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The application of EC law to defence industries—changing interpretations of Article 296 EC

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Introduction

For a long time, defence industries were considered to be entirely beyond the reach of EU law. Their function for the organization of national defence was deemed to place them at the core of national sovereignty, a space much removed from the incrementally developing purview of Community law and the increasingly expanding jurisdiction of the European Court of Justice. The validity of this view was purported to be substantiated by Article 296 EC, a rather obscure provision of the EC Treaty which refers specifically to arms, munitions and war materials.

However, recent developments have questioned this assumption, highlighted its flaws and gradually rendered defence industries at the centre of an increasingly multilayered legislative and political dialogue at EU level. These developments are legal, political and economic in nature and are all interrelated in their implications.

This Chapter will tell the story of this gradual shift of the position of defence industries from the margins of European integration to the centre of EU policy-making. In doing so, it will chart this development, explain its significance and set out its constitutional, institutional and political implications for the EU and its Member States.

The position according to primary law: Article 296 EC

The only provision in the EC Treaty referring expressly to defence industries is Article 296 EC. It reads as follows:

1. The provisions of this Treaty shall not preclude the application of the following rules:

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(a) no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

(b) any Member state may take such measures as it considers necessary for the protection of the essential interests of its security which are concerned with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.

2. The Council may, acting unanimously on a proposal from the Commission, make changes to the list, which it drew up on 15 April 1958, of the products to which the provisions of paragraph 1(b) apply.

In essence, this obscure EC Treaty provision introduces a public security derogation. However, it goes considerably further than the other similar derogations provided in the areas of free movement of goods (Article 30 EC), persons (Article 39(3) EC and Article 46 EC) and capital (Article 48(1)(b) EC) in so far as it authorizes the Member States to deviate from the entire body of EC law. It is for this reason that, while the above provisos are exceptional Article 296 EC has been viewed by the Court of Justice as ‘wholly exceptional’¹ The implications of this definition are twofold: on the one hand, there is no limit to the type of measure which a Member State may adopt and, on the other hand, in adopting such a measure, the State in question may deviate from the entire body of EC law.

The ‘wholly exceptional’ nature of Article 296 EC is further illustrated by the provision of an extraordinary procedure for judicial review. This is set out in Article 298 EC which reads as follows:

¹ Case 222/84 *Johnston*, n1 above, para. 27. See also the Opinion of AG Jacobs in Case C-120/94 *Commission v Greece (re: FYROM)* ECR I-1513 at para. 46. The other such EC provision is Article 297 EC which is remarkably badly drafted: ‘Member states shall consult each other with a view to taking together the steps needed to prevent the functioning of the common market being affected by measures which a Member State may be called upon to take in the event of serious internal disturbances affecting the maintenance of law and order, in the event of war, serious international tension constituting a threat of war, or in order to carry out obligations it has accepted for the purpose of maintaining peace and international security’. On the interpretation of this provision, see Koutrakos, ‘Is Article 297 EC “a reserve of sovereignty”?’ (2000) 37 *CMLRev* 1339.

If measures taken in the circumstances referred to in Articles 296 and 297 have the effect of distorting the conditions of competition in the common market, the Commission shall, together with the State concerned, examine how these measures can be adjusted to the rules laid down in the Treaty.

By way of derogation from the procedure laid down in Articles 226 and 227, the Commission or any Member state may bring the matter directly before the Court of Justice if it considers that another Member state is making improper use of the powers provided for in Articles 296 and 297. The Court of Justice shall give its ruling in camera.

While badly drafted and wide-ranging both in its content and implications, the ‘wholly exceptional clause’ of Article 296 EC does not grant Member states a *carte blanche*. This conclusion follows not only from the oft-repeated principle that the exceptional clauses set out in the EC Treaty ‘deal with exceptional cases which are clearly defined and which do not lend themselves to any wide interpretation’² but also from the wording of the EC Treaty provision itself. First, it is confined to the products which are described in the Article 296(2) EC list. Therefore, the reference in Article 296(1)(b) EC to ‘the production of or trade in arms, munitions and war material’ was not envisaged as an open-ended category of products. In this vein, it was not envisaged that products which may be of both civil and military application (that is dual-use goods) should be regulated by national measures deviating from the entire body of EC law. This is supported not only by the content of the Article 296(2) EC list but also the reference to the effects that such measures should not have on ‘products which are not intended for specifically military purposes’ in Article 296(1)(b) EC.

Second, national measures deviating from EC law must be deemed ‘necessary for the protection of the essential interests of [national] security’. This is quite an emphatic statement that Article 296(b) EC is not merely a public security clause: instead, it

² Case 13/68 *Salgoil Salgoil SpA v Italian Ministry for Foreign Trade* [1968] ECR 453, 463, Case 222/84 *Marguerite Johnston v Chief Constable of the Royal Ulster Constabulary* [1986] ECR 1651, para. 26..

should be invoked only when the protection of the core of national sovereignty is at stake.

Third, any reliance upon Article 296 EC should take into account the effects it may have on the status and movement of other products which fall beyond its rather narrow scope. In effect, this provision suggests that national measures deviating from EC law as a whole should not be adopted in a legal vacuum. Instead, Member States are under a duty to consider the implications that such measures may have for the common market.

Fourth, Article 298 subpara. 1 EC provides for the involvement of the Commission in cases where reliance upon Article 296 EC by a Member State would lead to distortions of competition. This provision should be interpreted in the light of the duty of loyal cooperation enshrined in Article 10 EC. In other words, a Member State invoking Article 296 EC is under a legal duty to cooperate with the Commission in order to adjust any ensuing distortions of competition to the EC rules.

