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BRIEFING NOTES ON DEFENCE PROCUREMENT

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LEGAL REMEDIES IN THE DEFENCE PROCUREMENT DIRECTIVE

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Executive summary

The current proposal for a Directive on the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security aims to achieve an open cross-border defence procurement market.

To achieve a truly open market in this field, it would be essential to introduce specific legal remedies into the current proposal. Existing remedies at European level, i.e. recourse to the ECJ, are not adequate: If a claim is brought before the ECJ, it generally has no suspensive effect. Even a positive judgement generally does not prevent the conclusion of the contract with the competitor. Unfairly disqualified tenderers can only seek damages, which is often an unsatisfactory compensation.

The current proposal restricts the existing level of legal protection. The current proposal has the effect that all contracts which are at present governed by Procurement Directive 2004/18/EC and as such covered by the Remedies Directive, are no longer open for review.

There is no real legal detriment to implementing such provisions. Strongest arguments against legal remedies seem to be legal uncertainty and time delay. However these disadvantages can be limited. The question is only how remedies provisions can be usefully and practically implemented.

As far as contracting authorities are concerned, these legal remedies would lead to better redress and ultimately, to improved value-for-money in defence procurement. On the other hand, the procedures could entail unwelcome delays.

As far as the defence industry is concerned, these legal remedies would perceptibly change the existing system and approach to public procurement in this field. However, taking into account the political dimension and the limited number of market players this change is a long-term goal. In the field of civil procurement it also took several years before tenderers accepted the remedies and contested unfair decisions on a large scale. The legal remedies provide for the possibility of increased cross-border competition and transparency.

An Amendment of Directive 2007/66/EC does not seem appropriate. It would entail the danger that the discussion regarding non-defence related matters might be re-opened. A separate remedies directive for the defence sector would be in line with the systematic approach in the field of civil procurement.

CHAPTER 1 - INTRODUCTION

The proposal for a "Directive of the European Parliament and of the Council on the Coordination of Procedures for the Award of Certain Public Works Contracts, Public Supply Contracts and Public Service Contracts in the Fields of Defence and Security" has the scope to enhance transparency and openness of defence markets between Member States.

At present, the contracts covered by this proposal are governed by Procurement Directive 2004/18/EC, apart from the exemptions arising in the situations provided for by Articles 30, 45, 46, 55 and in particular 296 of the Treaty. However, Member States have used Article 296 extensively to exempt almost all defence-related and sensitive procurement from Internal Market rules. This practice stands in contrast to the case law of the European Court of Justice. The current proposal aims at improving this situation and provides special provisions for sector-specific issues.

Furthermore, the proposal does not contain any specific provisions ensuring its effective application.

The Remedies Directive 2007/66/EC contains an effective review system to ensure fairness in award decisions. But this Directive is not applicable to the current proposal, as it refers only to Directives 2004/18/EC and 2004/17/EC.

CHAPTER 2 – ADVANTAGES AND DISADVANTAGES OF IMPLEMENTING LEGAL REMEDIES WITHIN THE CURRENT PROPOSAL

2.1. Advantages

- **Same arguments as for the "classic" Remedies Directive:**

To ensure a substantial increase of transparency and non-discrimination, effective and rapid remedies must be available.

Existing arrangements at both national and Community levels for ensuring the application of the current proposal are not adequate to ensure compliance with the relevant Community provisions at a stage when infringements can be corrected.

Court of Justice rulings take too much time. After contracts are already concluded or executed, former tenderers have no more interest in the ruling: they are not interested in damages but in the contract. Damages alone are often unsatisfactory compensation for a unfairly disqualified tenderer, having regard to the difficulties it might face, in particular, in quantifying its losses and proving a causal link with the infringement of community law. The same problem exists within most national review systems.

In Germany, for example, there is no effective review system for contracts not governed by the classic Procurement Directive and the Remedies Directive, i.e. service concessions and contracts below the thresholds. In general the legal outcome of a review procedure is restricted to an award of damages. The tenderers can only stop the procedure before conclusion of the contract through "temporary legal protection" before the civil courts.

Unsuccessful tenderers, however, are not generally aware of the award decision before the conclusion of the contract, which means that the opportunity for recourse to any effective or satisfactory remedies may have expired. In these cases neither civil nor administrative courts have jurisdiction to set aside the contract or to prohibit further performance of the already concluded contract.

In its presentation of the reasoning behind the draft amended Remedies Directive 89/665, the Commission expressly lists, amongst the shortcomings in the national systems concerning review procedures, the fact that it is not possible in all Member States to have the award decision set aside by administrative or judicial means[1].

Moreover, a potential complainant is likely to be reticent about instituting proceedings fearing to compromise its future relations with the contracting authority, when in any event the contracting authority is highly unlikely to put it back into a position where it could ultimately win the contract[2].

For a truly open market it would therefore be essential to provide a review system allowing tenderers to review the procedure before the conclusion of the contract.

Contracting authorities will not comply with the rules if there are no severe consequences resulting from infringements. Irregularities in the decision awarding the contract would have no consequences at all if legal remedies whereby the tenderers may have the awarding decision set aside are not implemented in the current proposal.

[1] Amended proposal for a Council Directive coordinating the laws, regulations and administrative provisions relating to the application of Community rules procedures for the award of public supply and public works contracts (Doc (88) 733 final)

[2] See explanatory statement in Commission proposal (Com(87) 134 final

- **Restriction of Legal Protection**

The current proposal has the effect that all contracts which are at present governed by Procurement Directive 2004/18/EC and as such covered by the Remedies Directive, are no longer open for review. As mentioned previously, the Remedies Directive does not apply to the current proposal. Therefore, the current proposal restricts the existing level of legal protection.

According to current Article 10 of Directive 2004/18/EC the Procurement Directive applies to public contracts awarded by contracting authorities in the field of defence, subject to Article 296 of the Treaty.

According to the current Article 14, the Procurement 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.

Consequently all contracts governing the supply of war material listed in the Article 296 product list[3] and all security related contracts are, at present, governed by the Procurement Directive.

Only in the case of the exemptions to Art. 296 of the Treaty or Art. 14 Dir. 2004/18 can Member States exempt defence procurement contracts from Community rules.

The exemption of Art. 296 of the Treaty, for example, can only be used in very exceptional and clearly defined cases[4]: the products in question must be intended for specifically military purposes and the Member State invoking the exemption must prove that essential security interests are at stake[5].

In case of application of Art. 296, all EC-Treaty provisions are generally affected which means that defence procurement activities would not be subject to EC rules[6].

Thus, the Remedies Directive applies to all of these cases. If no exemption applies, tenderers benefit from full protection. If one of the exemptions applies, potential tenderers can at least control whether the exemption has been used legally.

According to Article 1 of the proposal, the new Directive shall apply to public contracts awarded in the field of defence and security in a number of specially mentioned cases, i.e. the supply of arms, munitions and war material to which the provisions of Article 296 apply. Similarly to the current situation, Member States will still have the possibility to use Art. 296 to exempt defence procurement contracts which are so sensitive that even the new rules do not satisfy their security needs (see Art. 1 "This Directive shall apply without prejudice to Articles …. 296 of the Treaty").

Art. 44 amends Art. 10 Dir. 2004/18 in the way that the classic Procurement Directive still applies to defence and security contracts with the exemption of contracts to which the proposal applies. Consequently, with the new Directive, there will be defence and security contracts governed by three different provisions:

[3] Council Decision of 15 April 1958 defining the list of products to which the provisions of Art. 223 (1b) of the Treaty apply.
[4] i.e. Judgment of 8 April 2008, Case C 337/05 – *Commission ./. Italian Republic*.
[5] Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement, COM(2006) 779 final, 7.12.2006, par. 3 and 4.
[6] Baudouin Heuninckx, 'Towards a Coherent European Defence Procurement Regime?' , (2008) 17 (1), PPLR 1-20

- Art. 296 of the Treaty for very sensitive contracts
- the new Directive for most of the contracts
- the classic Procurement Directive for contracts for which the new Directive does not apply.

Thus, **the current proposal legally restricts the status quo.** With the current proposal, tenderers have no more possibility to effectively control the use of Art. 296 of the Treaty: This means that the Remedies Directive does not apply. The new Art. 10 of the classic Directive states that the classic Procurement Directive only applies to defence and security contracts not covered by the current proposal. Only the current proposal directly refers to Art. 296. Should a discriminated bidder - making use of his rights according to the classic remedies directive - seek review with a court with regard to the unlawful non-application of the civil procurement directive, the court would only decide whether the contracting authority did observe the limits of article 10 of the classic Directive. The tenderer will not be able to call into question the appropriateness of resorting to Art. 296, since this is only subject to the current proposal, on which the remedies directive does not apply.

Furthermore, all contracts which will be governed by the new Directive and for which Art. 296 of the Treaty can not be legally invoked, will be – in contrast to the present situation - without effective legal protection. The only aspect tenderers can still control is whether the current proposal applies or not to the new Art. 10 of the Procurement Directive. The Remedies Directive will only apply to the third type of contracts still governed by the classic Procurement Directive.

2.2. Disadvantages?

The implementation of a review system inevitably results in certain time delays and higher administrative costs. If the tendering procedure is reviewed there also is an uncertainty with regard to the award of the contract: The award decision might be set aside and the tenders would have to be re-evaluated. Depending on how a review system would be implemented, there might also be a certain period in which an awarded contract could be considered ineffective.

However, the relevance of these **disadvantages mainly depends on the question of "how" to implement an effective system and not "whether" such a system should be implemented** (see also below Chapter 4).

The costs, for example, could be reglemented in the way that the company who seeks review has to bear the expenses if the review is rejected. To prevent time delays, the time limits and periods have to be as short as possible.

If the award decision is set aside by a review body; the above mentioned disadvantages seem to be adequate for having in mind the aim of the current proposal, which is to create fair competition and a truly open European market for defence products.

CHAPTER 3 – IMPACT FOR STAKEHOLDERS

3.1. Contracting authorities

Due to the fact that in each Member State the defence market only has one customer (the government), it is "per se" not in the same competitive environment as other markets. Member States tried for a long time and still try to award contracts without competition for protectionist reasons more than for security reasons[7].

Furthermore, the defence market is generally susceptible to corruption because of the large amounts of money involved, the relatively low number of large contracts and, most importantly, the fact that governments themselves are the enforcers of secrecy[8]. It is therefore very important to guarantee through the new Directive an increase in competition and transparency. For this, it is necessary to allow for remedies against the decisions of contracting authorities.

By allowing a review of their award procedures, **contracting authorities will have better quality for lower prices**. Only if contracting authorities know that the award decision can be scrutinised in terms of equal treatment and best value-for-money, will they set aside protectionism and address corruption.

Studies have shown that 10 to 17 % of the European defence procurement budget could be saved by centralising procurement and opening-up the defence equipment market[9]. Some other studies even argue that up to 32 % of the budget could be saved by a combination of reduced market fragmentation, increased efficiency through collaborative procurement programmes and harmonisation of requirements[10].

On the other hand, an **important argument against implementing legal remedies in the proposal could be that the tendering procedure becomes to complex and takes to much time.**

If the award decision is set aside by a review body, the contracting authority will have to re-evaluate the decision process or even the whole tendering procedure. This could interfere with essential security interests if a contract has to be awarded urgently. However, in these cases even the classic Procurement Directive contains derogations for direct awards and a similar derogation could be included in the proposed Directive.

3.2. Tenderers

Although it might be highly desirable for defence companies to receive lucrative contracts without facing competition, without an effective review system the current proposal will not considerably change the existing system. If it is known that illegally awarded contracts will not be scrutinised, companies can see an incentive to cut out the risk of losing a bid by influencing key officials to obtain a non-competitive contract. Furthermore, as a general rule, companies respect the field of business of competing companies to a high degree in the way that they do not interfere in each other territories.

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[7] Wheaton J.B. 'Defence Procurement and the European Community: The Legal Provisions', (1992) 1, PPLR 432; Heunincks, above fn. 5

[8] Wilson and Pyman, 'The extent of single sourcing and attendant corruption risk in defence procurement: a first look', presented at the conference "Public Procurement"; Nottingham, June 19-20, 2006.

[9] Mawdsley J, Quille G. et.al. `Equipping the Rapid Reaction Force – Options for and Constraints on a European Defence Equipment Strategy´, Paper 33, Bonn International Centre for Conversion (BICC), 2003, p. 21.

[10] Unisys study, `Intra-Community Transfers of Defence Products´, Brussels, February 2005, § 6.7.

Additionally, the defence industry is generally not prone to use legal remedies due to the often close relationships to national governments which they entertain.

In order to achieve a truly open cross-border market in the EU it is crucial for the tenderers to have the opportunity to bring judicial attention to their concerns. **Only with an effective review system will companies be encouraged to take part in tendering procedures in other Member States**. As the experience in the field of the "classic" remedies directive shows, the reluctance to use legal remedies often decreases after a certain time.

In addition an effective review system could enhance competition within each Member State. Small and medium-sized entreprises (SME), for instance, could be encouraged to take part in tendering procedures. This would also be an important aspect for contracting authorities as SMEs often offer highly innovative products.

CHAPTER 4 – OPTIONS IN TERMS OF INCLUDING LEGAL REMEDIES

4.1. Reference to Remedies Directive

One possibility to implement an effective review system could be to simply refer to the Remedies Directive.

However **this option may not take sufficient account of the specific requirements that have to be met by defence and security related contracts.** As the Commission considers that because of the sensitivity of these contracts it is necessary to introduce a new legal instrument – the current proposal – it does not seem adequate to refer to the Remedies Directive, which deals in first instance with "non-sensitive" contracts, in terms of remedies.

The Remedies Directive contains a number of provisions that could interfere with security interests.

This concerns especially the provisions regarding the ineffectiveness of a contract. If a contract is concluded before the end of the so called "standstill period" it is considered ineffective. An illegal direct award is also considered ineffective. Only if the review body finds, after having examined all relevant aspects, that overriding reasons relating to the general interest require that the effects of the contract should be maintained, the contract may not be ineffective. Of course, this derogation could be applicable for most of defence and security related contracts but it would always be a point of discussion. However, this legal uncertainty is inconsistent with defense and security interests.

Furthermore, the review procedure may take too long when security interests are at stake. Generally the review procedure takes at least several weeks. During that time the conclusion of the contract is suspended. The Remedies Directive stipulates a time limit of at least 30 days for the tenderer to seek review. In this time the contract could still be reviewed and declared ineffective by the review body. Only in very exceptional cases may it be possible to conclude the contract as an interim measure before the decision of the review body, i.e. in cases of extreme urgency. However, it is not granted that sensitive defence contracts are in all cases extremely urgent.

Assuming that the aim of the current proposal is the creation of an European defence market, another argument against the reference is to reserve the possibility to prevent non EU-companies from seeking review under the Remedies Directive.

The classic Procurement Directives 2004/17/EC and 2004/18/EC are based on international agreements relating to trade, notably the WTO's General Procurement Agreement. As far as GPA-Members are concerned, the Procurement Directives and the Remedies Directive are fully applicable. As far as third countries are concerned, only Directive 2004/17/EC contains a restriction for tenders from specific countries (Art. 58). For this reason, the Review System installed by the Remedies Directive is not limited to EU-companies.

