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

on transposition of directive 2009/81/EC on Defence and Security Procurement

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I. Executive Summary

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/EC¹ is an important element of the Commission's policy to create a truly European Defence Equipment Market and a European level playing field for defence procurement. For the first time it subjects defence and sensitive procurement to the specific rules of the Internal Market, fostering transparency and competition and ensuring the satisfaction of procurement needs in an ever tightening financial framework.

Most of the 23 Member States who have transposed the Directive as of July 2012 have *prima facie* done so correctly. The vast majority of Member States have also transposed the non-mandatory provisions on sub-contracting which aim in particular at enhancing competition in the supply chains of successful tenderers. The Commission will continue to monitor the state of transposition and the content of the national implementing measures to ensure full compliance with European law. In particular it will take action to accomplish the phasing out of offsets which diverge from the basic principles of the Treaty.

Following the transposition of the Directive, the Commission will focus as a matter of high priority on its correct application in the Member States. The challenge will be different in each Member State, depending in particular on its national defence industrial capabilities. However, ensuring fair and open competition throughout the Union is a prerequisite for establishing a level playing field for European industry and an efficient European defence market.

At the same time, the Commission is continuing to explore how to reinforce the internal market in this sector, which is of strategic importance for the Union, with the Member States and the European Defence Agency.

II. Introduction

Together with Directive 2009/43/EC of the European Parliament and of the Council of 6 May 2009 simplifying terms and conditions of transfers of defence-related products within the Community on intra-EU transfers of defence products², the Directive is an important contribution toward the creation of a truly European Defence Equipment Market and at strengthening the European Defence Technological and Industry Base.

¹ OJ L 216 of 20 August 2009, p. 76 (the "Directive").

² OJ L 146 of 10 June 2009, p. 1.

Defence and (to a lesser degree) security markets are very specific markets. The customer side is primarily (for defence exclusively) public, and both defence and security are national prerogatives. Moreover, defence spending and defence industrial capabilities are highly concentrated in a few Member States. Due to the nature of the products, markets are highly regulated, certain companies of strategic importance, and procurement decisions often also determined by political and strategic considerations.

The Directive provides procurement rules tailor-made for the uniqueness of defence and security equipment, namely sensitivity and complexity. It includes specific provisions on security of supply and security of information, and it allows for unrestricted use of the most flexible award procedure. Member States now have at their disposal EU-wide rules they can apply to complex and sensitive transactions without putting their legitimate security interests at risk. Defence contracts should therefore, as a rule, no longer be awarded outside Internal Market rules by invoking the exception clause of Article 346 TFEU. This should lead to more transparency and competition, which in turn should foster the competitiveness and innovativeness of European industries and help Member States to satisfy their procurement needs despite ever-shrinking budgets.

The Directive had to be transposed by Member States by 21 August 2011. This report implements Article 73 of the Directive, which requests the Commission to present a report *"on the measures taken by Member States with a view to the transposition of this Directive, and in particular Article 21 and Articles 50 to 54 thereof"*.

The Report assesses the general state of transposition of the Directive by Member States, before addressing the crucial provisions for the creation of a European Defence Equipment Market: the scope of application (Article 2); the exclusions from the application of the Directive (Articles 12 and 13); the subcontracting provisions (Articles 21 and 50-54); and the review procedures (Articles 55-64). It also highlights the situation concerning offsets whose continuing existence is a major risk to the correct application of the Directive.

III. State of play of the transposition of Directive 2009/81/EC

Three Member States had notified complete transposition of the Directive to the Commission by 21 August 2011, and a fourth Member State notified complete transposition in September 2011. The Commission therefore opened infringement procedures against 23 Member States (Article 258 TFEU) by sending letters of formal notice. As a result, by March 2012, 15 additional Member States had notified complete transposition. For the remaining eight Member States the Commission continued the infringement procedure by issuing reasoned opinions to them. By June 2012, two of these Member States had completely transposed while two Member States had only partially transposed the Directive.

By July 2012, four Member States had still not notified any transposition measure to the Commission. The Commission intends to refer the cases of missing or only partial transposition to the European Court of Justice in due course.

Since a majority of Member States have transposed the Directive with a considerable delay, the Commission is still verifying whether the national implementing measures comply with the Directive.

IV. National implementing measures for key elements of the Directive

A. Scope of the Directive (Article 2)

It is crucial for the effective implementation of the Directive that the Member States' national implementing measures apply to all procurements falling within the scope of the Directive. The correct transposition of Article 2 is therefore a key element.