Finally, any deviation from EC law pursuant to Article 296 EC is subject to the jurisdiction of the Court of Justice. The reference to the ‘improper use of the powers provided for in Article... 296’ in Article 298 subpara. 2 EC refers both to the substantive conditions which need to be met by a Member State invoking Article 296 EC (namely those regarding its scope of application, the assessment of ‘essential interests of security’) and the procedural ones (that is the duty to cooperate with the Commission inferred from Article 298 subpara. 1 EC).

Prevailing interpretations of Article 296 EC

It follows from the above that, according to a strict reading of Articles 296 and 298 EC, the right of Member States to regulate their defence industries by deviating from the entire scope of the *acquis communautaire* was confined to a specific class of products, should be exercised in accordance with certain principles, and was subject

to the jurisdiction of the Court of Justice should its exercise amount to an abuse of power. However, contrary to this interpretation, Article 296 EC was viewed for a long time as rendering defence industries beyond the scope of EC law altogether.³

On the one hand, the Member States were only too eager to assume that Article 296 EC applied to the defence products generally, without engaging in any assessment of whether the specific conditions laid down therein were met. A case in point is public procurement: as the Commission points out, the low number of publications in the Official Journal appears to imply that some Member States believe they can apply the derogation automatically.⁴ This approach was not challenged directly by the EU institutions for a long time. While none of the latter suggested that armaments were, in principle, beyond the scope of EC law, in practice they shied away from any controversy which would raise the question of the position of defence industries in the EC legal order, the extent to which this should be covered under EC law and the leeway which Member States enjoyed under Article 296 EC. It is noteworthy that, since the establishment of the Community, there has only been only one infringement action against a Member State the subject matter of which was armaments.⁵ In the context of specific procedures, such as in the area of state aids, the Commission examined the compatibility of a national measure with Article 296 EC only in terms of whether that measure applied to products intended solely for products of a specifically military nature.⁶

On the other hand, the fate of the list of products to which Article 296 (2) EC refers is indicative of the ambiguity into which the *ratio* of Article 296 EC was shrouded. While it was drawn up, as Council Decision 255/58, in April 1958, it was not published in the EC Treaty or in any official document. Over the years, it was

³ See P Koutrakos, *Trade, Foreign Policy and Defence in EU Constitutional Law* (Hart Publishing 2001) 175-182.

⁴ COM (2004) 608 fin *Green Paper on Defence Procurement*, p6.

⁵ Case C-414/97 *Commission v Spain* [1999] ECR I-5585. See the analysis in M Trybus, *European Union Law and Defence Integration* (Hart Publishing 2005) 152-154.

⁶ See, for instance, Dec. 1999/763/EC on the measures, implemented and proposed, by the Federal State of Bremen, Germany in favour of Lürssen Maritime Beteiligungen GmbH & Co KG [1999] OJ L 301/8.

published in certain academic publications⁷ and it was only in 2001 when it became publicly available by the European Commission in a response to a question at the European Parliament.⁸ The list is quite broad.⁹ This rather elusive quality of the list appeared to enhance the general view that defence industries were somehow afforded a special kind of protection under EU law.

Gradually questioning old assumptions: legal and economic developments

In the 1990s, a cautious and distinctly gradual shift developed in relation to the position of Article 296 EC in our EU vocabulary. This was due to a variety of factors. One of them was the case-law of the EU Courts. The first judgment on the applicability of Article 296 EC was delivered by the Court of Justice in Case C-414/97 *Commission v Spain*.¹⁰ This was about Spanish legislation exempting from VAT intra-Community imports and acquisitions of arms, munitions and equipment exclusively for military use. The Sixth VAT Directive excluded aircraft and warships. The action against Spain was brought because the relevant Spanish rules also covered an additional range of defence products. The Spanish Government argued that a VAT exemption for armaments constituted a necessary measure for the purposes of guaranteeing the achievement of the essential objectives of its overall strategic plan and, in particular, to ensure the effectiveness of the Spanish armed forces both in national defence and as part of NATO.

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⁷ See H Wulf (ed.) *Arms Industry Limited* (OUP 1993) at 214.

⁸ Written Question E-1324/01 [2001] OJ C 364E/85.

⁹ It covers the following categories, some of which are further divided into subcategories: 1. Portable and automatic firearms. 2. Artillery, and smoke, gas and flame throwing weapons. 3. Ammunition for the weapons at 1 and 2 above. 4. Bombs, torpedoes, rockets and guided missiles. 5. Military fire control equipment. 6. Tanks and specialist fighting vehicles. 7. Toxic or radioactive agents. 9. Warships and their specialist equipment. 10. Aircraft and equipment for military use. 11. Military electronic equipment. 12. Cameras specially designed for military use. 13. Other equipment and material. 14. Specialised parts and items of material included in this list insofar as they are of a military nature. 15. Machines, equipment and items exclusively designed for the study, manufacture, testing and control of arms, munitions and apparatus of an exclusively military nature included in this list.

¹⁰ See n5 above.

The Court of Justice held that, as in other public safety clauses set out in the EC Treaty, ‘it is for the Member State which seeks to rely on those exceptions to furnish evidence that the exemptions in question do not go beyond the limits of such cases’.¹¹ It went on to point out that ‘Spain has not demonstrated that the exemptions provided for by the Spanish Law are necessary for the protection of the essential interests of its security. It is clear from the preamble to [the relevant national] Law that its principal objective is to determine and allocate the financial resources for the reinforcement and modernization of the Spanish armed forces by laying the economic and financial basis for its overall strategic plan. It follows that the VAT exemptions are not necessary in order to achieve the objective of protecting the essential interests of the security of the Kingdom of Spain’.¹²

In addition to the above, the Court reiterated an economic argument, already made by Advocate General Saggio: ‘the imposition of VAT on imports and acquisitions of armaments would not compromise that objective since the income from payment of VAT on the transactions in question would flow into the State’s coffers apart from a small percentage which would be diverted to the Community as own resources’.¹³

The judgment is characterized by a distinct focus on a construction of Article 296 EC which would not render it a *carte blanche* for the Member States. The conditions laid down in that provision were viewed as substantive conditions which needed to be met in a manner about which Member States need to convince the Court of Justice. This appeared to remove defence industries from a twilight zone of EC law and put the onus on the Member States for to justifying their exceptional status of particular defence industries on a case-by-case basis.

