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;"

[14] 'Dual use' goods are equipment that are not specifically designed for military purposes but may be used for both military and civilian purposes

[15] COM (2006) 779 *op. cit.* p. 6

[16] *Ibid* p. 4.

First of all the communication clarifies that Article 296 (1b) EC does not introduce an automatic exemption for arms, ammunition and war material from the EC Treaty's field of application.

Moreover the Communication recognises that Article 296 (1b) EC provides Member States with a significant margin of discretion in the evaluation of what measures are necessary for the protection of their essential security interests. Moreover the definition of what constitutes *essential security interests* is a prerogative that lies with each individual Member State.[17]

The Communication also submits that according to the case law of the European Court of Justice grounds for derogation from the EC Treaty –including Article 296 EC- are subject to specific conditions which must be interpreted narrowly. This means that Member States do not enjoy an unfettered discretion to exempt hard defence materials from the EC Treaty.[18] Consequently the existence of certain limits in the use of Article 296 EC suggests that Member States must evoke it and prove that they have not gone beyond these limits.

Moreover according to the Communication Member States must show that the extraordinary measures *are necessary* for the protection of their essential security interests –in other words they have to demonstrate that there was no other way for attaining this objective but to resort to national purchasing.

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[17] *Ibid.*

[18] *Ibid*

Furthermore the communication suggests that other interests such as industrial and economic interests cannot justify the use of Article 296 EC. It is only the *essential* security interests –namely the measures must be linked with areas of the *highest importance* for the State. Interestingly the communication stipulates that in defining their essential security interests Member States should take into consideration the European dimension, namely the *convergence of* national *interests* in the field of Common Foreign and Security Policy (CFSP) and the European Security and Defence Policy (ESDP). In this regard the communication argues that all Member States share in particular the objective of developing a Common Defence Equipment Market and a competitive Industrial and Technological base. It is therefore important for the Member States to consider whether the application of European procurement rules –which are aimed at fostering intra-community competition- would undermine their essential security interests.

As an illustration of a national measure that cannot be justified by Article 296 EC are the so called indirect non-military offsets, namely industrial compensations of *civil* nature that governments require from foreign defence contractors as a condition for purchasing military equipment and which by definition are not linked with the protection of the essential security interests of Member States.

Guidance for the Application of Article 296

The communication attempts to provide some guidance on how should national contracting authorities approach the evocation of Article 296 EC.

As a starting point the Commission underlines that Article 296 EC provides Member States with sufficient flexibility in making sure that necessary measures are taken for the protection of their essential interests. Nevertheless this flexibility should not be abused.

In other words Member States *should not go beyond the limits* set by Article 296 EC. In the case of defence procurement Member States should assess carefully in *each procurement*, whether departure from Community law is justified or not.

According to the communication the 'rule of thumb' in the case of defence procurement would be for contracting authorities to assess:

a) Which is the essential interest concerned?
b) What is the connection between this security interest and the specific procurement decision?
c) Why is the non-application of the Public Procurement Directive necessary for the protection of this essential security interest?
d) Whether the derogation measures would affect the conditions of competition in the internal market regarding products which are not intended for specifically military purposes. (For instance the requirement for indirect non-military offsets).

Role of the Commission

The communication clarifies that while recognising the prerogative of Member States to assess their essential security interests the Commission, as the guardian of the Treaty, may evaluate whether the conditions for exemption of Article 296 EC have been met in the context of a particular procurement.

Consequently in such cases Member States are to provide *at the Commission's reques*t the necessary information and *prove that the exemption is necessary* for the protection of their security interests. The Commission argues that according to the Jurisprudence of the European Court of Justice Member States are required under Article 10 EC to cooperate in good faith with the Commission and provide all evidence required in the context of proceedings under Article 226 EC. According to the Commission this duty of cooperation extends to all investigations carried out by the Commission.

As a result when the Commission decides to investigate a defence procurement case Member States should provide evidence that the use of the Community rules in the award of a specific defence procurement contract would undermine their essential security interests. More importantly the Commission argues that *general references* to *geographical* and *political* situation, *history*, and *Alliance* are not sufficient in this context.

Moreover the Commission submits that the general confidentiality duty imposed on Community officials and employees during and after the termination of their duties suffices to guarantee that the sensitive information submitted by the Member States will be treated with the outmost confidentiality.

Finally the Communication provides that the Commission will take into account the sensitivities of the defence sector in the exercise of its supervisory duties. Meanwhile

exactly because it recognises that the European Public Procurement rules might not be flexible enough for some defence procurement, it continues its preparatory work on a defence procurement directive for military equipment to which Article 296 EC does not apply.