According to Article 2, the Directive applies to contracts awarded "*in the fields of defence and security for (a) the supply of military equipment, including parts, components and/or subassemblies thereof; (b) the supply of sensitive equipment, including parts, components and/or subassemblies thereof; (c) works, supplies and services directly related to the equipment referred to in (a) and (b) for any and all elements of its life cycle; (d) works and services for specifically military purposes or sensitive works and sensitive services*". It is therefore the subject of the procurement that determines the application of the Directive.

In the area of defence, the scope of the Directive is based on that of Article 346 TFEU and covers, in principle, all contracts for the procurement of military equipment, works and services. In addition, the Directive also applies to all sensitive purchases that have a security purpose and involve classified information. All other contracts in the fields of defence and security continue to be subject to Directives 2004/17/EC of the European Parliament and of the Council of 31 March 2004 coordinating the procurement procedures of entities operating in the water, energy, transport and postal services sectors³ and 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 contracts⁴, which regulate civil public procurement.

Sixteen Member States have transposed Article 2 by using in essence a similar wording to that of the Directive. However, six Member States have used a different wording. Of those, only some have the potential materially to change the scope of application of the Directive.

One Member State, for example, has restricted the application of the national implementing measure to specific contracting authorities. Contracts awarded by other contracting authorities within the material scope of the Directive will therefore not be covered. Such a differentiating approach constitutes a risk for a European level playing field for the procurement of all contracts covered by the Directive and is incompatible with the Directive.

Some Member States use specific national lists to define the field of application of the Directive in the area of defence. In principle, these lists constitute legitimate references for the

³ OJ L 134 of 30 April 2004, p. 1.

⁴ OJ L 134 of 30 April 2004, P. 114.

interpretation of Article 2 provided that they reflect the list of 1958⁵. It will be subject to further detailed assessment, whether this is the case.

One Member State explicitly subjects the so-called "dual use products" to the application of the Directive. However, according to the case-law of the European Court of Justice (Case C-615/10, Judgment of 7 June 2012), such products are subject to the more stringent rules of Directives 2004/17/EC and 2004/18/EC and not to those of the Directive.

On the whole, the Commission is nonetheless satisfied that most Member States have correctly transposed Article 2. It will have to review carefully what action will be required in order to ensure the complete application of this particular provision in all Member States.

B. Exclusions from the application of the Directive (Articles 12 and 13).

The Directive provides for specific exclusions from its scope in Articles 12 and 13. In accordance with Article 11 and the ECJ case law, these exclusions from the application of EU law have to be interpreted restrictively. It is therefore of major importance for the effectiveness of the Directive that the Member States transpose those provisions correctly.

According to Article 12 certain contracts awarded pursuant to international rules are excluded from the Directive. While these exclusions are based on the respective exclusions of Directives 2004/17/EC and 2004/18/EC, they have been adapted to the specific situation of defence. Article 12 (c) in particular specifies that a procurement pursuant to the specific procedural rules of an international organisation is excluded from the Directive if this organisation purchases for its purposes, or if a Member State is obliged to award the contracts in accordance with such rules.

The national implementing measures of ten Member States use the same wording as Article 12 of the Directive. Thirteen Member States, however, have adopted a different wording which does not seem to change the material scope of the exclusions. At least one Member State, however, has broadened the scope of the exclusion of Article 12 (c). Its national implementing measure does not restrict the exclusion to purchases for an international organisation's purposes.

Article 13 contains all other specific exclusions, some of which are identical to the exclusions of Directives 2004/17/EC and 2004/18/EC. Defence specific exclusions concern principally contracts involving the disclosure of information (Article 13(a)); for the purposes of intelligence activities (Article 13(b)); in the framework of cooperative programmes (Article 13(c)); and awarded in third countries (Article 13(d)). A final exclusion concerns government to government sales (Article 13(f)).

The national implementing measures of nine Member States use the same wording as Article 13 of the Directive. Fourteen Member States adopted a different wording. As for Article 12, most of these differences do not seem to change the material scope of this Article.

⁵ Decision defining the list of products (arms, munitions and war material) to which the provisions of Article 223 (1)(b) – now Article 346 (1)(b) TFUE – of the Treaty apply (doc. 255/58). Minutes of 15 April 1958: doc. 368/58.

The few material changes mainly concern the exclusion in cases of disclosure of information, Article 13 (a), and the exclusion in the framework of cooperative programmes, Article 13 (c).

According to Article 13 (a), the Directive does not apply to *contracts for which the application of the rules of this Directive would oblige a Member State to supply information the disclosure of which it considers contrary to the essential interests of its security*. This exclusion is based on Article 346 (1)(a) TFEU according to which *"no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security"*. The Directive clarifies that where a Member State is not obliged to supply information within the meaning of Article 346 (1)(a) TFEU, it is not obliged to apply the Directive.