¹¹ Para. 22. For the strict interpretation of the exemptions set out in the public procurement measures, see Case C-324/93 *R v Secretary of State for the Home Department, ex parte Evans Medical and MacFarlane Smith LTD* [1995] ECR I-563 at para. 48.

¹² See n5 above, para. 22.

¹³ Ibid, para. 23.

Four years, later, in 2003, the Court of First Instance delivered a judgment in Case T-26/01 *Fiocchi*.¹⁴ In this case, the applicant, an Italian undertaking operating in the arms and munitions manufacturing and marketing sector, complained to the Commission about subsidies granted by the Spanish government to a Spanish arms production undertaking and enquired about their compatibility with the EC Treaty competition provisions as well as Article 296 EC. The Commission, then, entered in communication with the Spanish Government and requested information from the Spanish Government as to the nature and amount of the aid granted. When more than 15 months had passed and , the applicant had heard nothing, it brought an action against the Commission for a declaration of failure to act.

It is interesting that the Spanish undertaking which received the subsidies in question also produced engines for civil aviation and components for olive oil decanting equipment. This illustrates that type of issues which the Commission needs to explore in cases of alleged use of Article 296 EC. The action was dismissed by the CFI as inadmissible, because the Commission, following the complaint by the applicant, had defined its position and, therefore, there was no failure to act within the meaning of Article 232 EC. Nevertheless, the CFI did engage in an examination of both Articles 296 EC and 298 EC. In relation to the former, it acknowledged the ‘particularly wide discretion [conferred on the Member States] in assessing the needs receiving such protection’ under Article 296 EC. However, the CFI made it clear that the special protection set out in that provision is limited to the Article 296(2) EC list.¹⁵

In relation to the latter, tThe CFI also referred to the bilateral examination which it set out to be carried out by tthe Commission and the Member State concerned are required to carry out under Article 298 EC and pointed out that the Commission former is not under no duty required to adopt a decision concerning the measures at issue at the conclusion of the examination; provided therein; the Commission has not power to address a final decision or directive to the Member State concerned.

Comment [CB1]: What does ‘it’ refer to – the list?

¹⁴ [2003] ECR II-3951.

¹⁵ To that effect, see also the Opinion of AG Jacobs in Case C-367/89 *Richardt et Les Accessoires Scientifiques SNC* [1991] ECR I-4621 at para. 30.

In terms of the substance of the dispute, the applicant argued that the subsidies in question benefited the export activities of the company receiving them and, as such, fell beyond the scope of Article 296 EC. This was a point which the Commission pursued with the Spanish authorities and whose explanations appeared to be deemed credible. .

Comment [CB2]: Do you know what the outcome was?

Finally, the Court of Justice reinforced the wholly exceptional nature of Article 296 EC in three rulings on the application of sex equality rules in the armed forces. In Case C-273/97 *Sirdar*,¹⁶ Case C-285/98 *Kreil*¹⁷ and *Dory*,¹⁸ it ruled that all the EC Treaty exceptional provisions, including Article 296 EC,

‘deal with exceptional and clearly defined cases. It is not possible to infer from those articles that there is inherent in the Treaty a general exception covering all measures taken for reasons of public security. To recognise the existence of such an exception, regardless of the specific requirements laid down by the Treaty, might impair the binding nature of Community law and its uniform application’.¹⁹

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In addition to the correct interpretation of Article 296 EC stressed by the Court in its case-law, another development which questioned the validity of the position of defence industries as entirely beyond the reach of EC law was of the change of political and economic nature of the climate. Following the end of the Cold War, the defence industries in the Member States suffered from considerable financial and structural problems: fragmentation and divergence of capabilities, excess production capability in certain areas and shortages in others, duplication, short production runs, reduced

¹⁶ [1999] ECR I-7403.

¹⁷ [2000] ECR I-69.

¹⁸ [2003] ECR I-2479.

¹⁹ Case C-273/97 *Sirdar*, n16 above at paras 16, Case C-285/98 *Kreil*, n17 above at para. 16 and Case C-186/01 *Dori*, n18 above at paras 30-31. For a comment, see P Koutrakos, ‘How far is far enough? EC law and the organisation of the armed forces after *Dory*’, (2003) 66 *Modern Law Review* 759 and M Trybus, *European Union Law and Defence Integration* (2005 Oxford, Hart Publishing, 2005) Ch. 6.

budgetary resources, and failure to engage in increasingly costly research.²⁰ This highly fragmented state gave rise to a number of initiatives, originating in both industry and State bodies, to achieve a degree of convergence which would enhance the competitiveness of the European defence industries.

Against this background of economic and structural deterioration, the European Commission took the initiative in the late 1990s and put forward a comprehensive approach to the restructuring and consolidation of the defence industries of the Member States. Based on an assessment of the economic problems and challenges facing their fragmented state in an increasingly globalised market,²¹ it adopted a document entitled *Implementing European Union Strategy on Defence Related Industries*.²² This suggested a detailed set of legal measures which was comprehensive in scope and covered areas such as public procurement, defence and technological development, standardisation and technical harmonisation, competition policy, structural funds, export policies and import duties on military equipment. This document articulated the need for a wide synergy of Community, EU, national and international measures whilst affirming the link between their subject matter and the core of national sovereignty.