However, the Community's Policy towards third country access in general has since the late 1980's been based in general on the principle of reciprocity. One of the specificities of defence markets is that they are excluded from the general international agreements mentioned before.

The current proposal does not contain an explicit preference provision as comprised in Directive 2004/17.

The current proposal, however, does not seem to have the aim of generally opening the European market for defence products for non-EU-companies on a non-mutual basis.

Should a reservation with regard to third-country companies be intended, it should be possible within a potential review system, to limit correspondingly the possibility of recourse to the beneficiaries of the proposed directive.

4.2. Special Provisions

Considering the above mentioned arguments it seems preferable to install a separate remedies or review system.

1.

This review system should be similar to the classic review system but should take into account the specificities of the defence sector.

For example, if the standstill-period, an integral part of the established remedies system, is to be maintained, but should be shortened. As mentioned before, the time delays can be a disadvantage of a remedies system when urgent or sensitive defence matters are at stake. In order to reduce the time delays to a minimum, the standstill period should be as short as possible to still allow an effective review between the decision to award and the conclusion of the contract in question. The Remedies Directive provides for two different standstill periods: a period of at least 10 calendar days when the contract award decision is sent if fax or electronic means are used or a period of at least 15 calendar days when the decision is sent if other means of communications are used. For the defence sector, however, **one shortened standstill period of 7 calendar days seems to be appropriate.**

The standstill period should give the tenderers concerned sufficient time to examine the contract award decision and to assess whether it is appropriate to initiate a review procedure. Therefore, when the award decision is notified to them, the tenderers should be given the relevant information which is essential for them to seek effective review.

In order to avoid legal uncertainty contracts **concluded illegally should in general not be ineffective but the review body should consider alternative penalties.** However ineffectiveness could be retained for deliberate and serious infringements.

Another important modification would be to **shorten the time limits for the application for review**. The Remedies Directive contains a time limit of at least 30 days when the contracting authority informed the tenderers and in any case a time limit of at least 6 months with effect from the day following the date of the conclusion of the contract. As during this time period a concerned tenderer could still seek review, which could lead to a suspension of the contract, it seems advantageous where security and defence procurement is concerned to shorten these time limits in order to obtain legal certainty. It seems adequate to provide at least 15 calendar days and at least 3 months.

The following provisions from the Remedies Directive could be maintained:

Art. 1 § 1 to 4 – general provisions concerning application field and review procedure

Art. 2 §. 3 – suspension of the conclusion of the contract during the review procedure

Art. 2 § 4 – no other supensive effects

Art. 2 § 6 – claim of damages

Art. 2 § 7 to 9 – general provisions concerning the review bodies

Art. 2a § 1 – Standstill period general provision

Art. 2a § 2 – Standstill period including the above mentioned shortened period

Art. 2b – Derogations of the standstill period

Art. 2c – Time limits for applying review – also with a shortened period of 7 calendar days

Art. 2d § 4 - 5 – ex-ante transparency (with shortened period of 7 calendar days)

Art. 2e – alternative penalties as a rule

Art. 2f – Time limits – also with shortened periods

Art. 3a – Notice for voluntary ex-ante transparency

The following provisions should not be maintained:

Art. 1 Nr. 5 – preliminary review with the contracting authority and suspension of the contract: not necessary for effective review – further time delay

Art. 2d Nr. 1 - 4 – Ineffectiveness

The remaining articles 3, 3b, 4 and 4a do not concern national review system and may also be adopted for defence procurement, i.e. the corrective mechanism. However this provision could also lead to further time delay and should be revised in order to limit the suspension of the contract to exceptionally serious infringements.

It also seems important that a specific review system ensures that sensitive information provided by companies to the contracting authority or information related to essential security interests will not be disclosed during the review procedure.

2.

The question is how to implement these provisions.

A **separate remedies directive for the defence sector** would have the advantage of being in line with the systematic approach in the field of civil procurement: One directive would contain the substantive provisions, the other the procedural background. This system would therefore already be familiar.

Furthermore, the relevant interests at stake might lead to a controversial political debate with regard to the introduction of a remedies system. Therefore, it might be preferable to secure an accord regarding the current proposal as a first step, without burdening it with provisions regarding the review system.

An Amendment of Directive 2007/66/EC does not seem appropriate. It would entail the risk that the discussion regarding non-defence related matters might be re-opened.

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FACTUAL INFORMATION ON "OFFSETS" AND RECIPROCAL ARRANGEMENTS IN DEFENCE

This briefing note was requested by the European Parliament's Committee on Internal Market and Consumer Protection (IMCO).

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FACTUAL INFORMATION ON 'OFFSETS' AND RECIPROCAL ARRANGEMENTS IN DEFENCE PROCUREMENT

ABBREVIATIONS

EDEM European Defence Equipment Market

EDTIB European Defence Technological Industrial Base

DTIB Defence Technological Industrial Base

pMS 'participating Member States', i.e. all Member States participating in the EDA, which is all EU MS except Denmark

EXECUTIVE SUMMARY

Offsets are compensations offered by a seller to a buyer. It is applied for so called off-the shelf procurement, i.e. for already developed systems. The most basic distinction of offsets are between direct and indirect offset, further subdivisions and categories then follow.

Neither the provisions of the EC Treaty nor those of the relevant EC Public Sector Procurement Directive[1] expressly rule out offsets. However, offsets clearly represent violations of the core free movement of goods and services regimes of the EC Treaty (Articles 28 and 49 respectively), unless justified[2]. Furthermore, they risk violating the fundamental freedom of establishment and other crucial principles of EC law, most notably the prohibition of discrimination on grounds of nationality. The European Commission is of the view that offsets usually entail discrimination by their nature and therefore stand in contrast with the EC Treaty.[3] Consequently, the proposed procurement Directive (COM(2007) 766) can neither allow nor regulate them.

Different arrangements of offsets exist in the Member States. For example, in about half of the pMS[4] offsets are regulated by statute law, for the other half, the field remains unregulated. On the pMS side, the majority accept offset and plan to continue with this whereas the two major pMS, France and Germany, take the opposing attitude to offsets. This information indicates that overall level most countries see offsets as useful for their national Defence Technological Industrial Basis.[5] In general, it could also be stressed that pMS are becoming 'more European' in their defence trading patterns, but still 'non-Europe' accounts for three quarters of pMS exports and half of their imports.

The effects of offsets can be seen at the prime contract level as well as the supply chain level of the European defence equipment markets and there are both positive and negative aspects on both levels also depending on what perspective used when studying the issue. From an European Defence Technological Industrial Base perspective, the role of offsets could be seen as transitional. With Europe-wide sourcing increasingly becoming the norm, the positive market opening role of offsets is likely to diminish in magnitude and the market-impeding role will grow. If and when EDTIB policies succeed in opening up defence supply chains for Europe-wide participation, this practice of offsets will no longer be helpful. This call for the need to monitor developments in European defence supply chains to identify changes in the role of offsets which could, in turn, constitute an important input to the process of phasing out these forms of offsets as EDTIB instruments increasingly replace offsets in their function.

[1] 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

[2] Based on the derogation in Article 296 of ECT, Member States can exempt contracts in the field of defence and security if this is necessary for the protection of their essential security interests.

[3] see for example Memo/07/547, page 5

[4] 'participating Member States', i.e. all Member States participating in the EDA, which is all EU MS except Denmark

[5] This does not imply that these countries do not seek better methods in the future

1. INTRODUCTION AND DEFINITIONS

This note sums up the results of the study on the '*Effects of offsets on the Development of a European Defence Industry and Market*'[6] from July 2007, financed by the European Defence Agency as well as integrating other research conducted in the area. The abovementioned study follows what is in line with the development of an European Defence Technological Industrial Base (EDTIB) as agreed by the EU Ministers in May 2007.

It is worth noting that there is a great shortage of reliable background data on European Defence Equipment Markets (EDEMs) and Defence Technological Industrial Bases (DTIBs), this situation calls for improvements in order to seriously develop an EDEM and an EDTIB.

Offsets are compensations offered by a seller to a buyer. It is applied for so-called off the shelf procurement, i.e. for already developed systems. The European Commission is of the view that offsets usually entail discrimination by their nature and therefore stand in contrast with the EC Treaty.[7] Consequently, the proposed Procurement Directive (COM(2007) 766) can neither allow nor regulate them. The Commission therefore leaves it to Member States to make sure that possible offset requirements are in line with the rules of the Directive and the Treaty.

The most basic division between offsets are:
- **Direct offsets**: Offset transactions that are directly related to the defence items or services imported. These are usually in the form of co-production, subcontracting, training, production, licensed production, or possibly technology transfer or financing activities.
- **Indirect offsets**: Offset transactions that are not directly related to the defence items or services imported. The kinds of offsets that are considered 'indirect' include purchases, investment, training, financing activities, marketing/exporting assistance, and technology transfer.

These are further subdivided into:
- **Defence (related) indirect offsets**
- **Non-defence (related) indirect offsets**

In addition, offset can be of different categories like:
- **subcontracting** (direct or indirect – here receiving firms enter the supply chain of the supplying or other firms cooperating with the prime contractor),
- **purchases** (indirect; including 'swapping' i.e. both involved countries are both receiver and supplier and decide to cancel these obligations out),
- **export assistance, technology transfer, training, internships, credit assistance**, **etc**.

[6] The study has been financed by the European Defence Agency under a contract with FOI and SCS. 2007-07-11 Final report of 06-DIM-022

[7] see for example Memo/07/547, page 5

2. EC LEGISLATION

Neither the provisions of the EC Treaty nor those of the relevant EC Public Sector Procurement Directive[8] expressly rule out offsets. However, **offsets clearly represent violations of the core free movement of goods and services** regimes of the EC Treaty (Articles 28 and 49 respectively), unless justified[9]. Furthermore, they risk violating the equally fundamental freedom of establishment and other crucial principles of EC law, most notably the prohibition of discrimination on grounds of nationality.

Moreover, the specific rules of the EC Public Sector Procurement Directive, in particular those on the selection of suppliers and service providers and the evaluation of tenders do not allow taking offsets into account. Contracts should be awarded on the basis of objective criteria which ensure compliance with the principles of transparency, non-discrimination and equal treatment and which guarantee that tenders are assessed in conditions of effective competition. As a result, it is the norm to apply two award criteria: either 'the lowest price' or 'the most economically advantageous tender'.[10]

While the rules on the latter accommodate economic considerations other than price, such as quality, delivery time and after sale service, they do not allow the taking of offsets into account. As a result the contracting entities on the national, regional and municipality level (and the utilities) in the Member States of the EU do not require offsets in their supply, services, and works contracts.

However, **armaments are subject to a special exemption** based on Article 296 (1) (b) EC Treaty which allows any Member State of the European Union "to take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production or trade in arms, munitions and war material […]".Moreover, Article 296 (1) (b) EC Treaty provides that "[…] such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended specifically for military purposes."

The study finds that according to the legal analysis done it is generally **difficult to justify any type of offset on the basis of Article 296**. Not only do Member States have to prove that the offset would promote their essential national security interests, not their economic interests, they also have to prove that the offset is necessary to address these essential security interests.

[8] 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
[9] Based on the derogation in Article 296 of ECT, Member States can exempt contracts in the field of defence and security if this is necessary for the protection of their essential security interests.
[10] Recital 46 to Directive 2004/18/EC

3. NATIONAL LAWS OF THE PARTICIPATING MEMBER STATES

In about half of other pMS[11] offsets are regulated in binding laws:

Poland, Lithuania	Acts of Parliament
Greece, Belgium	Presidential or Royal Decrees
Italy and the Czech Republic	Decide on offsets on a case-by-case basis on the basis of ministerial directives
All other pMS	Ministerial Regulations

:

For the other half, the field remain unregulated:

Cyprus, Estonia, Germany, and Malta	No offsets policy and therefore no binding laws on the matter
Netherlands, the United Kingdom, Ireland, France, and Latvia	Offsets policies not legally binding

In the Czech Republic and Sweden adherence to offsets arrangements is a requirement of participation. In Hungary, Finland, Greece, Poland, Belgium, Slovakia, Slovenia, and Portugal offsets are an award criterion taken into account as one aspect of the tender evaluation process. In the Netherlands, the United Kingdom, Malta, Latvia, Ireland, France, Germany, Cyprus, Estonia, and Lithuania it is not taken into account as an award criterion. However, in Lithuania the winning bidder can be eliminated for the benefit of the runner-up if he or she does not accept the required offset arrangements.

Arbitration clauses for offsets arrangements exist in Greece, Finland, the Czech Republic, Poland, Belgium, Sweden, Portugal, and Lithuania.

The information above shows that on the pMS side the majority accept offsets and plan to continue with this whereas the two major pMS, France and Germany, are taking an opposing attitude to offsets. This information indicates that on the overall level most countries see offset as useful for their national DTIB:s.[12]

[11] 'participating Member States', i.e. all Member States participating in the EDA, which is all EU MS except Denmark

[12] This does not imply that these countries do not seek better methods in the future

4. OVERVIEW OF EUROPEAN OFFSETS ARRANGEMENTS

· France and Germany (Group 1) do not accept offsets as a matter of policy. Their export is globally oriented, while their (fairly limited) imports are increasingly European making them predominantly **defence equipment exporters**.

· Italy, the Netherlands, Sweden and UK (Group 2) are a group of **net exporters but also with considerable imports**. As a group, their import patterns have a strong transatlantic orientation while, in contrast, their exports have a strong European focus. **Indirect military** offsets constitute the typical form of offset.

· Finland, Greece, Poland, Portugal, and Spain (Group 3) are the big European **defence equipment importers**. Some are also significant exporters. Their offsets seem to be **direct** to a high degree (although the margins of uncertainty are particularly wide here, see table 1). This may indicate some risk of duplication.

· The other pMS (in the EDA-24[13] study population) (Group 4) are relatively small actors both in terms of exports and imports. As a group, their DTIBs are small and their limited absorption capacity means that they tend to favour **indirect civil offsets**.

Table 1 shows in more detail the results from the analysis of the study with regard to the four groups of pMS.

Table 1. European offset based on 2000-06 SIPRI and study data (values in € (2007))

	Group 1: DE, FR	**Group 2: IT, NL, SE, UK**	**Group 3: EL, ES, FI, PL, PT**	**Group 4: all other EDA-24**	**Sum/Average**
A. Defence equipment import contracts p.a. (SIPRI data)	297	1 461	2 346	374	**4 478**
B. Defence equipment import contracts with offset p.a.		1 461	2 346	374	**4 181**
C. Offset percentage average (pMS range)		122% (100-178*)	145% (81*-230)	124% (72-237)	**135%**
D. Direct offset: share of total (uncertainty range)		35% (27-35)	44% (13-48)	3%	**38%**
E. Defence indirect offset: share of total (uncertainty range)		55% (44-58)	28% (7-34)	20% (2-21)	**36%**
F. Civilian non-defence offset: share of total (uncertainty range)		10% (7-29)	28% (28-52)	77% (76-95)	**26%**

*particularly uncertain data (based on single observations)

Note also that Groups 2 to 4 differ considerably in how they accept offsets. The results indicate - with variations within groups - that Group 2 uses offsets to facilitate defence industry specialisation, as well as a pattern of mutual interdependencies.