All but two Member States have transposed this exclusion correctly. One Member State has not transposed it; the other Member State excludes all contracts where publication would lead to disclosure of classified information, which goes beyond the wording of Article 13 (a). Contracts involving classified information are covered by the Directive and can be subject to specific provisions guaranteeing the security of information.

Other material changes in the scope of a specific exclusion concern Article 13 (c). It excludes certain contracts in the framework of cooperative programmes from the Directive. The exclusion as such appears to have been correctly transposed by all Member States. This is not the case, however, for the obligation to inform the Commission upon the conclusion of the respective agreement foreseen under Article 13 (c). In one Member State there is no obligation to inform the Commission and in another the Commission has to be informed only when the cooperative programme ends. All other exclusions foreseen under Article 13 seem to have been transposed correctly.

Since exclusions have to be interpreted strictly, the Commission will monitor closely the use of exclusions by Member States and verify that none of them, especially the exclusions under Article 12 and the exclusion of government to government sales, Article 13 (f), is used to circumvent the rules of the Directive.

C. Provisions relating to subcontracting (Articles 21 and 50 to 54 – title III).

The Directive lays down extensive rules on subcontracting. Their aim is to enhance competition within the supply chains of successful tenderers. The more systematically they are used by contracting authorities the more they will improve market access in particular for SMEs and economic operators established in smaller countries and thereby contribute to a truly European Defence Equipment Market. The subcontracting rules are therefore a cornerstone of the Commission's policy.

Article 73 requires the Commission to report specifically on their transposition. Such rules are new to European public procurement legislation. Directive 2004/17/EC and 2004/18/EC only state that *"the contracting authority may ask or may be required by a Member State to ask the tenderer to indicate in his tender any share of the contract he may intend to subcontract to third parties and any proposed subcontractors"*. Contracting authorities have no further rights

under Directives 2004/17/EC and 2004/18/EC to intervene in the choice of subcontractors by the main contractor.

While reiterating this basic principle in Article 21 (2), the rules of the Directive provide important additional tools for the Member States and their contracting authorities.

Firstly, according to Article 21 (3), contracting authorities can oblige the successful tenderer to award all or certain of its proposed subcontracts through the competitive procedure described in Title III of the Directive. While Member States had to transpose this provision, they could decide whether contracting authorities are free to impose to award subcontracts through such a competitive procedure or whether they are obliged to do so.

Twenty-two Member States have given their contracting authorities the option to oblige the successful tenderer to award their subcontracts using the competitive procedure. No Member State obliges its contracting authorities to so oblige the successful tenderer. One Member State seems to have omitted to transpose Article 21 (3) at all.

Secondly, under Article 21 (4), Member States may provide for compulsory subcontracting by the successful tenderer. However, the transposition of these provisions is left to the discretion of the Member States. If a Member State introduces compulsory subcontracting, it has two options: It can either give its contracting authorities the possibility to require subcontracting from the successful tenderer or it can oblige its contracting authorities to do so. Both options, if exercised, create additional business opportunities for potential subcontractors.

It has to be noted that the successful tenderer can only be obliged to subcontract up to 30% of the main contract and that the subcontracts have to be awarded using the competitive procedure of Title III.

Only two Member States have chosen not to provide for compulsory subcontracting. All other Member States have given their contracting authorities the possibility to require subcontracting without obliging them to require it.

A preliminary assessment suggests that Member States' transpositions of the subcontracting provisions are generally compatible with the Directive. The Commission is satisfied that a majority of Member States have seized these opportunities to enhance competition in the supply chains and is confident that this will have a positive impact on the internal market. Since the subcontracting provisions are an important tool for the creation of a European level playing field in the defence market, the Commission will closely monitor their use by Member States.

D. Review mechanism, Articles 55-64

The Directive includes a comprehensive set of provisions aimed at making effective means of redress available to aggrieved bidders. These provisions are based on those coordinating national review systems for civil procurements Directive 2007/66/EC of the European Parliament and of the Council of 11 December 2007 amending Council Directives

89/665/EEC and 92/13/EEC with regard to improving the effectiveness of review procedures concerning the award of public contracts⁶.

Approximately half the Member States have transposed the provisions on review in the national implementing measures of the Directive, the other half have chosen to transpose these provisions within their general rules on remedies.

The Directive foresees some adaptations to the general review system to take the special characteristics of defence into account. This report will highlight the two most important ones.