However, this initiative was not taken up by the Member States. In response to a request by the European Parliament, the Commission returned to the issues raised by the need for the consolidation of the defence industries in 2003. In a document adopted that year, it reiterated the need for a coherent cross-pillar approach to the legal regulation of defence industries with special emphasis on standardisation, intra-Community transfers, competition, procurement, exports of dual-use goods and research.²³

²⁰ See, amongst others, A. Georgopoulos, 'The European Armaments Policy: A condition sine qua non for the European Security and Defence Policy?' in M Trybus and N White, *European Security Law* (Oxford, OUP 2007) 198 at 203-205.

²¹ COM(96) 10 final *The Challenges facing the European Defence-Related Industry. A Contribution for Action at European Level*, adopted on 24/1/1996.

²² COM(97) 583 final, adopted on 12/11/1997.

²³ COM(2003) 113 fin *European Defence – Industrial and Market Issues. Towards an EU Defence Equipment Policy* (adopted on 11/3/2003).

The recent initiative by the Commission: clarifying the application of Art. 296 EC

In December 2006, the Commission adopted the *Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement*.²⁴ Its objective is ‘to prevent possible misinterpretation and misuse of Article 296 EC in the field of defence procurement’ and ‘give contract awarding authorities some guidance for their assessment whether the use of the exemption is justified’.²⁵

Drawing upon the wording of Article 296 EC and the Court’s case-law on the interpretation of the exceptional clause set out in primary and secondary legislation, the thrust of the Commission’s initiative is that ‘both the field and the conditions of application of Article 296 EC must be interpreted in a restrictive way’. In relation to the former, and drawing upon the CFI judgment in *Fiocchi*, it is argued that the material scope of Article 296 EC is confined to the Article 296(2) EC list which is ‘sufficiently generic to cover recent and future developments’, therefore enabling the exceptional clause to cover the procurement of services and works directly related to the goods included in the list, as well as modern, capability-focused acquisition methods.²⁶ However, it would not cover dual-use goods, for whose procurement security interests may justify the exemption of EC rules only on the basis of the exceptional clause set out in the Public Procurement Directive.²⁷

In relation to the conditions of application of Article 296 EC, the Commission acknowledges the wide discretion granted to a Member State in order to determine whether its essential security interests ought to be protected by deviating from EC

Comment [TC3]: Should this read ‘discretion’?

²⁴ COM(2006) 779 final, adopted on 7 December 2006. On the area of defence procurement, see M Trybus, *European Defence Procurement Law* (Kluwer 1999).

²⁵ p3.

²⁶ p5.

²⁷ On the other hand, the Commission argues that the procurement of dual-use goods may be covered by Art. 296(1)(a) EC ‘if the application of Community rules would oblige a Member State to disclose information prejudicial to the essential interests of its security’ (p6).

law. However, this discretion is not unfettered. To that effect, it is argued that any interests other than security ones, such as industrial or economic, cannot justify recourse to Article 296 EC even if they are connected with the production of and trade in arms, munitions and war material.²⁸ Furthermore, the reference in Article 296 EC to ‘essential security interests’ is viewed as ‘limit[ing] possible exemptions to procurements which are of the highest importance for Member States’ military capabilities’.²⁹

The Commission’s Communication, then, refers to the role of the Member States. It states that it ‘is the Member States’ prerogative to define their essential security interests and their duty to protect them. The concept of essential security interests gives them flexibility in the choice of measure to protect those interests, but also a special responsibility to respect their Treaty obligations and not to abuse this flexibility’.³⁰ This general understanding of the Member States’ role is further defined in relation to public procurement. The Commission argues that ‘the only way for Member States to reconcile their prerogatives in the field of security with their Treaty obligations is to assess with great care for each procurement contract whether an exemption from Community rules is justified or not. Such *case-by-case assessment* [emphasis in the original] must be particularly rigorous at the borderline of Article 296 EC where the use of the exemption may be controversial’.³¹

The corollary of the above is the careful definition of the role of the Commission. It is described as follows:³²

²⁸ To that effect, it is argued that ‘indirect non-military offsets which do not serve specific security interests but general economic interests, are not covered by Article 296 EC, even if they are related to a defence procurement contract exempted on the basis of that Article’ (p7).

²⁹ Ibid.

³⁰ Ibid.

³¹ P8. The document goes on to mention the particular questions which need to be addressed by the national authorities: ‘which essential security interest is concerned? What is the connection between this security interest and the specific procurement decision? Why is the non-application of the Public Procurement Directive in this specific case necessary for the protection of this essential security interest?’ (ibid).

³² Ibid.

It is not for the Commission to assess Member States' essential security interests, **nor** which military equipment they procure to protect those interests. However, as guardian of the Treaty, the Commission may verify whether the conditions for exempting procurement contracts on the basis of Article 296 TEC are fulfilled.

Comment [TC4]: Should this be 'nor'?

In such cases, it is for Member States to provide, *at the Commission's request*, [emphasis in the original] the necessary information and prove that exemption is necessary for the protection of their essential security interests. The Court of Justice has repeatedly stated that "Article 10 EC makes it clear that the Member States are required to cooperate in good faith with the enquiries of the Commission pursuant to Article 226 EC, and to provide the Commission with all the information requested for that purpose" [Case C-82/03 *Commission v Italy*, para. 15]. This concerns all investigations carried out by the Commission as guardian of the Treaty, including possible verifications of the applicability of Article 296 EC to defence contracts.