Analysis

The current interpretative communication is the first tangible follow up initiative that stemmed from the results of the consultation process set by the Green Paper on defence procurement. The consultation process had very clearly indicated that an interpretative communication would be a necessary instrument towards European defence procurement integration.

The publication of an interpretative communication is always a welcome development but it is even more so when it concerns such an ambiguous and controversial provision as Article 296 EC. Moreover this instrument would clarify the approach and intentions of one of the main actors in the field. The following points are noteworthy.

First of all the starting point for understanding the approach adopted by the Commission regarding the conditions for the application of Article 296 (1b) EC is the premise that procurement contracts (works, supplies, services) awarded by contracting authorities in the field of defence are covered in principle by the Directive 2004/18/EC,

subject to Article 296 of the Treaty.[19] Thus according to the Commission the interpretation and application of Article 296 EC is a preliminary condition *which affects the field of application of a Community Law instrument*, namely Directive 2004/18/EC. In this way the Commission tries to establish its competence or at the very least underline its stake in the area of defence procurement.

Moreover it is important to note that the Commission clarifies that the prerogative for the definition of what constitutes 'essential security concerns' lies with the Member States. This acknowledgment is repeated in various instances throughout the document.

However the Commission argues that this prerogative does not amount to a *carte blanche* according to which Member States could exempt blithely a big part of the internal market from the rules of the Treaty. It is important to note in this regard that the communication draws a line by stating that industrial and economic concerns cannot justify the use of Article 296 EC. As an illustration the Communication makes specific reference to the *case of indirect non-military offsets.*[20]

However the communication does not address at all what happens with measures that are linked *both* with essential security intersts but also with other economic and industrial interests for example the use of *indirect military offsets*[21] or of *direct offsets.*[22] The Commission seems to condone military offsets by requiring that

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[19] See Article 10 of Directive 2004/18/EC.

[20] For example: The MoD in country A puts as a condition for the purchase of X number of fighting aircraft from a company from country B, the purchase by the foreign Company of X number of photocopy machines from companies in Country A.

[21] Namely offsets which are not linked with the subject of a particular main defence contract but are of military nature -as opposed to the previous example of indirect non-military offsets. In the case of indirect

'[M]ember States must therefore make sure that *offset arrangements* related to defence contracts covered by Article 296 (1b) EC do respect this provision'.[23]

This wording suggests that at least *some offset practices* are allowed under Article 296 EC.

This link between security and industrial concerns may exist even in the extreme example of the direct allocation of a defence contract – extreme because it is clearly the most detrimental barrier to trade, since it denies market access completely. Let us take for example the decision of a national MoD to allocation directly a contract for the construction of submarines to a national champion in order to maintain national capabilities (aiming at the independence or limited dependence from foreign sources of supply). This measure is linked with both security concerns (domestic capability in a given field, security of supply) and has also industrial consequences (maintenance of post of employment) etc.

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military offsets the previous example changes as follows: The foreign company is required to purchase X amount of military components or X value of military services from companies in country A.

[22] Namely industrial compensations linked directly with the execution of a particular defence procurement contract. In the case of *direct offsets* the previous example would change as follows: The foreign company would have to hire defence subcontractors in country A for assembling Y number of fighting aircraft for the MoD.

[23] COM (2006) 779 final *op.cit* p. 8.

This *duality* of concerns is self evident. It should be remembered that this immediate link between capabilities and security considerations is advocated at the EU level by the European Commission itself and other actors with regard to the importance of maintaining a healthy and vibrant European Defence Industrial and Technological Base. The fact that this thesis when advocated by the European Commission refers to the European level does not alter the nature of the link between industrial capabilities and security concerns. Ultimately the issue of whether specific cases are linked more with industrial concerns rather than security concerns is a matter of judgment.

The Communication does not touch upon the previous issue or the immediately connected matter of security of supply- this silence is interesting because both the *Green Paper* and *COM (2003) 113* have recognised the issue of security of supply as a valid consideration and an intrinsic characteristic that differentiates defence procurement from general public procurement.

Instead the Commission suggests that Member States, because of the *ever growing convergence of security interests,* should consider why following the European public procurement rules –which aim to foster intra-community Competition- would undermine their essential security interests. Here the syllogism of the Commission appears to have two weaknesses.

Firstly the proposition of an *ever growing convergence of national interests* is not entirely accurate. The fact of the establishment of CFSP and ESDP is not necessarily a conclusive testimony of convergence of national interests, since recent experience has exposed on a number of occasions and in most emphatic ways that differences of national interests still exist.

In addition the proposition that *Member States share a particular objective* in developing a common Defence Equipment Market and a Competitive European Defence Industrial base also needs qualification. It is reminded that one Member State, Denmark participates neither in the European Defence Agency nor in the Code of Conduct for armaments procurement in accordance with its opt out from CFSP matters that may have military implications. In addition Spain and Hungary decided to not participate in the Code of Conduct for armaments procurement.