First, Article 56 (10) foresees that *"Member States may decide that a specific body has sole jurisdiction for the review of contracts in the fields of defence and security"* in order to guarantee an adequate level of confidentiality of classified information. The provision also contains specific rules on how *"to reconcile the confidentiality of classified information with respect for the rights of the defence"*.

It seems that no Member has used the option to endow a specific body with jurisdiction. Only a few Member States have included specific rules on security clearance for the members of the review body. These rules deal with the capacity of a member of the review body to sit on a case but do not contain specific provisions for granting or requesting security clearance. It seems, therefore, that the Member States did not share some of the concerns voiced in the legislative process, which had given rise to the specific rules of the Directive on that point.

Second, Article 60 (3) foresees that a review body may not consider a contract ineffective, even though it has been awarded illegally, *"if the review body finds that overriding reasons relating to a general interest, first and foremost in connection with defence and/or security interests, require that the effects of the contract should be maintained (...) In any event, a contract may not be considered ineffective if the consequences of this ineffectiveness would seriously endanger the very existence of a wider defence or security programme which is essential for Member State's security interests."*

All Member States but two have included this specific possibility to abstain from declaring a contract ineffective.

A preliminary assessment suggests that Member States' transpositions of the review provisions in general are compatible with the Directive. The Commission, therefore, expects that procurement in the field of defence and security will be subject to effective national review.

V. Impact of the Directive on Member States' offset provisions

In the past, 18 Member States maintained offset policies requiring compensation (offsets) from non-national suppliers when they procured defence equipment abroad. In these Member States, contracting authorities were generally obliged to require such compensation for purchases above a certain value. Such offset requirements are restrictive measures which go against the basic principles of the Treaty. They discriminate against economic operators,

⁶ OJ L 335 of 20 December 2007, p. 31.

goods and services from other Member States, and they impede the free movement of goods and services.

Offsets thereby jeopardize the proper application of the Directive and hinder the creation of a European level playing field in defence procurement. EU law can tolerate offsets only on the basis of a Treaty-based derogation, in particular Article 346 (1)(b) TFEU, i.e. if an offset requirement is necessary for the protection of the essential security interests of a Member State. The use of the derogation, however, has to be justified by the Member State concerned on a case-by-case basis.

The Commission has, therefore, been in close contact with the 18 Member States concerned, helping them to abolish or revise their offset rules. As a result, most of these Member States have either abolished the respective rules or revised their legislation. In this case, offsets are no longer required systematically but solely in exceptional cases where the conditions of Article 346 TFEU are met. Major legal changes have, therefore, been implemented. In addition, the European Defence Agency and its participating Member States clarified that its Code of Conduct on Offsets may be applied only to offsets which are justified on the basis of Article 346 TFEU.

The Commission will now monitor whether these changes will bring about a change in practice. It is convinced that a rapid phasing out of the discriminatory practice of offsets is necessary to create a truly European Defence Equipment Market. The Commission will, therefore, take appropriate action where this is not the case. It will also do so where Member States continue to have offset rules that are clearly incompatible with EU law.

VI. Conclusion

The aim of the Directive is to create a European level playing field, applying to large and small Member States and companies alike. Defence procurement is now subject to internal market rules and only exceptionally exempted from them. Thus, Member States now have to publish business opportunities, apply harmonised procedures, and phase out offsets.

Timely transposition proved challenging for the vast majority of Member States. However, most of the 23 Member States who have transposed the Directive as of July 2012 have *prima facie* done so correctly. In particular, the Commission considers it an encouraging sign that many Member States have also transposed the non-compulsory subcontracting provisions and thereby seized additional opportunities to foster competition.

A consistent and correct application of the Directive is necessary to strengthen the European Defence Technological and Industrial Base. Therefore, the Commission will closely monitor especially the use of exclusions and derogations as well as the phasing out of offsets. In general, this report is without prejudice to the power of the Commission to bring infringement proceedings against individual Member States whose national implementing measures are not in compliance with the provisions of the Directive.

Moreover, the Commission will pay particular attention to the impact of the Directive on the openness of the Defence market and the strength of the European Defence Industrial Base. By

21 August 2016 the Commission will report on this subject to the European Parliament and the Council as provided under Article 73(2).

Further initiatives may be necessary to promote the internal market in this area, with efforts from all relevant actors, in particular Member States and industry. The Commission has, for its part, set up a Task Force to examine ways of further developing European policies in the defence sector. It will do so in association with the European Defence Agency and in close cooperation with all other stakeholders in order to ensure overall coherence of European efforts in an area which is of strategic importance for the Union as a whole.