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

The Commission's initiative does not advocate either the abolition or the revision of Article 296 EC. In the past, such radical solutions had been advocated by the European Parliament³³ which had viewed them as essential to the full application of the *acquis communautaire* to the defence industries.³⁴ Instead, this wholly exceptional provision appears to carry out an understandable function in the whole context of EC law, namely to ensure that certain activities associated with the core of national sovereignty are not subject to the rules and principles set out in the EC Treaty and

³³ See, for instance, Resolution A3-0260/92 on the Community's role in the supervision of arms exports and the armaments industry [1992] OJ C 284/138 at 142 and Resolution on the need for European controls on the export or transfer of arms [1995] OJ C 43/89 at 90, Resolution A3-0260/92 [1992] OJ C 284/138 at 142.

³⁴ The Parliament adopted subsequently a subtler position, asking for the revision of Article 296 EC and even pointing out its potential usefulness in shielding European defence industries from coming under the control of third-country companies: Report A4-76/97.

articulated by the Court of Justice. It is interesting that, in its effort to justify the retention of Article 296 EC, the Commission actually engages in a creative exercise of adjusting and updating the Article 296 (2) EC list: it states that it the list should be interpreted in a way which recognises developments in technology since the list was drawn up, and the different practices now employed to procure such items, such as ‘modern, capability-focused acquisition methods’ and the inclusion of contracts for related services and works.³⁵

In its document, the Commission draws upon the very limited case-law of the EU judiciary time and again. By doing so, not only does it substantiate its approach but it also suggests that its initiative aims at consolidating and clarifying the existing position rather than introducing change in a highly sensitive area. The extent to which the Commission draws upon the Court’s case-law is by no means a novelty. It certainly lacks the direct interaction underpinning its response to the judgment in *Cassis de Dijon* where it underlined the latter’s policy ramifications introduced by *Cassis* and where it signalled a shift in the model of regulatory intervention.³⁶ Neither does it suggest such a direct policy effect as that underpinning the revision of the common rules on exports of dual-use goods where Regulation 1334/2000 abandoned the previous inter-pillar regime³⁷ and introduced new rules exclusively based on the Community legal framework with express reference in its preamble to the judgments in *Werner*³⁸ and *Leifer*.³⁹ Instead, the emphasis in the Commission’s document on the Court’s rulings aims to confine Article 296 EC to its proper context by clarifying the conditions under which Member States may invoke it.

Furthermore, the Communication stresses the role of the Member States and the discretion which they enjoy in assessing whether the protection of their security warrants reliance upon Article 296 EC – the prerogative of the Member States to define their essential security interests is acknowledged time and again throughout the

³⁵ N24 above, p5.

³⁶ ‘Communication from the Commission regarding the *Cassis de Dijon* judgment’, [1980] OJ C 256/2.

³⁷ That was established under Regulation 3381/94 [1994] OJ L 367/1 and Decision 94/942/CFSP [1994] OJ L 367/8.

³⁸ Case C-70/94 [1995] ECR I-3189.

³⁹ Case C-83/94 [1995] ECR -3231.

document. What the Commission does not do is to bring this point to its natural conclusion and be clearer as to the corollary of the wide discretion enjoyed by the Member States, namely the inherently limited control which the Court of Justice may exercise pursuant to Article 298 EC. In another, albeit related, context, that of exports of dual-use goods, the Court of Justice stressed the discretion enjoyed by national authorities when adopting measures they deem necessary in order to guarantee public security and pointed out that it was **its the exercise** of their discretion in accordance with the principles of necessity and proportionality which was to be determined by national courts.⁴⁰ In yet another context, that of Article 297 EC, Advocate General Jacobs stressed the highly subjective nature of the assessment that national authorities are called upon to make and the corresponding paucity of judicially applicable criteria for the exercise of judicial control of high intensity.⁴¹ In this vein, it is suggested that, in terms of the essential interests of national security, the Commission, in the context of Article 298 subparagraph 1 EC and the Court of Justice, in the context of Article 298 subparagraph 2 EC, would only seek to establish only whether the argument put forward by the national Government is unreasonable.⁴² This interpretation, which differs from the application of the traditional proportionality test, is consistent with the wording and the general scheme of Articles 296 EC and 298 EC.

Comment [TC5]: What does 'its' relate to?

Finally, the emphasis on the limited material scope of Article 296(1)(b) EC, the consultation procedure set out in order to address any ensuing distortions of competition under Article 298 subpara. 1 EC, and the role of the Commission, all point towards the proceduralisation of the exceptional powers set out in Article 296 EC. This approach would allow the Commission to become more involved in cases where national authorities invoke this provision. Indeed, the entire Communication reads like a statement of intent, declaring the Commission's readiness to step into areas of high political sensitivity. This political character of the document should not be underestimated, all the more so as the interpretation put forward is rather stating what, from a legal point of view, has been obvious. This political dimension is also recognised by the Commission which seeks to strike the balance between its more

⁴⁰ See, for instance, Case C-367/89 *Richardt*, n15 above, at paras 20 and 25.

⁴¹ N1 above .

⁴² See Koutrakos, n3 above, at 189-191.

pronounced role and the discretion enjoyed by the Member States. For instance, it is stated that ‘in evaluating possible infringements, the Commission will take into account the specific sensitivity of the defence sector’.⁴³

Comment [TC6]: This is all very interesting.

In the light of the above, the content, emphasis and tone of the Commission’s Communication suggest a gradual shift towards the normalisation of the application of Article 296 EC: rather than enabling Member States to approach it as the source of legal ambiguity and political sensitivity, it is to become subject to the Community law mechanisms of interpretation and enforcement, account being taken of the political and economic specificity of the defence industries. This is a significant development not only because of the apparent political sensitivity of the area, but also because of the number of developments and initiatives which have rendered placed the defence industries at the centre of EU legislative and political **dialogue**. It is within this context, outlined in the following section, that Article 296 EC, and the Commission’s recent approach to it, need to be assessed.