[13] The tender for the study was conducted before the accession of Bulgaria and Romania to the EU, and even at the time of accession, they had not yet joined the EDA.

Assuming that the leading role for direct offset is true, Group 3 is building a national DTIB geared at the equipment they are currently buying. This is problematic from an EDTIB perspective since it carries high risks for duplication and overcapacity.

Group 4 countries as a rule do not have the absorption capacity in their national DTIBs to handle defence offsets and therefore try instead to use their market power to gain other perceived benefits from their defence imports through the use of indirect civil offsets.

As can be seen the offset percentage is frequently far above 100%. This is a matter of considerable debate. Comparing data for 1991-2000 with 2001-2005 there is a strong tendency to increasing offset percentages, in particular for very big contracts. In the study's opinion, the debate is however somewhat exaggerated. It is in no way certain that a pMS receiving 72% offsets have been any worse at negotiating than pMSs receiving 237%. Typically high offset percentages are due not to increasing power for buying countries but to either or both of:

- High offset multipliers, such that the 'actual value' of an offset transaction is perhaps just a third, or a fifth or a tenth, of the credited value. Even though use of multipliers in actual contracts is another area where the information is quite limited the authors believe that this is the explanation as to why Group 3 countries can have such high figures for direct offsets; around two thirds of the underlying contract volume. With a multiplier of one, this would be impossible save for licensed production.

- A high content of indirect offsets to the offset supplying prime contractor in the 'cheap' category such as purchases or investments.

In a 1998 American Congress' report[14] on offsets requested by European countries to American companies (Europe and offsets), the reasons for Europe's dominance in demanding offsets on US military exports is coming from the fact that more advanced economies demand a high level of offsets relative to the value of the imported weapon system. The Congress' report stresses that for Europe, with its large overall defence market and requirement for sophisticated weapon systems, offsets can make good political sense by redirecting what would otherwise be large international outflows back into the domestic economy. Furthermore, in so doing European countries may also promote technology transfer, supplement defence infrastructure or provide commercial business opportunities.

In the study the authors conclude that pMS are becoming 'more European' in their defence trading patterns, but still 'non-Europe' accounts for three quarters of pMS exports and half of their imports.

[14] US department of Commerce, 1998, 'Offsets in Defense Trade', 'Third Annual Report to Congress Conducted under Section 309 of the Defense Production Act', Washington D.C., from the Federal Public Service, Economy SME, Self-Employed and Energy, Policy on Industrial Participation in Defence Contracts, September 2006, p. 7

5. EFFECTS OF OFFSETS

5.1. Prime contract level of the European defence equipment markets

There are many indications provided for both positive and negative effects of offsets with regard to defence equipment markets. However, the stronger of these generally apply to the subcontractor level. Also the Centres of Excellence (CoEs) that pMS may want to help through the use of offsets are likely to be in the supply chain rather than at the prime contracting level.

- The findings on offset effects on the competitiveness of European vs. overseas players on European defence equipment markets are rather inconclusive. US legislation limiting technology transfer might give an advantage to European players. Also indirect civil offsets were claimed to be beneficial for European primes contractors.

- Some respondents in the study warn against a situation where offsets would be allowed for non-EU firms but prohibited in intra-EU trade. However, to the degree that offsets are illegal, the breach of the rules lies with those in receipt of offsets, irrespective of whether suppliers are European or not.

- The study was not able to find conclusive evidence that offsets lead to increased defence budgets and to the opening of new prime contract markets.

- In many cases offsets do not have a strong effect on contract award, e.g. as competitors tend to offer comparable offset packages.

- At prime contracting level, there is little evidence of offsets preventing firms from competing.

- Some respondents, however, warn that a tendency in some pMS towards excessively demanding offset requirements and stringent implementation rules may become a market inhibitor in the future.

- Direct and to some extent also indirect military offsets are seen as more prone to affect participation and contract award. Consequently indirect civil offsets are least likely to distort markets.

- There are indications in some cases of lacking transparency and professionalism, which in extreme cases may even lead to corruption.

5.2. Supply chain level of the European defence equipment markets

In general the study argues that the relevant aspect of offsets is the access they give to the business networks of the defence primes contractors. The classical case for offset has been to accept a higher cost in order to build and maintain the national DTIB. The main mechanisms for this among pMS today, at least if restricting attention to what may have EDTIB relevance, is to boost the already competent domestic firms in the supply chain, making them internationally competitive defence subcontractors.

When evaluating this situation from a European perspective certain effects of offsets are beneficial compared to a traditional supply chain pattern of national preference. But if, on the other hand, the standard of comparison is a pan-European DTIB where primes contractors consistently apply state-of-the-art Supply Chain Management (SCM) practices Europe-wide, then offset instead turns into an obstacle, and its reduction presents a saving potential in addition to the static one.

The study stresses that we are in a situation where the types of offset that have a particularly strong impact on DTIB, namely subcontracting with R&D content as part of either direct or defence-related indirect offsets, both create value by integrating European supply chains and dissipate value by preventing the full exploitation of the potential for such integration. The study did not find it possible to quantify this potential but believes that state-of-the-art SCM practices are already used in substantial parts of the European DTIB. This is a likely explanation to the preference of many prime contractors for indirect civil offsets over direct.

It can be said, however, that forms of subcontracting offsets with R&D content that allow primes contractors flexibility in selecting partners and hence to apply current SCM practices, are ways to make offsets more encouraging to the development of a future EDTIB or in other words, to help create a Europe-wide structure of internationally competitive industrial defence-related competence centres, without unreasonable levels of duplication. This is true in particular for defence-related indirect offsets, but also for direct offsets, if kept within reasonable limits which are dependent on the potential for industrial development in the receiving country.

From an EDTIB perspective, the role of offsets, according to the study, should be seen as transitional. With Europe-wide sourcing increasingly becoming the norm, the positive market opening role of offsets will diminish in magnitude and the market-impeding role will grow. If and when EDTIB policies succeed in opening up defence supply chains for Europe-wide participation, this practice of offsets is no longer helpful, and calls for the need to monitor developments in European defence supply chains to identify changes in the role of offsets which could, in turn, constitute an important input to the process of phasing out these forms of offsets as EDTIB instruments increasingly replace offsets in their function.

Legal framework:

European Commission, Proposal for a Directive of the European Parliament and of the Council on the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security COM(2007)0766

http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52007PC0766:EN:NOT

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

http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0017:EN:NOT

European Commission, Green Paper on Defence Procurement, COM(2004)608

http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52004DC0608:EN:NOT

European Commission, 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, COM(2005)1572

http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52005DC0626:EN:NOT

European Commission, Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement, COM(2006)779

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ECONOMIC IMPACT OF THE DEFENCE PROCUREMENT DIRECTIVE

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EXECUTIVE SUMMARY

This briefing note discusses the potential economic impacts of the Defence Procurement Directive. The Directive aims to address the fragmentation in European defence markets, particularly by clarifying the use of Article 296 exemptions to Single Market rules concerning procurement, and by making bidding procedures more open, transparent, and even-handed.

We have reservations about the Directive's practicability, in two respects. Firstly, it is not obvious that much would be achieved by publishing the contract notices for defence equipment which is currently procured non-competitively for strategic or practical reasons. Secondly, it will not always be possible to invite bids from "not less than three" capable contractors, in order to qualify for access to the flexible procedures within the Directive.

The Commission attaches importance to publishing contract notices in the OJEU, but does not demonstrate its relevance in the defence context. The Commission assumes that publication would reduce prices by five per cent, leading to annual savings for the public of €250m. This assumed rate of saving is consistent with those that were estimated by Europe Economics to have been achieved by previous Public Procurement Directives, and we would not dispute it as an average for a range of defence procurement contracts. However, it may be an optimistic figure for equipment projects – see below.

We are more sceptical about the volume of additional cross-border purchases that would be generated by the Directive because we find no statistical link between publishing contract notices in the OJEU and importing equipment from other Member States. We judge also that the bulk of the increase in notifications is likely to concern services whose delivery requires a local presence.

We are cautious about the rate of savings that can be expected from any cross-border trade in equipment that the Directive may promote. Most Member States insist that foreign contractors provide offsets. Over the 2000-2006 period, these applied to 50 per cent of EU imports and averaged 135 per cent of the value of the contracts concerned. Offsets add an estimated 5-15 per cent to costs. The Directive would not alter this situation. It may encourage more cross-border tenders, but foreign bidders might build the expected cost of offsets into their bids.

The second reason for scepticism about the Directive's benefits is the problematic character of defence equipment development projects: they often over-run on cost and time, but once the contracting authorities have committed substantial sums, it is too difficult, politically, for them to write them off. The contractors are therefore able to renegotiate their contracts. (In economist's language, there is "non-renegotiation-proofness".) For this reason the contracting authorities may have no strong motive to invite more bidders: they anticipate the possibility of having to pay prices that are substantially higher than were originally contracted, whichever contractor wins the contract. That being so, the contracting authorities might prefer to engage large, national companies, with whom at least they are familiar and for which the possibilities of exploiting economies of scope and scale are likely to be greater. There is a considerable risk, therefore, that the economic benefits from having a greater number of bidders for these types of project will be close to zero.

As to the scope of the Directive, we suggest that there is a case for excluding non-military security equipment. Inclusion poses some security risk because it would limit the use of exemptions to protect very sensitive information, while not seeming to solve any clear problem. The objective of the Directive is to facilitate competition in markets where it is absent. The security equipment market already features a high degree of competition.

1. INTRODUCTION

This briefing paper for the European Parliament discusses the potential economic impacts of the proposed defence and security Directive,[1] hereafter "the Directive". It is organised broadly in accordance with the Commission's own Impact Assessment format. The paper looks in detail at some of the provisions of the Directive, and attempts to assess its costs and benefits. To do this, it was necessary to place the Directive in its context – the differing situations faced by Member States, and the realities and challenges of defence procurement.

[1] Proposal for a Directive of the European Parliament and of the Council, on the coordination of procedures for the award of certain public works contracts, public supply contracts and public service contracts in the fields of defence and security, COM(2007) 766 Final.

2. IDENTIFICATION OF THE PROBLEM

The Directive is motivated by a wish to integrate the fragmented European defence equipment market, which is characterised by small production runs and high unit costs. As the Commission noted, "despite spending (in 2005) one-third as much as the US, the EU has 89 different weapon programmes, compared to the US's 27" [2]. The 27 different sets of national rules and procedures for all relevant areas (exports, transfers, procurement, etc.), plus specific arrangements for cooperative programmes, are major obstacles to both competition and cooperation. [3]

Lack of transparency is part of the problem. In its 2006 Interpretive Communication the Commission drew attention to the fact that the publication rate for defence procurement was only ten per cent of the total expenditure, and that there were significant disparities in publication rates between Member States (between one and 20 per cent).

2.1. Use and misuse of Article 296

The Commission regards the misuse of Article 296 as part of the problem. Although intended for exceptional and clearly defined cases, Article 296 is used by national contracting authorities in the context of defence and security as a justification for exemption from Community rules on procurement.

This brief contains no separate analysis to identify whether specific cases of the use of Article 296 represent entirely appropriate exercise of it or not. But to illustrate its use (legitimate or otherwise), we here quote a few examples.

The most straightforward class of cases relate to equipment purchasing. The Impact Assessment observed that "many Member States have used Article 296 extensively, exempting from EC rules almost automatically the procurement of military equipment." (page 15). For example, Article 296 was invoked by the Italian government in April 2008, to defend its purchase of Agusta and Bell/Agusta helicopters without any competitive tendering process.[4]

[2] Commission Staff Working Document (2007) 1598.
[3] The Impact Assessment also noted that: "According to the annual report of the EU Code of Conduct on Arms Exports, Member States procured in 2005 only 13% of their military equipment from other Member States."
[4] Case C-337/05.

3. CHANGES TO DEFENCE PROCUREMENT RULES PROPOSED IN THE DIRECTIVE

Essentially, the proposed Directive would bring defence procurement within the provisions of Directive 2004/18/EC. It is about openness, transparency, and even-handedness towards all bidders. Chapter V would require contracting authorities to publish contract notices in full in the OJEU, in an official language of the Community, and not to publish anything at national level that is not included in these (Article 23). Contracting authorities will be required to take account of the complexity of the contract when fixing time limits for receipt of requests to participate (Article 24), allowing no less than 40 days for this in cases of flexible procedures – see below.

The Directive recognises that defence equipment requirements are complex, sometimes highly classified, and not always clear at the outset to the contracting authorities themselves. It proposes some relaxation of the procedures to accommodate these realities ("innovations tailored to the specificities of such procurement cases"). Three key terms, in this context, are set out in Article 2:

- "*Restricted procedures*", whereby any contractor ("economic operator") may ask to participate in bidding for a contract but only those who are invited by the contracting authority may submit a tender.
- "*Negotiated procedures*", whereby the contracting authority consults contractors of their choice and negotiates terms with them; this could take place in successive stages to reduce the number of tenders (Article 18), but the contracting authority shall not provide information in "a discriminatory manner which may give some tenderers an advantage over others". These procedures can take place without publishing a contract notice, for example, in respect to contracts awarded as part of a cooperative programme between two or more Member States (Article 20, sub-paragraph 1).
- "*Competitive dialogues"*, in which the contracting authority discusses ways of meeting its requirements with selected contractors, and then invites chosen candidates to tender.

Conditions would be attached to these procedures (Article 29). Significant among these is the requirement that the contracting authorities would not be able to restrict the number of candidates to less than three. Negotiated procedures *without* publication are exempted from this condition.

In these and other ways the proposed Directive is intended to provide contracting authorities with the means to address the potential security risks that are associated with defence equipment. The intention here is that Member States will in future have fewer legitimate grounds for invoking Article 296, thus making its use the exception rather than the rule. The Code of Conduct[5] - a voluntary agreement in which a general set of principles of defence procurement should be adhered to in circumstances where defence contracts are exempted from Community rules on the basis of Article 296 – would still be in play.

[5] A voluntary 'Code of Best Practice in the Supply Chain' (CoC) was established in 2005 by the European Defence Agency to inject transparency and competition into defence procurement, an area where, on the basis of the application of Article 296 of the EC Treaty, a majority of defence contracts are currently exempt from cross-border competition. Most of the participating Member States (pMS) - 24 out of 26 - have signed up to this voluntary regime.

4. FACTORS INFLUENCING THE LIKELY EFFECTIVENESS OF THE DIRECTIVE

4.1. Differences between member states

Member States differ with respect to the size, structure, technical capabilities and ownership of their defence industries. At one end of the spectrum, France and the UK produce the complete range of advanced air, land and sea systems (e.g. combat aircraft, nuclear-powered submarines, aircraft carriers). Germany and Italy have significant independent technical capabilities (Germany in land systems, in particular), as has Sweden, with its tradition of neutrality and independence. The smaller nations possess strengths in particular technology areas.