These discrepancies are not problematic from a legal point of view in the second pillar but would be highly problematic in the context of the first pillar when specific community instruments are involved (for example a European defence procurement directive) and especially when general pronouncements on the applicability of the wider framework of the Treaty are made.

Secondly the implied premise that the promotion of European Defence Industrial and Technological Base (EDITB) is only assisted if the European public procurement rules are followed is not entirely true, since support to EDITB may also be achieved either by engagement in collaborative procurement within the EDA or participation in the regime of the Code of Conduct for armaments procurement (whose field of application is defence contracts exempted under Article 296 EC). Neither of these regimes follows the European Public Procurement rules per se.

The last observation highlights another important point, namely the potential tensions between the Commission's field of supervision and that of the Code of Conduct –and as a result EDA which is its administering body. It is interesting to mention that although the

EDA welcomed the interpretative communication[24] it subtly reminded that the Code of Conduct's field of application is the *"Article 296 area"*.[25] As suggested elsewhere[26] it is far from certain that the two institutions have the same understanding as to what constitutes the 'Article 296 area'. In order to explicate the tensions between the commission and the EDA as a result of overlapping areas of competence the following example is relevant:

Member State A which is also participating Member States (pMS) of the Code of Conduct for armaments procurement decides to exempt a defence contract for the purchase of tanks from the EC treaty by means of evoking Article 296 EC. Then Member State A decides to include a contract opportunity notice for the same contract on the Electronic Bulletin Board – the electronic portal where pMS of the Code of Conduct *may* announce contract opportunities. The question that arises is whether the publication of the contract opportunity on the Electronic Bulletin Board contradicts the claim of protection of the essential security interests for not using the EU rules? This is an accurate observation which would enable the Commission to challenge the decision of the Member State to use Article 296 EC in the first place. The same would be the case for every defence contract announced on the Electronic Bulletin Board.

By challenging this decision the Commission would enter directly in the field of competence of the Code of Conduct and the EDA. Nevertheless this eventuality is less

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[24] 'EDA Welcomes European Commission Clarification on EU Defence Procurement', press release, Brussels, 7 December 2006.

[25] This is a quote from the press release. Emphasis Added.

[26] These tensions have been highlighted in Georgopoulos, Aris "The European Defence Agency's Code of Conduct for Armament Acquisitions: A Case of Paramnesia" *op.cit.*

likely because such a move on the part of the Commission would give an incentive to Member States not to advertise heir defence contracts at all –in other words it would be a coup de grace for the efforts under the Code of Conduct for more openness in EU defence markets and would not bring any benefit to the Commission.

Another very interesting point is the fact that the Commission explicitly submits that Member States are under a duty to provide the necessary information *at the Commission's request.* This means that the Commission believes that Member States are under the duty to provide information on their decision to exempt a particular defence contract from EU rules *only when the Commission investigates* a defence procurement case. In other words Member States are not required to provide this information every time they decide to use Article 296 EC. This is in direct contrast with what was considered to be the Commission's position, namely that Member States should notify the Commission of their intention to use Article 296 EC.

In this regard it should be remembered that Article 95 (4) EC stipulates that:

'[I]f, after the adoption by the Council or by the Commission of a harmonisation measure, a Member State deems it necessary to maintain national provisions on grounds of major needs referred to in Article 30, …. it shall notify the Commission of these provisions as well as the grounds for maintaining them.'

The Commission could have argued that although Article 296 is not explicitly mentioned in Article 95 (4) EC, the lack of prior notification of the Member States

intention to use Article 296 EC[27] undermines a specific harmonization measure, namely the public procurement directive, since the *ex post* investigation would not be as effective as the prior notification. This kind of *teleological* interpretation based on the principle of effectiveness is far from unknown in European Union law. Yet despite this possibility the Commission decided to go for something less forceful. This is a clear indication that the Commission adopts a *realistic* view which puts pressure on Member States but not too overwhelmingly. According to this approach the Commission *can decide if* and *when* to investigate specific defence contracts.

Nevertheless even under this admittedly more realistic approach regarding the question *when* Member States are required to provide information for their decision to use Article 296 EC there is always the question *what* sort of information are required to provide. Here the Commission purposefully does not refer at all to Article 296 (1a) EC which provides that:

> [N]o Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

Instead the Commission refers to Article 287 EC and the general duty for confidentiality that Community officials and employees have even after their duties have ceased, in order to alleviate Member States concerns for disclosing sensitive information.

[27] Member States often have specific set of rules that govern their defence procurement. This becomes legally more problematic because national officials and courts have a specific national legislation that they have to apply as opposed to take a simple decision to use Article 296 EC or not.