Comment [TC7]: Can you give some examples?

Policy initiatives within the EC legal order and beyond

The Commission’s recent expression of intent to enforce a stricter interpretation of Article 296 EC is not an isolated and random measure. Instead, it was designed as part of a wider and concerted host of policy initiatives focused on the rationalisation of the European defence industries.

These initiatives, outlined in advance and in a state of gestation for some time,⁴⁴ were formalised and presented in December 2007 as the Commission’s ‘defence package’. This consists of three measures. The first is a Communication on the competitiveness of the defence industry in which the Commission sets out a number of measures which would strengthen the European defence market.⁴⁵ These include common

⁴³ N24 above, p9.

⁴⁴ In March 2003, it adopted a document in which it sought to define the various strands of an effective defence equipment policy (COM(2003) 113 fin *Communication on European Defence – Industrial and Market Issues: Towards an EU Defence Equipment Policy*). This deals with issues such as standardisation, intra-Community transfers, competition, procurement, export controls of dual-use goods and research.

⁴⁵ COM(2007) 764 fin (along with the other two documents, this was adopted on 5 December 2007).

procurement rules, rules on intra-community transfers, the promotion of the use of common standards, the development of an EU system on security of information, the possibility of a common control system of strategic defence assets, and a host of measures aimed at improving overall coordination between national authorities in the process of defence planning and investment.

The first two of the above measures were further articulated by the Commission in the form of specific legislative proposals adopted on the same date. In the area of defence procurement, a proposal for a Directive on public procurement of arms, munitions, war material, and related works and services was put forward.⁴⁶ Following from a long period of consultation,⁴⁷ this proposal is based on the assumption that the highly fragmented state of the defence markets has serious implications for the European taxpayer, the competitiveness of the European defence industries and the effectiveness of the European Security and Defence. The main objective of this proposal is to introduce transparency and non-discrimination in an area where legal ambiguity and political considerations have imposed national solutions on the basis of considerations often at odds with economic efficiency. A central feature of the proposed Directive is the acknowledgement of the specific requirements of defence procurement: its preamble refers to them ‘in terms of complexity, security of information or security of supply’.⁴⁸ To that effect, provision is made to allow Member States flexibility in the process of the negotiation of all aspects of the award as well as to impose specific clauses in order to ensure the confidentiality of sensitive information.

The second proposal adopted by the Commission in December 2007 is for a Directive on intra-Community transfers.⁴⁹ It targets the existing divergent national licensing regimes and suggests their simplification and harmonisation. Its aim is twofold: on the one hand to facilitate specialisation and industrial cooperation within the EU, hence, strengthening the European defence industries; on the other hand, to improve security of supply of European defence products for Member States.

⁴⁶ COM(2007) 766 fin.

⁴⁷ In September 2004, the Commission had adopted COM(2004) 608 final in which it introduced the idea for a specific EC Directive in the area. The results of the public consultation process were presented in December 2005 in COM(2005) 626 final *Communication on the results of the consultation launched by the Green Paper on Defence Procurement and on the future Commission initiatives*.

⁴⁸ N46 above, para. 25.

⁴⁹ COM(2007) 765 fin.

In addition to the above, the Commission has also dealt with the area of research and development. In 2004, it produced a document about the need to focus on research and development in the area of security.⁵⁰ The main tenet of this proposal is the development of a coherent security research programme at EU level which would be ‘capability-driven, targeted at the development of interoperable systems, products and services useful for the protection of European citizens, territory and critical infrastructures as well as for peacekeeping activities’ whilst also directly linked to ‘the good functioning of such key European services as transport and energy supply’.⁵¹ Four different areas are targeted: consultation and cooperation with users, industry and research organisations under the umbrella of a European Security Research Advisory Board; the establishment of a European Security Research Programme implemented as a specific programme with its own set of procedures, rules for participation, contracts and funding arrangements; cooperation with other institutional actors established under the CFSP and ESDP framework and especially the European Defence Agency; the establishment of a structure which would ensure the flexible and effective management of the European Security Research Programme. In addition to the above, the Commission also adopted a Green Paper on Defence Procurement.⁵²

So far, this section has examined the various initiatives undertaken by the Commission in order to address the status and rationalisation needs of the European defence industries within the Community legal order. However, there is a parallel development seeking to serve similar objectives and originating beyond the Community legal order. This development follows directly from the process of the drafting of the Treaty Establishing a Constitution for Europe. Whilst While this Treaty proved to be ill-fated, it is significant in the context of this analysis because it provided for a number of innovations which were in fact taken up by the EU institutions as a matter of policy prior to the protracted death of the Treaty and which are maintained in the Lisbon Treaty.

⁵⁰ COM(2004) 590 final *Security Research: The Next Step*.

⁵¹ Ibid at 4.

⁵² COM(2004) 608 final.

The Constitutional Treaty provided for the establishment of an agency under the name of European Defence Agency (EDA) which would be specialised in the area of defence capabilities development, research, acquisition and armaments.⁵³ This was reproduced in the Lisbon Treaty, according to which the Agency ‘shall identify operational requirements, shall promote measures to satisfy those requirements, shall contribute to identifying and, where appropriate, implementing any measure needed to strengthen the industrial and technological base of the defence sector, shall participate in defining a European capabilities and armaments policy, and shall assist the Council in evaluating the improvement of military capabilities’.⁵⁴

However, the establishment of this Agency became an issue separate from the fate of the Constitutional Treaty. Following a decision by the Thessaloniki European Council in June 2003, the Council set up an intergovernmental agency in the field of defence capabilities pursuant to a Joint Action in July 2004.⁵⁵ The objective of the Agency is ‘to support the Council and the Member States in their effort to improve the EU’s defence capabilities in the field of crisis management and to sustain the ESDP as it stands now and develops in the future’ without prejudice to either the competences of the EC or those of the Member States in defence matters.⁵⁶ The tasks carried out by EDA are in the areas of defence capabilities development, armaments cooperation, European Defence Technological and industrial base and defence equipment market, and research and technology.