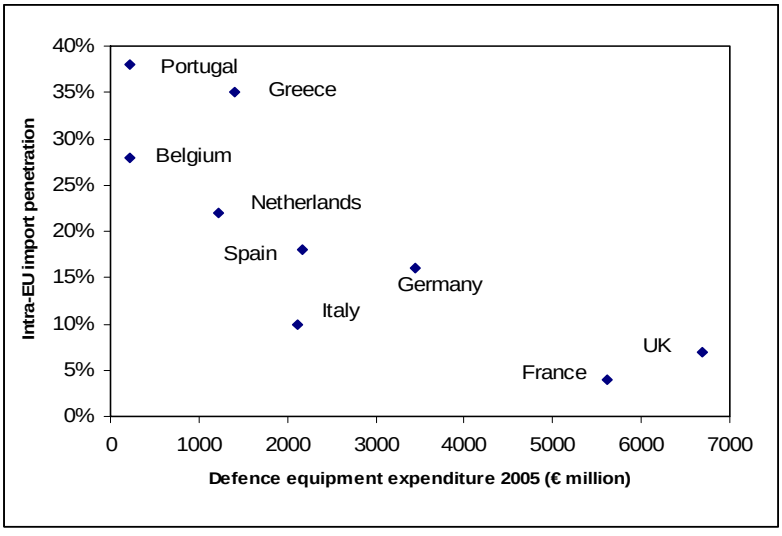
There are also major differences between the defence procurement policies of the Member States, in two other respects:

a) The smaller European nations, unencumbered with significant defence industries, tend to buy more off-the-shelf. For example, smaller nations favoured the US's F-16 fighter aircraft,[6] whereas the larger nations developed their own (independently in the case of Sweden and France, cooperatively in the case of UK, Germany, and Italy).

b) Traditionally, much of equipment-related work was carried out in-house within defence ministries (e.g. in dockyards, repair workshops, ordnance factories, research establishments, weapon-testing ranges). An important step towards opening contracts to European bidders is to engage the private sector in such activities.[7] In this respect, too, the Member States start from different positions.

These national differences find expression in very different levels of intra-Community import penetration in defence equipment.

Figure 1: Intra-Community import penetration rate and defence equipment expenditure, 2005: Eight EU "old NATO" countries and France



Source: Commission Staff Working Document: Impact Assessment, SEC (2007)1598: defence equipment expenditure, page 64, Table 9.2; intra-Community import penetration, page 82, Table 18.2.

[6] Four nations (Netherlands, Belgium Denmark and Norway) set up a consortium (EPAF, European Participating Air Forces) to produce F-16, with the USA. F-16s were assembled in the Netherlands (Fokker) and Belgium (SABCA), with components supplied from the five countries involved.

[7] For example, the UK Ministry of Defence has privatized its dockyards and engaged private contractors to manage nuclear warhead production.

The potential significance of this pattern is that the smaller Member States are already quite open in their procurement decisions – as open as are most Member States to manufactured products in general. Hence, there is less potential for the Directive in these cases. The larger nations are much less open, which suggests that there are powerful forces working within them against greater reliance on imported defence equipment, forces too powerful, perhaps, to be overcome by changes in legal procedures alone.

4.2. Industry structures, defence industrial strategy, and market dominance

4.2.1. Public ownership and defence industrial strategy

The defence sector in several countries is still dominated by public ownership (see Annex 1). In France, Spain and Italy in particular, governments have traditionally been heavily involved in defence production. The French government wholly owns DCNS, Nexter and SNEP; the Italian government owns 90 per cent of Finacantieri. In contrast, defence suppliers in Germany, the UK, and Sweden, are privately owned. As many European companies are still part-government-owned, the pattern of restructuring and industry consolidation has typically been slower in the EU than the US**.** Nevertheless, there have been major consolidations, such as BAE Systems, EADS and Thales.

Public ownership is just one manifestation of the fact that defence procurement is intimately bound together with defence industrial strategies. The US pursues an explicit and coherent strategy for defence-related industries, aimed at technological superiority in all relevant sectors. France is traditionally the most ambitious promoter of an autonomous Europe, and was a driving force behind the restructuring of Europe's Aerospace and Defence Electronics sectors - see Annex 1. The UK has an explicit defence industrial strategy.[8] It wishes to retain certain capabilities, for example, in complex ships, submarines and their nuclear steam raising plant, and armoured fighting vehicles. The perhaps curious point about this strategy document is that in an age in which industrial strategy is elsewhere considered no longer to have a role, industrial strategy in defence is alive and well, and is welcomed by Parliament, industry, and the defence community.

The question for this paper is whether having a defence industrial strategy is compatible with the Directive. If a particular capability forms part of a Member States's industrial strategy, how could that Member State place contracts other than those with its own industries?

4.2.2. Market power in defence equipment markets

The consolidation in the defence equipment industry has intensified the already high concentration of economic power, and created national monopolies. This would seem to be to the disadvantage of the procurement authorities, were it not for the fact that they tend to encourage these mergers, sometimes using a major contract as a lever. For example, the UK Ministry of Defence (MoD) has made it a condition of placing a £4 billion order for two aircraft carriers that BAE Systems and the VT Group (formerly Vospers Thornycroft) merge their shipbuilding assets. Why might this be the case? It is possible that:

a) Governments hope that the merged companies will stand a better chance of winning export orders;

b) as a monopsonist (single buyer), it is confident that it can cope with monopoly suppliers;

[8] Defence Industrial Strategy: Defence White Paper, Presented to Parliament by the Secretary of State for Defence, December 2005 (Cm 6697).

c) having two or more national suppliers can pose a problem for a contracting authority. Major projects are infrequent, and with shrinking defence budgets, are becoming more so. What are the losers in a competition to do next? Will they still be in a position to compete for the *next* major competition? It is easier in some sense to deal with a BAE Systems, EADS or Thales, which are capable enough to look after themselves, by winning export contracts.

As we shall explain further below, the most important source of market power in defence equipment markets is likely to be the post-contract-signing bargaining power of the contract winner, irrespective of whether or not it won the contract in competition: once large sums have been spent on the initial stages of a development contract, the contracting authority has difficulty - contractually and politically - extricating itself from it.

We will return to these themes: when considering the practicability of some of the Directive's provisions (Section 4.3.2 and 4.3.3), and the volume of procurement over which the Directive would have an impact (Section 6.2.2).

4.3. Administration and implementation

4.3.1. Administrative burdens

The Directive would impose administrative burdens on the contracting authorities, in terms of procedure and reporting. The procedural requirements would permit the contracting authorities only two contract award criteria, "the most economically advantageous tender" or the lowest price tender (Article 37). The "most economically advantageous tender" criterion would allow consideration of matters such as quality, price, technical merit, functional characteristics, running costs, life-cycle costs, delivery date, security of supply and interoperability. The contracting authority would be required to state in the contract notice or in the contract documents, the relative weighting (as a range) that it would accord to each criterion, or, where that is deemed not possible, to rank the criteria.

The reporting obligations would include providing written reports on each contract, to be submitted to the Commission if it so requested, explaining the reasons for choosing some candidates and rejecting others, and for rejecting tenders found to be "abnormally low" (Article 28). In addition to the administrative burdens that the Directive might add to an already elaborate procurement process, two further points may give Member States particular difficulty.

4.3.2. Non-publication

The conditions that allow non-publication might prove too restrictive. Publication would be the rule: the Commission does not wish to leave it to the contracting authorities to decide whether to publish notices or not, but prefers to limit non-publication to specific cases, such as "urgency", additional deliveries of spare parts, long term maintenance and modernisation. It is not clear how this would accommodate the fact – if, indeed, that is the intention at all - that Member States currently place a significant proportion of their contracts on a noncompetitive basis.

Writing in 2006, Transparency International (UK) (2006) estimated that the proportion of defence procurement placed on a non-competitive (usually single source) basis in the following countries was: Czech Republic, 84 per cent; Poland, 61 per cent; Germany, 39 per cent; UK, 26 per cent; and Portugal, 22 per cent. In 2007, the UK placed 22 per cent by value of its equipment contracts on a non-competitive basis, including contracts with the BAE Systems shipyard in Barrow-in-Furness, which supplies nuclear submarines to the Royal Navy.

The cost of the equipment purchased non-competitively would still be the same, irrespective of the publication procedure, while the administrative costs would be higher under the new proposal.

4.3.3. The rule of three

Under the restricted procedures, negotiated procedures with publication of a contract notice, and in the competitive dialogue procedure, contracting authorities might be forced to hold more dialogue that they judge necessary, or appropriate: the number of suitable candidates that will be invited to tender "shall not be lower than three".

How useful or feasible would this condition be? It is not easy to judge because the Impact Assessment does not discuss specific equipment projects. How many of the current tendering arrangements would fall under the Directive's description "restrictive", and if so, would it have been feasible in all these cases to find three credible and willing bidders?

For example, some of the UK MoD's development stage projects that were mentioned in the UK's National Audit Office Report on major defence projects (2004) involve fewer than three bidders (although it is not clear in some cases how many were initially invited):

a) Watchkeeper (unmanned air vehicles): proposals were received from Thales (Anglo-French) and Grumman (US)

b) Future aircraft carrier (CVF): Contracts for the Assessment Phase were awarded to BAE Systems and Thales.

c) Ground-based air defence. Two contractors, Lockheed Martin (US) and EADS (European) were invited to demonstrate their solution.

d) A single tender solution (Westland Helicopters) was adopted for the Battlefield Light Utility Helicopter, as this was judged to offer a faster and lower risk route to provide the capability within the required timescale.

These examples suggest that if a contracting authority wished to avail itself of the Directive's flexible procedures, it might be required to invite bids from contractors that they did not consider capable. Conversely, contractors will not wish to incur the expense of bidding for a contract if they sense that they are being asked to do so merely in order to comply with the Directive's requirement that "not less than three" be invited.

4.4. Longstanding problems in defence procurement

4.4.1. Procurement over-runs: Optimism bias

Europe spends €10bn a year on defence R&D in order to support an expenditure of €30bn on the acquisition of new military equipment. This is a costly policy, which absorbs many of the best scientific brains in the EU, whose opportunity costs are considerable. It is not always effective, either, in operational terms. Equipment programmes tend to over-run on time and budget. Table 1 shows some recent UK examples of time slippages: note that three of these projects slipped by more than a year, *within* the year 2007-08.

Table 1: In-Service Date slippages in some major UK equipment projects 2007-08

Project	Type of equipment	Months of Slippage reported by previous year*	Months of Slippage experienced in 2007-08
A 400 M	Transport aircraft	+15	+9
Nimrod MRA4	Maritime patrol aircraft	+89	+3
Soothsayer	Land electronic warfare system	+8	+4
Watchkeeper	Unmanned air vehicle	-8	+7
Terrier	Armoured earthmoving vehicle	+9	+27
Next Generation Light anti-armour weapon	Man-portable weapon	+12	+15
Precision guided Bomb		-3	+12

Reported in National Audit Office, *Major Projects Report 2007, Project Summary Sheets*, HC 98-II Session 2007-08.
Source: UK House of Commons Defence Committee, *Defence Equipment 2008*, Tenth Report of Session 2007-08, 11 March 2008, page 21.

These slippages reflect the fact that, in addition to other issues discussed above, procurement in areas such as defence is subject to two classic and very significant problems. The first and more well-known problem is what economists term "optimism bias", a tendency amongst those involved in a specific project, on both the buying and the supplying side, to want it to succeed and to be overly optimistic about how much it will cost and over what timescale it can be delivered. In their study of the development and production of twenty-two pieces of military equipment, Marshall and Meckling (1959) found a positive correlation between the size of this bias and the size of the technological advance involved in the production of the equipment. Many public sector projects are subject to optimism bias, and the UK Treasury's Green Book suggests making a standard provision for cost over-runs in engineering projects.[9]

4.4.2. Procurement over-runs: Non-renegotiation-proofness

Less well-known, but more serious in the case of defence, is what economists describe by the technical term "non-renegotiation-proofness". What this refers to is the following problem. Suppose that a certain piece of technical equipment is really needed by a specific date and/or that once it has been agreed which company will produce it, it will be very difficult practically or very embarrassing politically to cancel the project. Suppose also that the contract must be carried out over a long timescale, so that there is the possibility of the contractor's costs rising very considerably for reasons beyond the contractor's control. Then, in practice, if the contractor requests a renegotiation of the project part-way through, so as to raise the price, arguing that this is necessary because of cost rises, the procurer will have no realistic option but to agree. This means that, once the project has been committed, the contractor becomes effectively a monopolist and is able to secure the monopoly price, regardless of what price was agreed initially.

The implication of this in the current context is twofold:

a) First, this may be a factor explaining why even in Member States that use private sector contracting (such as the UK and Germany) the number of players is small: given that in

[9] Source: Supplementary Green Book Guidance, http://www.hmtreasury.gov.uk/media/D/B/GreenBook_optimism_bias.pdf

practice the procurer is ultimately going to pay the monopoly price anyway, it is better for there to be only a small number of firms so as to maximize economies of scope and scale. Hence a requirement that a greater number of potential bidders be invited could be counter-productive.

b) Second, this may mean that even considerable improvements in the effectiveness of competition in the tendering process, and formal reductions in price offers at this stage, may not ultimately mean that the final price paid will be any less.

Various measures are attempted to limit non-renegotiation-proofness problems. They are almost always unsuccessful. (A recent classic example is the failure of renegotiation-proofness attempts relating to the procurement for the London Olympic bid.[10]) Thus it seems reasonable to include, amongst others, a scenario in which improved competition in tendering is entirely negated by non-renegotiation-proofness problems.

4.4.3. Offsets

Offsets are a major feature of European imports of defence equipment. As a condition for being awarded a contract for a defence system, a foreign contractor is usually required to enter into an "offset agreement", whereby the contractor agrees to place part of the work, or an equivalent amount of work, with local companies. According to a recent study financed by the EDA,[11] Member States other than France and Germany ask for offsets. Over the 2000-2006 period these applied to 50 per cent of the EU's imports of defence equipment and averaged 135 per cent of the value of the contracts concerned (Eriksson, 2007, pages 20 and 21, Table 3.1).[12]

Offsets are politically appealing, because they allow contracting authorities to select foreign equipment without sacrificing jobs in the national economy. But offsets are not the "free lunch" they appear to be. They are economically inefficient, in that they allocate work away from least-cost suppliers, to firms in the purchasing nation. Hence they add to costs, and the purchaser bears most of them. According to Martin and Hartley (1996, p.354), the cost premia ranged from 3-60 per cent, with a typical range of 5-15 per cent. In a survey of the literature on this subject, Brauer and Dunne (2004) reported studies that estimated the direct costs to be 20-30 per cent for Belgium and 10-15 per cent for Finland.

The Directive will not alter this situation, so caution is needed about the rate of savings that can be expected from any cross-border trade in equipment that the Directive may promote. [13] While on the one hand, a greater number of bidders could be expected to result in keener bidding and lower prices, on the other, the foreign bidders would need to factor in the possibility that they would be expected to provide offsets.