It is argued that the protection afforded by Article 287 EC is at the very least unclear. This is for two reasons.

Firstly it is not certain what the sanctions in case of non compliance would be (of financial, criminal or disciplinary nature). It is argued that merely financial or disciplinary sanctions would not be enough.

On the other hand if criminal sanctions where to be attached to non-compliance with Article 287 EC this has to be explicitly provided by a clear provision establishing a threat for criminal punishment together with clear reference to the maximum punishment, according to the principle of *nullum crimen, nulla poena sine praevia lege*. The maximum punishment should be set at levels similar to the ones for equivalent offences committed in the Member States. At the moment Article 287 EC alone cannot provide this level of protection.

Another important observation is that the communication despite the guidance that it provides it does not touch upon the question of *intensity of scrutiny* once an investigation for an abuse of Article 296 EC started. The communication provides various indications which occasionally create mixed messages. The requirement that Member States must provide evidence that *prove that the measures are necessary*[28] is in contrast to what the Commission submits elsewhere with regard to the *negative character* of the assessment *(*namely to Member states need to prove that they *did not go beyond* the limits of Article 296 (1b) EC[29] More importantly the Communication did not make any reference at all to

[28] COM (2006) 779 final *op.cit* pp. 5 and 8

[29] *Ibid* pp. 6 and 7.

the Case C-252/01 *Commission v. Belgium.*[30] . It is reminded that the case dealt with an action brought by the Commission against Belgium for failing to place a notice in the Official Journal of the European Communities with regard to a public services contract involving coastal surveillance by means of aerial photography. Although the aforementioned contract did not fall within the purview of Article 296 (1b) EC the way that the ECJ approached the case provides an unmistakeable benchmark for the approach that the ECJ would take under Article 296 EC which undoubtedly provides Member States with even wider discretion. Belgium argued that the contract had to be accompanied with special security measures and therefore evaded the application of the Services Directive pursuant to Article 4 (2) of the latter. Interestingly the Court tried to establish whether the national decision was manifestly unsuitable[31] for the protection of the concerns of security. The Court overcame effortlessly the arguments of the Commission and aligned wholeheartedly with the position of Belgium. In addition Advocate General Alber held that it is up to the national governments to assess and define the security interests of the State.[32] Furthermore more the assertion of the Member State that special security measures are required for the execution of a procurement

[30] Case C-252/01 *Commission v. Belgium* [2003] E.C.R. I-11859

[31] For an analysis of the Test of manifest unsuitability under 296 EC see Georgopoulos, Aris "Defence Procurement and EU Law" *European Law Review* 2005, vol. 30, issue 4, p. 559 at 569 *et seq.*

[32] Para [39:] "I also consider that *it is largely for the government of a Member State* to *evaluate and define that State's security interest"s*. [Emphasis added].

contract should be sufficient for the Court if there is not a case of *manifest doubt*. One can only wonder if the omission of this important case was fortuitous.[33]

Connected to the discussion of the level of scrutiny is the useful guidance provided by the communication with regard to what would be considered as insufficient justification for the existence of essential security interests in the view of the Commission. For example according to the Commission *general references* to geographical and historical situations or Alliances will not be sufficient. This clarification is particularly interesting because it sends a message to Member States that so far took the view that they have different security concerns (especially countries at the borders of the EU for example Spain, Greece, Poland) from the rest of the Member States, to articulate their particular security interests more clearly. By the same token a message is sent to new Member States who also joined NATO that they should not consider their membership to the Alliance as a justification for derogation of the rules of the Treaty.

Conclusions

The question that is raised is whether the interpretative has delivered its promises; in other words whether it clarified the legal regime in defence procurement. The answer should be affirmative but with a qualification. The Commission could not have provided anything more than what it did at this juncture because of the parallel initiatives under the

[33] An explanation based on the fact that *Commission v Belgium* did not deal specifically with Article 296 EC would not be convincing since the Communication refers to other cases that did not deal specifically with the application of this provision.

intergovernmental EDA, the establishment of the Code of Conduct as well as the inherent difficulties for interpretation imposed by Article 296 EC itself. It is argued that the interpretative communication is particularly useful because it provides an insight to the way that Commission approaches the scope of Article 296 EC and equally gives clues of the Commission's intentions.

It is submitted that the Commission wants to create the impression that it is ready to take action before the European Court of Justice. It might decide to do so by challenging a defence contract of low political sensitivity for example a contract for uniforms, or food supplies. By doing so it would try to make the case for the usefulness of a defence procurement directive tailored round the specific characteristics of defence procurement. It remains to be seen whether the Commission will eventually institute proceedings against Member States since this course of action in the context of Article 296 EC entails risks as the judgment of *Commission v. Belgium* suggests by analogy.