A general assessment of the function and record of EDA is beyond the scope of this Chapter.⁵⁷ Instead, it is its more recent initiative in the area of defence procurement which is relevant. In November 2005, the Defence Ministers of all the then

⁵³ Article I-41(3) subpara. 2.

⁵⁴ Art. 28A(3) TEU as amended by the Lisbon Treaty (this reproduces Article I-41(3) subpara. 2 of the Constitutional Treaty. Further, see Article 28 D TEU as introduced by the Lisbon Treaty.

⁵⁵ 2004/551/CFSP [2004] OJ L 245/17. See also Council Dec. 2003/834/EC creating a team to prepare for the establishment of the agency in the field of defence capabilities development, research, acquisition and armaments [2003] OJ L 318/19.

⁵⁶ Ibid, Articles 2(1), 1(2) and 2(2).

⁵⁷ See A. Georgopoulos, *The New European Defence Agency: Major Development or Fig Leaf?* (2005) 14 *Public Procurement Law Review* 103, P. Koutrakos, *EU International Relations* (2006 Hart) 473-475, M. Trybus, “The new European Defence Agency: a contribution to a common European security and defence policy or a challenge to the Community *acquis*?” (2006) 43 *CMLRev* 667

participating Member States,⁵⁸ agreed a voluntary code on defence procurement. This entered into force on 1 July 2006.⁵⁹ This Code applies to contracts worth more than €1m which are covered by Article 296 EC.⁶⁰ It sets out to establish a single online portal, provided by the EDA, which would publicize procurement opportunities. It is based on objective award criteria based on the most economically advantageous solution for the particular requirement. Furthermore, it provides for debriefing, whereby all unsuccessful bidders who so request will be given feedback after the contract is awarded. The regime provides for exceptions for reasons of pressing operational urgency, follow-on work or supplementary goods and services, and extraordinary and compelling reasons of national security. An interesting aspect of this regime is its focus, amongst others, on small and medium-sized enterprises and non-traditional supplies. The development of the portal for industry contract opportunities enables them to find sub-contracting opportunities listed in the same place, and, hence, help them in a tangible manner to participate in the developing transnational market.

The objective of this regime is to introduce transparency in defence procurement and increase the competitiveness of defence industries. The EDA considers the regime a success. In the first year of its application, governments advertised nearly 200 contract opportunities worth approximately €10 billion on the European Bulletin Board online portal. In its Report on European Security and Defence Policy, approved by the Council in June 2007, the German Presidency stated that the Agency ‘was proving itself a fully effective instrument’⁶¹ and implementation of the Code of Conduct was seen as ‘successful’.⁶²

⁵⁸ With the exception of Denmark, which has a permanent opt-out in the area of defence pursuant to Protocol 5 annexed to the Amsterdam Treaty. Currently all the other Member states participate, with the exception of Bulgaria and Romania which currently consider joining this regime.

⁵⁹ http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/misc/87058.pdf

⁶⁰ It excludes nuclear weapons and nuclear propulsion systems, chemical, bacteriological and radiological goods and services, and cryptographic equipment, as well research and technology and collaborative procurements. Contracts which fall beyond the scope of Article 296 EC are covered by the EC public procurement secondary legislation. According to Article 10 of Dir. 2004/18/EC on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts [2004] OJ L 134/114, ‘[t]his Directive shall apply to public contracts awarded by contracting authorities in the field of defence, subject to Article 296 of the Treaty.’

⁶¹ Document 10910/07, at p19.

⁶² Ibid at p20.

A multilayered approach: incrementally towards relative normalisation

This Chapter has highlighted the development of a gradual shift of the legal position of defence industries from a *terra incognita* shrouded by legal ambiguity to a legal space within the Union constitutional order and the Community legal order where it attracts institutional attention both at supranational and intergovernmental level. The combined effect of the initiatives outlined above is the gradual normalisation of the position of defence industries and the growing emphasis on the relevance of EU law to its consolidation and restructuring. This normalisation is facilitated by the emphasis on the economic argument for the reliance upon common formulas. It is noteworthy that a starting point for all the Commission's initiatives is the stagnation and lack of competitiveness of the European defence industries. In an interesting parallel, the Commission recently proposed the imposition of criminal sanctions for serious violations of EC rules on exports of dual-use goods in order to ensure their effective application.⁶³ Following the judgment in C-176/03 *Commission v Council (re: environmental crimes)*,⁶⁴ it suggested the application of this controversial instrument in an area which had been viewed for a long time to be too sensitive for Community regulation. It remains to be seen whether this proposal will be taken up.⁶⁵ It will be recalled that in the area of dual-use goods it was following two judgments of the Court of Justice⁶⁶ when that the export of such products became subject to the full discipline of EC law. Be that as it may, and whilstWhile the analogy with the legal regime of defence industries can only go so far, this is an interesting example of how 'legal normalisation' may occur in areas of acute political sensitivity.

However, it should be stressed that the origins of this gradual shift towards normalisation have been political as well as economic and legal. The development of

⁶³ COM (2006) 829 final *Proposal for a Council Regulation setting up a Community regime for the control; of exports of dual-use items and technology*.

⁶⁴ [2005] ECR –I-7879.

⁶⁵ The judgment in Case C-440/05 *Commission v Council (re: Ship Source Pollution)*, delivered on 23 October 2007, not yet reported, does not affect the substance of the Commission's proposal.