[10] The funding for the London 2012 Olympics was settled in 2005 at £2.375bn, including a 50% contingency. The expected cost had risen to £9 bn by 2007.

[11] E. Anders Eriksson (2007), *Study on the effects of offsets on the development of a European Defence Industry and Market, Final Report for the European Defence Agency by FOI and SCS, July 2007, Table 3.1, page 21.*

[12] The composition of these offsets was: 38 per cent "direct" offsets (i.e. involving the equipment in question); 36 per cent were "defence indirect" (involving other defence items); and 26 per cent involved non-defence products.

[13] The Directive does not mention offsets. The Impact Assessment explains why (6.2.3.3). "Since offsets usually entail discrimination by their very nature, they stand in direct contrast to the Treaty. Consequently, EC procurement rules can neither allow nor regulate them." On the other hand, "explicitly forbidding offsets in the Directive could create the impression that they would automatically be allowed for defence procurement contracts which are exempted under Article 296. This, however, is wrong."

5. ALTERNATIVE SOLUTIONS : THE DO NOTHING OPTION

The Impact Assessment, Section 6, considers alternative solutions at length, including the Do Nothing option. This option (like the other alternatives) is discussed mainly in legal terms: "Public procurement would continue on a legally problematic basis and in an economically unsatisfactory way" (Impact Assessment paragraph 3.8). There is another, economic, perspective on this option. Without the Directive, financial pressures might help to bring about, in some measure at least, the objectives that the Directive seeks to promote. With the end of the Cold War and the rise of terrorist threats, Member States are according less priority to defence, and more to security. Falling defence budgets, coupled with the rising costs of developing new defence systems, are already pushing governments, and the defence equipment industries, to move away from their traditional, national solutions. Member States are cooperating more with each other, under the auspices of the European Defence Agency and adopting its Code of Conduct, and are associating themselves, too, with US equipment programmes, as, for example, in the F-35 Lightning II Joint Strike Fighter (JSF). European defence equipment companies have been reconfiguring themselves, often into transnational groupings.

We are unable, within the scope of this note, to provide detailed counterfactual forecasts for how matters might have evolved if no new Directive were introduced or anticipated. But it does seem that savings versus the *current* situation should be, at the very least, considered an upper estimate of the true savings, compared to the most probable do nothing scenario.

6. COSTS, BENEFITS AND RISKS

6.1. Costs for contracting authorities and companies

The Commission's Impact Assessment was not able to assess the cost of implementing the Directive, either to contracting authorities or to companies. Administrative costs were investigated for the Commission by Rambøll Management (see Impact Assessment, Annex 19, pages 88-89). Twelve Member States responded: some replied that they did not expect any increase in their administrative costs, while others replied that there would be quite considerable increases, for example, by up to 50 per cent in the preparation of tenders, publication and reporting and other administration (Impact Assessment, page 88).

This assessment leaves something to be desired, in several respects:

a) no detail is provided on the costs of different types of procurement activity;

b) costs are expressed only as percentage changes from existing (unstated) levels, not as monetary values: the total administrative burden could be quite significant if it were the case that the biggest spenders (UK, France and Germany) faced the largest percentage increases in costs.

c) there is no discussion of whether compliance with the Directive would extend the procurement process, pushing the operational dates of new equipment further into the future.

The only evidence on compliance costs is the evaluation of previous Public Procurement Directives by Europe Economics (2006). It concluded that, for all the contracts examined (mostly service contracts), publishing in the OJEU added six days (35 per cent) to the time required to award a contract and some 0.2 per cent the contracting authority's cost. The additional burden, in terms of time, was greatest for Spain (75 per cent) and least for the UK (10 per cent). The additional cost for contractors was on average also 0.2 per cent of the value of the contract. In other words, compliance with the Directive added about 0.4 per cent to the cost of contracts.

6.2. Benefits

6.2.1. Higher publication rates in the OJEU

The Impact Assessment acknowledged that it is difficult to quantify the impact on competitiveness. It reported some qualitative findings from a study commissioned from The Yellow Window.[14] For example, the majority of companies welcomed the initiative and expected "positive impacts" on sales of their specific products in 14 of the 20 market segments which were analysed. The Commission expressed the general hope that if defence equipment markets do, as result of the Directive, become more transparent and competitive, European defence and security industries should be well placed to contribute to the Lisbon objective of creating "competitive, dynamic, knowledge-based economy" (Impact Assessment, Paragraph 6.2.4.3).

The Impact Assessment then made the plausible assumption that publication rates for defence in the OJEU would increase from about 11 per cent (their 2002 level) to about 25 per cent - the rate for central administrations other than defence administrations (Annex 21). It then applied a rate of savings of five per cent to the implied increase in the value of advertised contracts (€10bn, increasing from €8.2 to €19bn). Even, more conservatively, that the increase

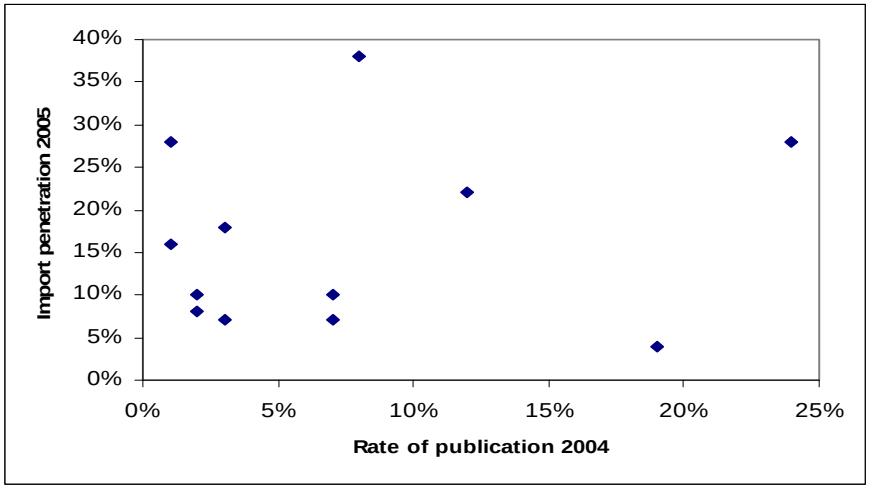
[14] The Yellow Window Market Study, see Impact Assessment, Annex 14.

in the value of advertised contracts was half this, this would imply that annual savings "of around €250 million would be returned to the public purse for use elsewhere." (Impact Assessment, Paragraph 6.2.4.3).

The Commission attaches particular importance, here, to the publication of contract notices in the OJEU. The Impact Assessment does not, however, demonstrate that this is particularly relevant in a defence context. As the Impact Assessment notes, about three quarters of all *defence product types* are already "normally" open to international competition, but only one quarter are actually published in the OJEU (and thus awarded according to EC rules).

Moreover, countries' rates of publication in the OJEU are not correlated at all with the extent that they actually buy defence equipment from each other. The intra-Community import penetration rates of 12 EU-15 countries in 2005, the year for which the Impact Assessment estimated these, cannot be explained, statistically, by their publication rates in the preceding year – see Figure 2.[15]

Figure 2: Rates of publication in the OJEU and intra-Community import penetration: 12 EU-15 countries



Sources: Based on data in the Commission Staff Working Document: Impact Assessment, SEC (2007)1598: rates of publication in the OJEU, page 79, Annex 17; and intra-Community penetration, page 82, Annex 18.2.

A more satisfactory comparison takes account of the fact that, as noted in Figure 1, among the old NATO Member States and France, import penetration is inversely related to the size of a Member State's expenditure on defence equipment. When that relationship is controlled for statistically, it turns out that for the eight of these nations for which there are data, import penetration in 2005 was *negatively* related, and to a statistically significantly degree, to the OJEU publication rate in 2004.[16] In other words, the Member States that published most in the OJEU in 2004, imported the least from the others in 2005.

This apparent disjunction between openness on the one hand, and procurement decisions on the other, prompts an obvious question about the Commission's proposal: while it is one thing to compel the contracting authorities to adopt more open *procedures*, will this change their procurement *decisions*?

[15] Nor, for the 11 of those countries for which there were relevant data, could these import penetration rates be explained by any *average* of their publication rates in preceding years.

[16] The logarithm of the intra-Community import penetration rates$_{2005}$ for eight Member States (seven "old NATO" plus France) = 1.42 – 0.33* Log(OJEU publication rate$_{2004}$) – 0.53*log(defence equipment procurement expenditure$_{2005}$). Adjusted R^2 = 0.88

6.2.2. The footprint of the Directive

What types of defence activities would probably be involved in the additional €10bn that would be brought within Community rules by the Directive? The bulk of it would probably concern services. The Impact Assessment lists (at Annex 18.3) products or services for which at least half of responding Member States currently publish contracts in the OJEU: apart from light trucks, all-terrain vehicles, buses and coaches, and uniforms, these contracts concern services and construction (equipment maintenance and parking areas).

The greater part – 65 per cent – of the EU-25's defence procurement expenditure in 2005 was spent on services (e.g. equipment support, property management, movements, servicemen's accommodation). Of the tradable items, 90 per cent was accounted for by equipment.

Table 4: Approximate composition of defence procurement expenditure, EU-25, 2005 (€ million)

Total defence procurement	84,900	100%
Defence equipment expenditure *	26,800	32%
Maintenance and operations	40,200	47%
(Of which, stock consumption and fuel)**	2,900	3%
RD&T	11,200	13%
Infrastructure	6,700	8%
Of total:		
Services	55,200	65%
Tradables (equipment, stock consumption and fuel)	29,700	35%
Of which		
Equipment	90%	
Stock consumption & fuel	10%	

Source: Impact Assessment, Annexes 8 and 11.

* Assuming that Denmark, which does not publish expenditure on equipment, follows the EU-24 pattern.
** Based on the UK data, Annual Abstract of Statistics, 2007 edition, No. 143, Table 4.1, 2005-06

It would not be realistic to expect that the bulk of the additional spending would involve equipment, since about half of this expenditure is not effectively open to competition. Cooperative projects accounted in 2006 for 21 per cent of the EU's expenditure on equipment.[17] These projects might be described (perhaps provocatively) as "arranged marriages", involving Europe's most capable contractors in the type of project concerned, rather than competitions. Another 30 per cent or so, to judge by figures published by Transparency International (UK), (2006), is probably accounted for by non-competitive single-tender contracts that are awarded this way, either because there is no alternative, or for strategic reasons. Import penetration, from within the EU (13 per cent) and from North America (about 9 per cent), accounts for another 22 per cent. This would leave about 30 per cent of the of the EU's expenditure on equipment, or about €8bn, potentially open to *additional* imports. These considerations, taken together, suggest that the composition of the additional €10 bn imports might be one-quarter equipment, three-quarters services.

[17] European Defence Agency, *European Defence Expenditure in 2006*, 19 November 2007.

A relevant point is the extent to which Member States involve industry. The UK, Germany and Italy spend about one-third of their defence spending with non-public sector industry. The US spends about 40 per cent.[18] Once Member States involve industry in the management of their operations, it would be easier for the Directive to open up these activities to international competition. One could imagine, for example, that major European facilities management companies could become involved in defence across the EU, operating, probably, from bases in each Member State.

6.2.3. The impact of previous procurement directives

We turn for guidance on the potential benefits of the Directive to the progress that has been made towards a Single European Market in other areas of public procurement. Europe Economics evaluated the effects the EU Procurement Directives 1992–2003 in the 15 Member States to which they applied (Europe Economics, 2006). This involved a legal review of the implementation of the Directives, 100 in-depth interviews of awarding authorities and suppliers, and an electronic survey administered by the Commission Services (see Annex 2). The Europe Economics study spanned a range of products and services.

The first lesson from this analysis is that the Public Procurement Directives achieved significant benefits, in terms of transparency, fairness, and better procurement practices. Some procurement officials noted that the Directives enabled them to fend off political pressure and to concentrate on value for money. On the other hand, both authorities and suppliers complained that the Directives too often required procedures which have no additional value and which reduce efficiency.

Most suppliers and authorities considered that the competitive pressure in procurement markets had increased, more so in markets for the more homogenous and tradable goods and services. Europe Economics concluded that prices had been driven down by between 2.5 and 10 per cent of the contract value by 2002.

The effects of the Directives on different sectors were strongly influenced by three characteristics:

a) Complexity of specifications: In sectors where proposals contain a significant intellectual input and where proposals require correspondingly greater effort for their preparation, the attitudes towards the Directives were much more negative. Suppliers found that the authorities lack sufficient technical expertise to specify tenders adequately and that many of them were deterred by the Directives from seeking advice from suppliers before the tender is issued. In markets of this kind compliance costs have therefore risen by more than average and the benefits of competition have been smaller than average. Some suppliers in these markets considered that the Directives have on balance made the market less competitive.

b) Tradability of good/service: Additional competition rose most strongly in markets where no local presence is needed to conduct the contract (e.g. homogenous or standardised supplies and bulk goods), as contractors did not have to change their company organisation or structure in order to compete.

c) Market share of public sector: In sectors where a local presence is needed the Directives increased competition when the market share of the public sector was big enough.

Defence procurement involves complex specifications and in some cases involves large market shares of the public sector, but need not always be conducted locally.

[18] Secretary of State for Defence, *Defence Industrial Strategy*, Defence White Paper, December 2005, page 25.

Thus one might expect it to lie in the bottom half of the 2.5-10 per cent range, but not right at the bottom. The implication is that the Impact Assessment's illustrative assumption of a rate of savings of 5 per cent seems a plausible one (subject to the qualifications discussed below under Risks and Uncertainties).

As to the likelihood that the Directive would promote trade, it would probably be:

a) High in military supplies, which are fairly homogeneous products and for that reason are more open to competition. However, these appear to account for quite a small proportion (perhaps only 3 per cent of defence procurement – see Table 4);

b) Less so in defence equipment, which although highly tradable, and for that reason, likely to attract more competition, lies at the extreme end of the range of complexity, posing problems of contract specification and additional administrative cost; and

c) Less so, also, in services. These will probably account for the bulk of the additional notifications in the OJEU, and there is considerable scope for involving the private sector in managing or providing them. However, they are not a promising field for international competition because the delivery of a service requires a local presence.

Another potential source of benefits is if increased contestability through the OJEU publication process means that rivalry increases and hence prices fall. This may lead to benefits of the order described above even in cases in which actual trade does not increase.

6.2.4. Distribution of benefits between Member States

As discussed, we find savings of 5 per cent, at the procurement stage, to be a plausible estimate of the benefits. However, benefits are unlikely to be distributed evenly amongst Member States. The potential for benefits for procurement agencies in larger Member States, that currently purchase much of their equipment domestically, are greater than those for Member States that at present purchase much of their equipment in global markets, principally from other EU Member State and from US contractors. The difference arises because larger Member States (such as the UK, Germany, and France) may potentially increase their procurement from other Member States (to which the savings of 5 per cent would apply) or at least increase contestability (thereby realizing savings even when actual trade does not increase). Those Member States currently purchasing from other Member States or from the US clearly have relatively less resistance to international purchasing.

In the longer term, the distribution of benefits will depend on the type of trade pattern that emerges. Various scenarios, or combinations of them, could be envisaged, for example:

a) Dominance: one or two Member States would provide the other Member States with most of their defence equipment;

b) Specialisation by types of systems: one Member State would produce the battle tanks, another the fighter aircraft, another the warships, another artillery, and so on;

c) Within-industry trade: two-way exchanges of different varieties of the same products ("horizontal differentiation"), or two-way exchanges of products of different qualities ("vertical differentiation").

d) Cooperation: Europe's major defence systems would be produced by international consortia.

These trade scenarios would generate different orders of economic benefits, different distributions of them, and different degrees of dislocation to the EU's national economies. The first two would probably generate the most economic benefits, and the most dislocation to European industry.

The within-industry trade scenario is of interest because this pattern of trade, and in particular, the exchanges of products of different qualities, accounts for most of the growth of trade arising from the Single Market (Fontagné, 1998). It involves less dislocation to industry than specialisation by industry, which is the feature of the first two scenarios.

What are the prevailing trade patterns in defence equipment? Not the "dominance" scenario discussed above. Table 5 shows the pattern of arms exports of the six major arms exporting Member States in the period 2000-2006. It suggests that the three major exporters, France, Germany and the UK, are less orientated towards the European market than two smaller Member States, Netherlands and Sweden.

Table 5: Arms exports of the six major arms exporting Member States, 2000-2006 (US$ 1990 prices)

	Europe	Non-Europe	Total	Proportion to Europe
France	1,590	9,500	11,100	14%
Germany	2,610	8,010	10,620	25%
UK	1,130	5,840	6,970	16%
Netherlands	2,210	1,460	3,660	60%
Italy	870	2,150	3,020	29%
Sweden	1,820	1,300	3,120	58%

.

Source: SIPRI data, cited in FOI & SCS study (2007), Annex 3, Table 8

The evidence in Table 6 points to the second pattern - specialization by type of system. This specialization reflects outstanding performances by a few companies. This suggests to us that whatever benefits flow from the Directive, are more likely to favour the successful specialists.

Table 6: Examples of cross-border purchases of major systems by more than one other Member State, scheduled for delivery in 2007

Supplying country	Weapon system	Company	Recipient country
Italy	Naval guns	Oto Melara, now Otobreda, part of FIAT	France, Germany, Greece, Poland
Netherlands	Air/sea surveillance radars	SIGNAAL, formerly Hollandse Signaalapparaten, now part of Thales	France, Germany, Greece, Italy, UK
Sweden	All terrain vehicles	Land Systems Hägglunds, now part of BAE Systems	Germany, Italy, UK
	Artillery locating radars	Ericsson Microwave Systems	Czech Republic, Spain
Germany	Battle tanks	Krauss-Maffei Wegmann and Rheinmetall	France, Greece
	Armoured howitzers	Krauss-Maffei Wegmann and Rheinmetall	Netherlands, Italy
	Submarines	Howaldtswerk-Deutsche Werft (HDW)	Greece, Portugal

Source: SIPRI Arms Transfers Database

Other possible beneficiaries from the Directive would be the US defence equipment contractors: they produce the most advanced defence equipment, on a greater scale than the Europeans.

In other words, it would be misleading to think about the long-term industrial consequences of the Directive solely in terms of reshaping the existing European defence equipment industries. There might also be shift in favour of US suppliers, whether as exporters to the European market, or as suppliers from a European base.

European taxpayers, for the most part, would probably welcome lower prices for defence equipment, irrespective of its source; but others value independence in equipment supply, and take a pride in their national industries.

6.3. Risks and uncertainties

6.3.1. A high benefit scenario

A long-term aspiration that motivates the Directive is for a restructured and more competitive European defence equipment industry. This could generate three sources of savings, attributable to the exploitation of economies of scale, to learning effects on longer production runs, and to "dynamic effects", due the introduction – or intensification – of competition.

Table 7: Savings from a Single European Market in defence equipment

Type of effect	Saving in unit production cost
Competition effect EU firms only EU open to firms from the rest of the world	 10-20% 15-25%
Scale effect	10-20%
Learning curves Average labour learning curve: 85%	5% (assuming labour is 30% of total costs)

Source: Hartley & Cox (1992), unpublished, as a contribution to the "Cost of Non-Europe study"(Cecchini,1988).

Labour learning curves refer to reductions in the number of man-hours required to manufacture a product, with greater experience of producing it (hence another description, "experience curves").[19]

The rates of savings that are implied by this type of analysis are clearly well in excess of those that are attributed to the Directive in the Impact Assessment. The Cecchini Report (1988) reached a more conservative assessment of the savings that the EU could expect to achieve through changes in industrial structures: ("about one-third of European industry could profit from cost reductions of ranging from 1 to 7 per cent" (European Commission, 1988).

Why, then, might the savings turn out in practice to be so much lower than those suggested by Table 7? The estimates of economies of scale are theoretical, and tend to overlook the problems associated with operating large plants and organisations. Unit costs are less likely to be driven down in accordance with what is technically possible in the defence environment, especially where public ownership is involved. The savings from learning throughout long production runs are not easy to predict[20] and they can fail to materialise due to "organisational forgetting" and employee turnover.

[19] Learning or experience curves are often quantified in terms of the relative cost, following each doubling in cumulative volume. Thus, a "90% learning curve" means that the unit labour cost of the 200th aircraft in a production run, for example, would be expected to be 90% of that of the 100th aircraft.

[20] Reviewing learning curves as a basis of business strategy, Ghemawat (1985) noted that even companies that understand them can get themselves into difficulties. In the industry in which experience curves were first studied, in the 1930s, "Douglas Aircraft fixed prices for the DC-9 on the basis of an 85% experience curve.

Another reason why Member States would not exploit the full potential of learning effects is, as discussed above, they tend to seek offsets when they buy foreign defence equipment. For the 40 per cent of the offsets that take the form of local production of the foreign-designed equipment, this would involve going back towards the top of the relevant learning curve, rather than building on the learning that the foreign contractor has already accumulated.

6.3.2. Low benefits scenarios

As discussed in previous sections, there are three reasons to think that under certain scenarios the benefits might be rather less than the five per cent figure favoured by the Commission and defended above.

First, and least significantly, in the Do Nothing scenario, it seems possible that competition would increase in a number of areas, so that some of the gains described above would be realized even without the Directive, and hence should not all be attributed as benefits of the Directive.

Secondly, as noted above, offsets apply to about 50 per cent of the EU's imports of defence equipment, and they absorb some of the savings that are potentially available from international trade.

Thirdly, the Directive will not in itself tackle either optimism bias or non-renegotiation-proofness problems.[21] As a consequence, even if the Directive succeeds in achieving savings of 5 per cent at the point of tendering and contracts being signed, it seems very likely to us that, unless other measures are introduced to counter particularly the non-renegotiation-proofness problem, then final savings are likely to be zero (or even negative if the requirement to make use of at least three contract bidders undermines economies of scope and scale whilst leaving the effective monopoly power of the contract winner untouched).

This is not a criticism of the Directive, or even, as such, an attack on the 5 per cent savings figure. If other measures succeed in addressing the non-renegotiation-proofness problem, then our analysis above suggests that the increased competition encouraged at the contracting level could indeed lead to savings of the order of 5 per cent.

When the estimated cost reductions failed to materialise, its losses forced Douglas into acquisition by the McDonnell Company".

[21] See the explanation of these terms in Section 0

7. THE SCOPE OF THE DIRECTIVE : NON-MILITARY SECURITY GOODS AND SERVICES

Non-military security equipment is included in the Directive. Non-military security equipment includes items such as alarms, electronic access control systems, CCTV/Video surveillance equipment, digital CCTV recorders, biometrics, and contraband detectors. The suppliers include ASSA ABLOY, Tyco International, United Technologies, Honeywell, Ingersoll-Rand, and Siemens. Non-military security procurement agencies include intelligence services, police and border officials.

Under the current arrangements, Member States invoke Article 14 of the Public Procurement Directive 2004 to exempt security equipment from EC rules, under specified conditions, e.g. when the contracts are secret.[22] Member States "deal with these contracts as they do with defence contracts, i.e. exempt them systematically" (Impact Assessment, Section 3.2.2). The case is made in the Impact Assessment that non-military security equipment should be included because in important respects, it is similar to military equipment. Both types of equipment have a high security; they are developed from similar technologies; they can be required to be interoperable with other systems, and with each other; and there are overlaps between their military and civilian uses. According to the European Commission,

"The emergence of transnational and asymmetric security threats has blurred the dividing line between external and internal, military and non-military security."

For these reasons, it is argued that security equipment requires the same flexibility of contracting procedures – the flexibility that the Directive claims to provide – and hence should be included.

The essential question here is whether the inclusion of non-military security equipment within the Directive would secure economic benefits without compromising the security of Member States. The matter of greatest and topical concern here to the publics of Europe is not the injection of more competition into the supply of security equipment, but whether the inclusion of this equipment in the Directive would render Europe more exposed to terrorism and organised crime.

It is difficult to see how inclusion would *not* do so. The Directive's stated operational objective is to limit the use of exemptions provided in Article 14 of the Public Procurement Directive (Impact Assessment, Section 4.2) to protect very sensitive information. Despite the assurance that "the realization of this objective, however, must not conflict with Member States' security interests", Member States would no longer, under the Directive, be the sole judge of their own security interests, despite their competence on matters of national security, currently and under the Directive.

It is possible that the current practice is just as it should be, on legitimate security grounds. The technical requirements – and perhaps their very existence – for some types of security equipment are matters that Governments may have good reasons to share only with trusted national suppliers. In order to justify the inclusion of security products within the scope of the Directive, it would have to be demonstrated that exemptions under Article 14 are restricting competition for these products in the EU market *to a disproportionate extent.* This the Impact Assessment does not do.

[22] Article 14 states that "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".

How significant would the economic benefits be expected to be? The security equipment industry operates in a global market, serving hundreds of independent customers, both in the public sector (defence, regional and local authorities, police forces, ports and airports), and in the private sector. With defence equipment, the R&D necessary to develop new systems is largely financed by Defence Ministries, either in their own laboratories or via research contracts. This limits the degree of competition. The security equipment industry, in contrast, funds its own R&D. R&D is the entry ticket, and there is lively competition. Opportunities are particularly attractive in the biometrics and explosive detection sub-segments. Civil electronics products can be as advanced as defence electronics products, and are certainly quicker-to-market.

In terms of its structure and behaviour, then, this industry could scarcely be more different to the defence equipment industry, with its dominant positions within closed national defence markets, each controlled by single procurement authority. So what, then, is the perceived problem that the inclusion of non-military security equipment in the Directive is intended to solve? The objective of the Directive is to facilitate competition in markets where it is absent or limited. The security equipment market already features a high degree of competition. The contracting authorities have a range of off-the-shelf alternatives to commissioning bespoke solutions. It looks unlikely, on the face of it, that the Directive would bring a significant degree of market opening here.

In our view, these general considerations – the security aspect and the existence of competition - weigh on balance in favour of excluding security equipment from the scope of the Directive.

8. CONCLUSIONS

This report concludes as follows:

a) The Directive has been designed with an appreciation of the singular features of defence procurement, and is supported by a substantial Impact Assessment **(Section 3)**.

b) A central objective of the Directive is to bring about a higher rate of publication for defence procurement contracts in the OJEU. The Impact Assessment made a plausible assumption that this rate would increase from about 11 per cent (their 2002 level) to about 25 per cent - the rate for central administrations other than defence administrations. It then applied a rate of savings of five per cent to the implied increase in the value of advertised contracts. This assumed rate of saving is consistent with the conclusions of an evaluation by Europe Economics of previous Public Procurement Directives, and we would not dispute it as an average for a range of defence procurement contracts. However, it may be an optimistic figure for equipment projects – see conclusions (g) and (h) below. **(Section 6.2.1)**

c) We are more sceptical about the volume of additional trade that would be generated by the Directive. We found no statistical evidence of a causal link between Member States' rate of publishing defence equipment procurement contracts in the OJEU and their propensity to import such equipment from other Member States. We also note that the bulk of any increase in notifications that might be brought about by the Directive would concern services, and these would require a local presence to deliver. **(Section 6.2.2)**

d) We have two principal doubts about the Directive's practicability. The first is that a significant proportion – perhaps one-third - of the EU's defence equipment is procured by means of non-competitive (usually single tender) contracts, for strategic or practical reasons. It was not clear what point would be served by publishing such contracts, unless it is thought that these strategic and practical concerns do not justify the adoption of this procurement route. **(Section 4.3.2)**

e) Our second doubt about practicability concerns what we term the "rule of three" requirement, that the flexible procedures that are permitted by the Directive require that the number of candidates that will be invited to tender "shall not be lower than 3". This might require contracting authorities to invite bids from contractors that they did not consider capable, or conversely, contractors might not wish to incur the expense of bidding for a contract, if they sense that they are being asked to do so merely in order to comply with this requirement. **(Section 4.3.3)**

f) Optimistic and pessimistic scenarios were considered. In the optimistic scenario the Directive would contribute to securing more significant savings than those anticipated from the Directive, as a result of the greater exploitation of economies of scale and learning effects. **(Section 6.3.1)**

g) In the pessimistic scenario, we note two features of defence procurement. The first is the prevalence in the EU of offset requirements. Over the 2000-2006 period these averaged 135 per cent of the value of the contracts concerned. Offsets are economically inefficient, allocating work away from least-cost suppliers, to firms in the purchasing nation. They add an estimated 5 -15 per cent to costs, and the purchaser bears most of them.

The Directive will not alter this situation, so caution is needed about the rate of savings that can be expected from any cross-border trade in equipment that the Directive may promote. While on the one hand, a greater number of bidders could be expected to result in keener bidding and lower prices, on the other, the foreign bidders would need to factor into their bids the probable cost of providing offsets. **(Sections 4.4.3 and 6.3.2)**

h) The second feature is that defence equipment development projects often over-run on cost and time. Once they have committed substantial sums to them, the contracting authorities are unwilling to write them off. The contractors are therefore able to renegotiate their contracts. (In economist's language, there is "non-renegotiation-proofness".) For this reason the contracting authorities may have no strong motive to invite a variety of bidders: they anticipate the possibility of having to pay prices that are substantially higher than were originally contracted, in order to see their projects through to completion. This will probably be the case, whichever contractor wins the contract. That being so, the contracting authorities would prefer to pay these prices to large, national companies, with whom they are familiar. It follows from this that there is a considerable risk that the economic benefits from having a greater number of bidders for these types of projects will be close to zero. Even if the initial contract price is bid down by 5 per cent because of this Directive, the winning bidders, whichever they are, will eventually look to renegotiate higher prices. **(Sections 4.4.2 and 6.3.2)**

i) As to the scope of the Directive, there is, in our view, a case for *excluding* non-military security equipment. Inclusion poses some security risk because it would, intentionally, limit the use of exemptions to protect very sensitive information. It is not clear what problem inclusion would solve. The objective of the Directive is to facilitate competition in markets where it is absent or muted. The security equipment market already features a high degree of competition, so it looks unlikely, on the face of it, that the Directive would add value here. **(Section 7)**

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ANNEXES

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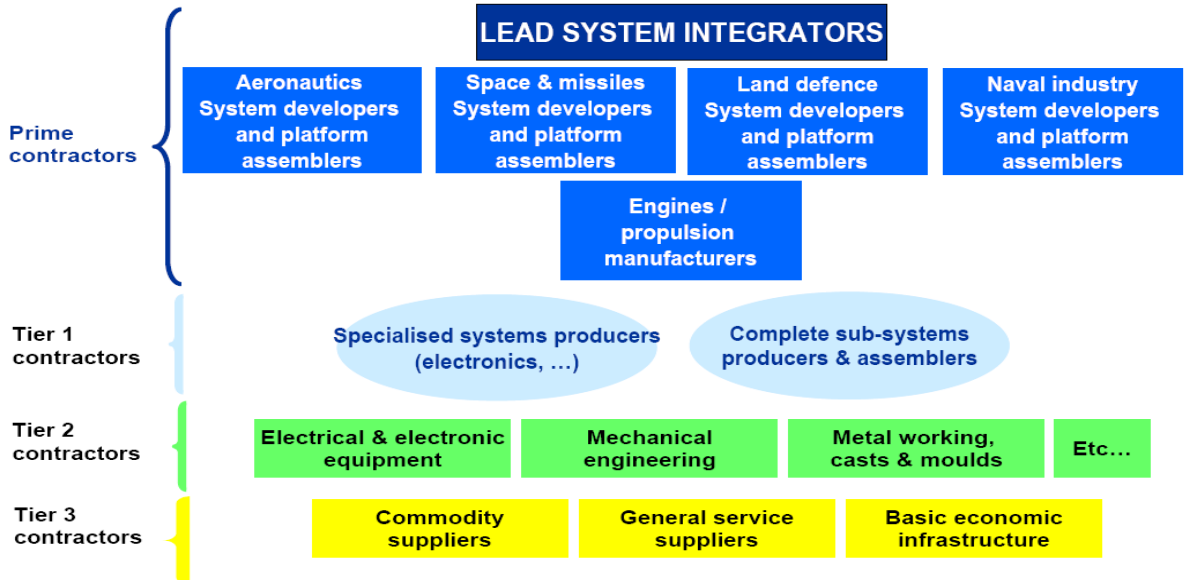
1. ANNEX 1: THE EUROPEAN DEFENCE INDUSTRIAL BASE (EDIB)

1.1 Introduction

Defence equipment contractors operate within the following structure.

Figure 1.1: The defence equipment supply chain



Source: BIPE

Prime contractors are responsible for platforms and weapons systems, and for system integration. Examples include:

a) **BAE Systems** (UK): the result of the merger of British Aerospace and Marconi Electronic Systems, and the acquisition of much of Royal Ordnance by British Aerospace, specializing in services for air, land and naval forces, as well as advanced electronics, information technology solutions and customer support services.

b) **Thales** (France): specialises in mission-critical information systems for the aerospace, defence and security markets.

c) **EADS (**European Aeronautic Defence and Space, Netherlands): the result of the merger of DaimlerChrysler Aerospace, Aerospatiale and Casa, specialises in developing and marketing civil and military aircraft, as well as missiles, space rockets, satellites, and other related systems.

d) **Finmeccanica** (Italy): specialises in the aerospace, defence and security sectors, helicopters and defence electronics. The firm also specialises in satellite and space services as well as having considerable know-how and production capacity in the energy and transport fields.

e) **Krauss-Maffei-Wegmann** (Germany): specialises in the production of wheeled and tracked armoured vehicles, ranging from main battle tanks to lighter armoured, multipurpose wheeled vehicles. The company also makes artillery, anti-aircraft, and combat engineering vehicles.

f) **Nexter** (France): specialises in designing, manufacturing, and supplying weapons systems, armoured vehicles, and ammunitions.

g) **Saab** (Sweden): specialises in fighter aircraft.

Tier 1 contactors are specialist suppliers of complete sub-systems or major components, usually subcontracted by the prime contractors, for example;

a) **Rolls-Royce** (UK): military aero engines and Mission Ready Management Solutions (MRMS). It is one of the world's two suppliers (with Pratt & Whitney) of aero engines for long-haul civil aircraft.

b) **MTU** (Germany): aero engines for commercial and military aircraft.

c) **Group Safron** (France): aerospace propulsion, aircraft equipment, defence security, and communications.

Tier 2 contractors produce components and supply services, and are typically SMEs or subsidiaries of Prime and/or tier 1 contractors. These companies can supply military and civil markets, such as communication and transport services.

Tier 3 contractors: general services.

1.2 The biggest arms-producing defence firms

The biggest arms-producing defence firms in the EU are listed in Table 1.1, according to their 2005 global ranking in terms of arms sales. Income from activities other than arms constitute a significant proportion of some of these companies' sales.

Table 1: Top European defence firms: arms sales (US$ m) and employment (2005)

World ranking	Company	Country	Arms sales	Total sales	Arms sales as a % of total sales	Employment
4	BAE Systems	UK	23,230	28,020	83	100,000
7	Finmeccanica	Italy	9,800	14,265	69	56,600
8	EADS	Europe	9,580	42,545	23	113,210
10	Thales	France	8,940	12,765	70	53,370
13	DCNS	France	3,520	3,524	100	12,200
14	Rolls Royce	UK	3,470	12,005	29	36,200
20	SAFRAN	France	2,390	13,155	20	58,000
21	Dassault	France	2,120	4,264	52	12,080
23	Saab	Sweden	2,110	2,585	82	12,830
28	Rheinmetall	Germany	1,740	4,296	41	18,550
29	CEA	France	1,710	3,993	43	15,010
33	QinetiQ	UK	1,550	1,912	81	11,450
36	Smith	UK	1,450	5,485	26	30,000
43	VT Group	UK	1,710	1,540	76	9,920

Source: Stockholm International Peace Research Institute

1.3 Countries

Distinguishable country groups are:

(a) **France and the UK** – The defence industries in this group are relatively large and have the capability of developing both conventional and nuclear weapons and a compete range of advanced air, land and sea systems (e.g. combat aircraft, nuclear-powered submarine, aircraft carriers).

- *The UK*: The UK's DIB, in recent years, has experienced privatization and disarmament following the end of the Cold War, which has lead to a significant downsizing of the DIB. Defence industry restructuring has created a UK DIB dominated by domestic monopolies in the supply of air, land and sea systems (e.g. BAE Systems; Rolls-Royce; Alvis).
- *France*: The defence industry in France is characterized by a greater degree of government ownership than the UK. However, progress is being made in defence privatization as well as defence restructuring.

(b) **Germany and Italy** – Germany, in particular, has a sizeable DIB and both Member States have independent technical capabilities in some land and sea systems and involvement in a range of collaborative aerospace projects.

- *Germany*: Virtually all defence contractors in Germany are privately owned, but many have stock owned by federal states or banks. Competition is allowed for contracts at all stages, from program definition to final production.
- *Italy*: Although the Italian defence industry is largely government owned, progress is being made with privatisation. According to the European Diversification and Defence Market Guide published by the U.S. Department of Commerce, it is expected that by the end of the century, the entire Italian defence industry will be privatised.

(c) **Spain and Sweden** – Although the defence industries in these countries are of similar size, they are very different. Spain is developing a DIB whereas Sweden's DIB is of longstanding, in line with its tradition of neutrality and independence.

- *Spain*: The Spanish defence industry has gone through a decade of strong growth, largely as a result of its participation in a number of large-scale programs for the procurement of military platforms. Spain's DIB is competitive in radars, air control and other electronic defence systems.
- *Sweden*: Sweden has strong positions in fighter aircraft (Saab supplies the Gripen multi-role fighter aircraft to the Swedish air forces, and to Hungary and the Czech Republic) and in land systems (Bofors in guns and Land Systems Hägglunds in all terrain vehicles).

(d) **Others** – This fourth group, which consists of the Netherlands, Belgium, Finland Portugal, Denmark and Austria, all have relatively small defence industries although some of them have distinct capabilities, notably the Netherlands, which has a strong position, through SIGNAAL, in naval surveillance radars.

1.4 Ownership and consolidation

Defence suppliers in most Member States are privately owned, but in France, Spain and Italy in particular, governments have traditionally been heavily involved in defence production activities, and remain so.

Table 1.2: Government Ownership in Major European Defence Firms (2005)

Country	Company name	Specialism	Public Ownership (%)
France	DCNS*	Naval	100
	Nexter**	Land systems	99.9
	SNEP	Explosives	99.9
	DCI	Consulting	49.9
	Thales	Warship design and naval electronics	27
	Safran	Aerospace propulsion and equipment, defence security	7
	EADS	Space equipment	15
Italy	Finmeccanica	Aerospace, helicopters, and defence electronics	33
	Finacantieri	Shipbuilding and repair	90
Spain	Navantia	Shipbuilding	100
	EADS	Military aircraft, helicopters, space, electronic systems, missiles, and weapons systems	6
	ITP	Defence aerospace	53

Source: Fondation Pour La Recherche Strategique

** Formerly DCN. In 2007, DCN and Thales consolidated their naval activities in France. DCN acquired all of Thales' French business, while Thales acquired a 25% stake in DCN, the French government retaining a 75% stake.*

*** Formerly known as GIAT Industries or Groupement des Industries de l'Armée de Terre, Army Industries Group).*

As many European defence companies are still partly owned by the government, the pattern of restructuring and industry consolidation has typically been slower in the EU than the US. However, since the late 1990s, there have been a number of major mergers and acquisitions in Europe, resulting in the formation of three major Western-European arms-producing companies: BAE Systems, EADS and Thales.

1.5 Defence procurement as an industrial strategy

Another central feature of the current world of defence is that defence procurement is intimately bound together with industrial strategy.[1] This is not a specifically European feature: US pursues an explicit and coherent strategy for defence-related industries, aimed at technological superiority in all relevant sectors. Among the six Letter of Intent (LOI) countries, France is traditionally the most ambitious promoter of an autonomous Europe, and was a driving force behind the restructuring of Europe's Aerospace and Defence Electronics sectors – see Table 1.1.

Aérospatiale-Matra was brought into EADS and THALES (formerly Thomson-CSF) transformed itself into an international player with strong links to the UK, through the acquisition of Racal. The French Government retains ownership in land armaments and naval shipbuilding.

[1] This section draws from Burkard Schmitt, European Union Institute for Security Studies, *Paris European and Transatlantic Defence-Industrial Strategies*, Prepared for the IISS/CEPS European Security Forum, Brussels, 25 November 2002.

The UK's industrial policy is characterized by a "value for money" policy, which includes relative openness of its defence market for foreign competitors. This openness also compensates for a growing lack of competition in the national market. In fact, after the take-over of GEC Marconi by British Aerospace and the recent acquisition of Vickers by Alvis, there are two national champions left which distorts the market-led approach that the British claim to champion. To counterbalance this dominance and to create a second "national" defence electronics supplier competing with BAE Systems, the UK MoD accepted, for example, the take-over of Racal by THALES. Competition may also come from American companies that regularly team-up with British firms for bids in the UK. Transatlantic cooperation in general is welcomed not only for political reasons, but also as a means to benefit from US technology.

In Germany, the aerospace industry is now integrated into EADS. Germany's leading land systems companies – Krauss-Maffei and Rheinmetall – remain independent. In naval shipbuilding, Howaldswerke-Deutsche Werft (HDW) is part of the ThyssenKrupp Marine Systems shipbuilding group. Italy, Spain and Sweden have all tried to integrate their defence industrial assets into wider international structures, without pursuing a clear European preference. The Spanish government has integrated Casa into EADS, but preferred General Dynamic's bid for Santa Barbara over Rheinmetall's offer; the Italian government has pushed Finmeccanica – with more or less success – to integrate its units into European joint ventures, but left the A 400M program and joined the F-35 program. In Sweden, Bofors was sold to US investors.

1.6 Defence industrial strategy in action: the UK case

It is worth noting the UK's defence industrial strategy both because the UK spends more on defence and defence equipment than any other EU Member State, and because it is an explicit strategy. Like France, the UK maintains a wide span of most defence capabilities (nuclear, global reach using versatile maritime expeditionary forces). From the 1980s onwards, the MoD began opening its operations to industry (e.g. privatising naval dockyards, ordnance factories, research establishment, even engaging contractors to operate its nuclear weapons research establishment), such that the MoD could claim in 2005 "that a greater proportion of our overall business is available to industry than any other major defence nation".

In response to industry's request for greater clarity, the MoD has made explicit that the UK's Ministry of Defence has a Defence Industrial Strategy (DIS) 2. It both wishes to retain an onshore Defence Industrial Base (DIB), has responsibility for defining what that base should consist of, and for ensuring that it is sustained.

The interesting point about this document is that in an age in which industrial strategy no longer has a place, and indeed, is incompatible with the rules of the EU, e.g. on trade, State Aids and public procurement, in defence, such a strategy is alive and well, and is welcomed by Parliament, industry, and the defence community.

A feature which drives the strategy is that major platforms (in the UK's case, aircraft carriers, Type 45 Destroyers, armoured fighting vehicles, the heavy lift A400M, the fast jets Typhoon and Joint Combat Aircraft) have long service lives, throughout which they will need support and upgrading by the insertion of new technologies.

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[2] Defence Industrial Strategy: Defence White Paper, Presented to Parliament by the Secretary of State for Defence, December 2005 (Cm 6697).

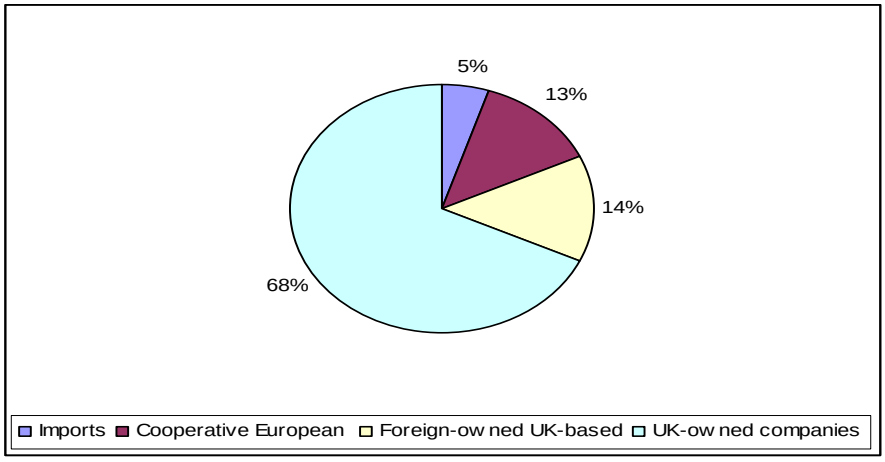
Key industrial capabilities include: "the suite of capabilities required to design complex ships and submarines and their nuclear steam raising plant, to enable their design, development, build, support, operation and decommissioning"; This represents a greater requirement than hitherto (that warship hulls should be built onshore: it now includes the ability to integrate complex and sensitive subsystems. The only issue is the capacity required). There are "compelling advantages" to retaining an armoured fighting vehicles capability (where BAE Systems supplies 95% of the MoD's current inventory) including, as with warships, the ability to design, build and integrate critical sub-systems, including electronic architecture, sensors and survivability options, and to repair and overhaul them. The DIS makes clear that the MoD will require BAE Air Systems to maintain and periodically upgrade its two new fast jets, Typhoon and the Joint Combat Aircraft.

The strategy also indicates major systems that the MoD would contemplate buying from abroad: helicopters (while sustaining Agusta Westland's systems engineering capability to support the existing fleet), small arms ammunition, and torpedoes.

A point of relevance for the Directive, and its consequences, is the importance in defence of long-term relationships with suppliers, especially when it comes to upgrading platforms in response to combat needs.[3] Economic theory predicts that, when buyer and seller need to invest in long-lived assets which are specific to an activity, each party is vulnerable to actions by the other, and that vertical integration (in this case, public ownership) is a natural outcome. That indeed has often been the case in the UK and remains so in France and Italy.

The various considerations give rise to the following procurement pattern. Even the "comparatively open" UK defence equipment market is not, by non-military standards, particularly open. In 2004-05, 68% of the MoD's expenditure was spent with UK-owned companies and only 5% was spent on imports. (In the same year, the US spent only 2% of its equipment budget on imports).

Figure.2: Source of defence equipment 2004-2005



Source: UK Secretary of State for Defence, Defence Industrial Strategy, presented to Parliament, December 2005, Defence White Paper, Cm 6697.

[3] Urgent Operational Requirements (UORs). Up until December 2007, 796 had been approved, to a value of £2.4 billion. A total of 219 UORs were approved in 2006-07 (124 for Afghanistan and 95 for Iraq) at a value of £793 million.

2. ANNEX 2: THE ECONOMIC IMPACT OF THE WIDER PROCUREMENT DIRECTIVES IN THE EUROPEAN UNION

2.1 Introduction

EU Public Procurement Directives constitute the main legislative attempt made by the European Union to deepen the Single Market via the tendering processes for public contracts, i.e. contracts commissioned by government agencies. Given that defence equipment is typically purchased by government agencies, the impacts of the EU Public Procurement Directives are of interest in considering the potential impacts of any legislative attempts to deepen the Single Market in defence equipment. The findings of past research by Europe Economics on the EU Public Procurement Directives are outlined in this Appendix.

This Annex is organised as follows:

(a) The benefits of EU Public Procurement Directives;

(b) The balance of the costs and benefits of these Directives;

(c) The parties upon whom these costs and benefits would appear to fall;

(d) The effect of the Directives on different economic sectors and public authorities;

(e) The costs and benefits that may be likely to accrue should the Directives be extended to economic sectors that have been exempt from their provisions. This section will make clear that the impacts of the Directives have varied across types of economic sector and public authority. These differences need to be taken into account when evaluating the potential impacts of any attempts to deepen the Single Market in defence equipment.

2.2 Background

In 2006 Europe Economics reported to DG Internal Market in the European Commission after evaluating the effects in the 15 Member States that were subject to the EU Procurement Directives 1992–2003. This was part of the European Commission's still relatively new policy of systematically evaluating the effects of its interventions in the EU economy, in order both to increase accountability and to help improve the basis for future policy-making.

The study commenced at the beginning of 2005. It required an economic analysis of the ways in which the Directives are likely to have affected the markets for procurement goods and services, and involved a legal review of the implementation of the Directives and new empirical research comprising 100 in-depth interviews of awarding authorities and suppliers and an electronic survey administered by the Commission Services.

The analysis that Europe Economics conducted on public procurement Directives took place against a backdrop of increasing opportunities to bid for public contracts across the EU. In 1995 only 8 per cent of total public procurement (including procurement not subject to the Directives) was published in the OJEU, while in more recent years the fraction was between 16 and 17 per cent (and even 20 per cent in the year 2003).

2.3 Benefits of Public Procurement Directives

The benefits took the following forms:

(a) **Transparency:** Nearly all suppliers and authorities interviewed thought that transparency has increased due to the Directives. Companies that have tried to enter new markets commended the OJEU publications as a significant help in providing market information.

(b) **Fairness:** Most suppliers say that the Directives have increased their expectations of a fair award procedure and that more authorities now award their contracts based on the published award criteria.

(c) **Better procurement practices:** In the opinion of most suppliers and awarding authorities the Directives have helped to improve the professionalism of procedures in public procurement. Some procurement officials say that the Directives enable them to fend off political pressure and to concentrate on value for money. (On the other hand both authorities and suppliers complain that the Directives too often require procedures which have no additional value and which reduce efficiency.)

(d) **Competition:** Most suppliers and authorities thought that, overall, the competitive pressure in procurement markets had increased. This impression was stronger in markets for the more homogenous and tradable goods and services.

(e) **Prices:** We concluded from three different sources of information the overall prices are lower than they would otherwise have been as a result of the Directives, but not by a great margin. We estimate this effect to be between 2.5 and 10 per cent of the contract value by 2002.

(f) **Quality:** Opinions were mixed on the impacts of the Directives on the quality of the goods and services purchased. For standardised products the general opinion was that the authorities now explain in more detail what they want and so receive better quality. For less standardised goods and services, however, negative opinions dominated as many suppliers thought that the technical knowledge of many authorities is not sufficient to achieve the desired quality.

2.4 Balance of costs and benefits

An exact calculus of the costs and benefits involved with the public procurement Directives is not possible but our study concluded that that the balance of costs and benefits has been significantly positive. For the overall welfare calculation we compared the compliance costs for awarding authorities and the enforcement costs with the price and quality gains resulting from increased competition. The net balance of benefits over costs is an approximation for the welfare gains to society (compliance costs for suppliers are included in the price developments as suppliers will include these in their calculations). We assumed for the purpose of this calculation that price reductions mainly reflect increased efficiency, rather than merely a transfer from producers to customers; and that savings by awarding authorities benefit those served by the authorities rather than being dissipated in internal inefficiencies. Overall we think that prices are lower than they would otherwise have been by more than 2.5 per cent (€6 billion) of contract value and that enforcement costs and compliance costs for awarding authorities are less than 0.7 per cent (€1.75 billion) of contract value. The overall welfare gain should therefore have been more than €4.25 billion a year by 2002.

2.5 Cost and benefits for the different parties

There appears to be a somewhat uneven distribution of costs and benefits.

(a) The benefit of lower prices than would otherwise have been paid accrues to the awarding authorities (and as a result, presumably, to the taxpayer or those served by the awarding authority). These benefits outweigh the costs of compliance but the balance is least favourable for complex requirements, and least for small contracts.

(b) Among the suppliers, costs and benefits are unevenly distributed. While efficient and expanding suppliers have been able to use the increased transparency and fairness in order to win additional business, other suppliers suffer from this increased competition as well as from the increased administrative costs of compliance. In the longer term, suppliers as a whole may be said to benefit from becoming more efficient.

2.6 The effect of the Directives on different economic sectors and public authorities

The Directives were in general more positive for larger awarding authorities than for small. Compliance costs increased less in relation to the value of large contracts than for small contracts so the small authorities had to bear proportionately greater cost increases. Moreover, the burden of ensuring compliance also fell harder on smaller authorities than on larger authorities, as their staff are less specialised and therefore have more difficulty in fully understanding the complex procedures and legal questions.

The Directives have increased the incentive of the authorities to increase average contract sizes, so small companies now have more problems in seeking to enter the public procurement markets. We found that small companies have on average more negative attitudes to the Directives.

The effects of the Directives on different sectors were strongly influenced by three characteristics:

(a) Complexity of specifications: In sectors where proposals contain a significant intellectual input and where proposals require correspondingly greater effort for their preparation, the attitudes towards the Directives were much more negative than elsewhere. Suppliers found that the authorities lack sufficient technical expertise to specify tenders adequately and that many of them are deterred by the Directives from seeking advice from suppliers before the tender is issued. In markets of this kind compliance costs have therefore risen by more than average and the benefits of competition have been smaller than average. Some suppliers in these markets think that the Directives have on balance made the market less competitive.

(b) Tradability of good/service: Additional competition rose most strongly in markets where no local presence is needed to conduct the contract (e.g. homogenous or standardised supplies and bulk goods) as companies did not have to change their company organisation or structure in order to compete.

(c) Market share of public sector: In sectors where a local presence is needed the Directives have only increased competition when the market share of the public sector is big enough.

As a result of these factors we found that compliance cost increases were much higher in relation to contract value in service contracts than in other contracts and that competition has increased most in supply contracts. Thus the overall balance was less positive in services than in supply.

We conducted an analysis of the exempted sectors that showed from a cost-benefit point of view, that some of the sectors (military supplies, rail transport, water transport services) offer arguments for an inclusion into the Directives as they are tradable, some of the tenders are not especially complex, and the average contract size is big.

If the Commission and Member States wish to pursue these possibilities, an ex ante impact assessment would be appropriate.

2.7 Costs and Benefits: Exempted Sectors

A number of services were freed from the full provisions of the Directives as they were regarded as less tradable than other services. Additionally military supplies were exempted in so far as national security aspects were concerned (meaning that all middle and high technology supplies would be exempt but not the low-tech supplies) and fuel for power generation was exempt for political reasons.

From our analysis of the costs and benefits of the Directives we found that overall competition has increased most in sectors that were more tradable (as local structures do not have to be built up before competing), but we also found out that the net benefits were also dependent on the complexity of the tender specification and the average size of the contracts.

The bigger a reasonable and practicable contract size and the lower the complexity of the tender specifications, the higher the probability that a formal tender process might bring significant net benefits. We have evaluated the different exempted sectors following those criteria.

Table 2.1: The Exempted Sectors

	Complexity of tender specification	Tradable	Size of contracts	Cost-Benefit Ratio[4]
Hotel and restaurant services	Low	Low	Small	-1
Rail transport services	Low	Low	Potentially large	+1
Water transport services	Low	Low	Potentially large	+1
Supporting and auxiliary transport services	Medium	Low	Medium	-1
Investigation and security services	Very diverse	Low	Very diverse	-2
Legal Services	High	Low	Small	-3
Personnel placement and supply services	Medium	Low	Small	-2
Education services	High	Low	Small	-3
Health and social Services	High	Low	Potentially large	-1
Recreational, cultural and sporting services	Very diverse	Medium	Very diverse	?
Military Supplies*	Very diverse	High	Potentially large	+3
Fuel for power generation	Low	High	Potentially large	+3

Source: Europe Economics

** Being a broad study, this previous analysis considered military supplies as a whole and did not distinguish between different categories and complexities of procured items. It was also noted that the +3 score was to be subject to a further detailed impact assessment. It should also be noted that there was no detailed consideration of the significance of exemptions such as Article 296.*

[4] For every favourable criteria (specification of low complexity, high tradability, big contracts) we awarded one plus point and for every unfavourable criteria we awarded -1 point.

The two exempted supplies sector are both tradable, while all the exempted service sectors are rated as being of low tradability (which was, of course, one of the reasons for exempting them). However, against the other criteria we have selected as important, they rate differently.

The complexity of the tender specifications is high in education, legal services and health and social services. The complexity of tender specifications for hotel and restaurant services, rail transport services, water transport services, auxiliary transport services, and also for fuel for power generation, is relatively low.

Looked at in this way it appear that:

(a) The inclusion of some military supplies and fuel for power generation into the scope of the Directives should have a positive cost-benefit result.

(b) There is no reason to exclude rail transport and water transport services from the full provisions of the Directives.[5]

(c) A case can easily be made for the continued exclusion of education services, legal services and personnel placement services on the grounds that the formulation for tender specifications requires considerable skill on the side of the awarding authorities while the average contract size is relatively small.

(d) For all other services the argument is not so clear. In restaurant and hotel services the net benefits to be derived from compliance with the Directives would probably be relatively small. In social and health services the outcome might be the reverse.

On the other hand, there is nothing to prevent those awarding authorities purchasing these services from following the practices that would apply under the Directives, and – because of limited tradability – the argument that requiring them to do so would promote the development of the Single Market is not a strong one. The purpose of the Directives is, after all, to require awarding authorities to behave in ways that are in their own proper interests. If the Commission or Member States were to be attracted by the possibility of extending the Directives to these sectors, an ex ante impact assessment would be appropriate.

Many authorities publish the contracts in these sectors, even though they are not obliged to do so. In 2004, for example, 3,729 ITTs were published in six of the exempted sectors (investigation and security service, legal services, hotel and restaurant services, personnel placement and supply services, education services, health and social services).

The extent to which the countries used the OJEU without being obliged to do so differs from country to country. In Germany, Sweden and Spain the usage was below average while Italy, Austria and Portugal made much greater use of the OJEU for the exempted sectors.

[5] The Commission has already undertaken steps in the proposed direction as it has proposed a regulation on public passenger transport services by rail and by road which, if adopted, would require public authorities entering into a contract with a third party for (among others) rail passenger services to do so on the basis of a competitive tendering procedure.

Table 2.2: Publications of ITTs in Some Exempted Sectors in 2004

	Education Services	Health and Social Services	Hotel and restaurant Services	Legal Services	Investigation and Security Services	Personell Placement Services	Sum of all six
	Percentage of total number of publications						
Austria	6.5%	0.3%	0.2%	0.1%	0.2%	0.4%	7.6%
Belgium	0.6%	0.3%	0.5%	0.6%	0.4%	0.3%	3.0%
Germany	0.2%	0.2%	0.2%	0.0%	0.4%	0.0%	1.0%
Denmark	0.4%	0.4%	1.1%	0.1%	0.2%	0.1%	2.3%
Finland	0.1%	1.6%	0.5%	0.1%	0.2%	0.1%	2.5%
France	0.4%	0.3%	1.0%	0.1%	1.0%	0.1%	2.8%
Greece	1.0%	0.1%	1.5%	0.7%	1.3%	0.1%	4.8%
Spain	0.1%	0.5%	0.4%	0.0%	0.6%	0.0%	1.5%
Ireland	0.8%	0.2%	0.4%	0.4%	0.6%	0.2%	2.6%
Italy	1.2%	3.9%	4.7%	0.0%	0.7%	0.3%	10.8%
Luxembourg	0.2%	0.2%	0.2%	0.2%	0.0%	0.4%	1.2%
Netherlands	0.6%	1.2%	0.9%	0.0%	0.2%	1.8%	4.7%
Portugal	0.0%	0.7%	3.5%	0.0%	3.8%	0.0%	8.0%
Sweden	0.2%	0.3%	0.2%	0.1%	0.3%	0.2%	1.2%
UK	0.6%	1.1%	0.6%	0.2%	0.6%	0.4%	3.6%
EU-15	0.6%	0.8%	1.1%	0.1%	0.7%	0.2%	3.6%

Source: Mapp database