⁶⁶ Case C-70/94 *Werner*, n38 above, and Case 83/94 *Leifer* n39 above.

the European Security and Defence Policy, the emphasis on the Union's security identity in the process of drafting and debating the Constitutional Treaty, the range of operations undertaken by the European Union around the world, all point towards the increasing significance of this policy for the development of the EU. This underlines, inevitably, the significance of its effectiveness which is undermined by the serious problems facing the defence industries. Therefore, a European defence industry riddled with economic problems would always prove to be an inherent limit to the effectiveness and efficiency of ESDP. This political dimension is central to the recent Commission's initiatives. In the proposed Directive on defence procurement, for instance, the very first recital of the preamble states that '[t]he gradual establishment of a European defence equipment market is essential for strengthening the defence industrial and technological base in Europe and developing the military capabilities required to implement the European Security and Defence Policy'.⁶⁷

Comment [TC8]: Is there a word missing here?

It is interesting that one of the main contributions of the process of drafting, negotiating and ratifying the Constitutional Treaty should be to render the ESDP, an intergovernmental policy *par excellence*, at the very centre of the Union's development and create the momentum for addressing the requirements for its effectiveness. The fate of the Constitutional Treaty did not undermine this momentum as illustrated, at policy level, by the initiatives of supranational as well as intergovernmental actors in this area which had been considered, until recently, alien to any common regulatory initiative imposed from above. In this vein, it is noteworthy that the European Security and Defence Policy is the most popular EU policy: the January 2007 Eurobarometer shows a 75% score of approval for having such a policy (in UK this the figure was 57% - ; only Sweden and Ireland scored lower). In other words, there is a clear political as well as economic imperative for the rationalisation of the defence industries.

However, precisely because of the political underpinnings of any effort to rationalise the defence industries, the process suggested by the recent initiatives outlined in this

⁶⁷ N46 above at 10.

Chapter is bound to be met with caution, be long in its elaboration and not devoid of uncertainties in its application. Put it differently, the process of normalisation suggested above will be inherently relative in its substance and effects. At an institutional level, the developing position of defence industries is addressed on the basis of an approach which is multilayered in its scope and involves a variety of institutional actors. It suggests reliance upon legal as well as voluntary measures and engages the EC and the intergovernmental level of governance for its implementation. Whilst While this approach addresses the multifarious dimensions of, and interests underpinning, the regulation of defence industries, it would also give rise to inter-institutional tensions which may slow down the process and hamper its effectiveness. For instance, it will be interesting to see how the Commission's initiative in the area of defence procurement would work along with the EDA Code of Conduct. Whilst their scope of application differs (the former applies to products covered by Article 296 EC, whilst the latter applies to products beyond the scope of Article 296 EC), the definition of the dividing line between the two is likely to be less clear cut than the Commission services envisage. The Commission is keen to stress the complementary nature of these initiatives.⁶⁸ However, any inter-institutional disputes in this area would be bound to be exacerbated by the political underpinnings of their subject-matter.

In terms of policy-making, for all the activity in the legislative sphere, the political will of the Member States for any substantial progress to be achieved is vital. This is not only in relation to the extent to which the Member States decide to commit themselves to this process, but also, in substantive terms, their willingness to bring about a convergence in their views of procurement policy.⁶⁹ Such commitment is essentially political in nature and cannot be forced on the Member States by means of

⁶⁸ In its document, the Commission states that it 'will ... follow with great interest the development of the Code of Conduct' and points out that this 'kind of intergovernmental initiative would usefully complement the initiatives taken at Community level'. See also Answer to Written Question E-5644/2006.

⁶⁹ In the context of the consultation in advance of the Commission's Interpretative Communication on Article 296 EC, UNICE (The Confederation of European Business, renamed in January 2007 Europe Business) pointed out the different fundamental views of procurement policy of the Member States. (November 2006).

secondary legislation.⁷⁰ In this respect, knowing the limits of the function of legal rules is to know how to rely upon them and with which other initiatives to combine them. In this respect, a related factor which will test the viability of the Commission's proposals is the climate of economic nationalism⁷¹ which appears to be increasingly popular in a number of Member States. Taking the form of measures preventing the takeover of domestic companies deemed 'national champions' from by other EU companies, national governments did not hide their willingness to adopt such tactics in high profile cases in Germany, France, Italy, Spain and Poland last year.⁷²

Conclusion

This Chapter told the story of a policy shift regarding an industry associated with the core of national sovereignty: once shrouded in legal ambiguity, political sensitivity and institutional caution, defence industries are gradually brought towards the centre of the EU constitutional framework and the Community legal order. The central position of their rationalisation for the effective conduct of the European Security and Defence Policy has created a political imperative which neither the Community institutions nor the Member states can afford to ignore. Viewed from this angle, the new interpretation of Article 296 EC suggested by the Commission along with the legislative proposals which it unveiled in December 2007 are welcome.

While the problems which their adoption would face should not be underestimated,⁷³ Whether they will be accepted by the Member States and, if so, to what extent, remains to be seen.

Comment [TC9]: This is a rather weak phrase...

⁷⁰ To that effect, see the French response to the Commission's Green Paper on Defence Procurement.

⁷¹ The French ex-Prime Minister De Villepin used the term 'economic patriotism': see *Financial Times*, 6 February 2007.

⁷² Indeed, in the recent financial scandal which hit the bank Société Générale, a number of senior politicians, including the European Affairs Minister, suggested that any foreign takeover attempt should be fought by the State, provoking a stern warning by Commissioner McCreevy: see *International Herald Tribune*, 31 January 2008.

⁷³ For instance, see *European Voice*, 28/2/2008-5/3/2008 at p31 for objections by the French Government. See also *Financial Times*, 5/12/2007 at p6 for concerns expressed by the industry.

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However, the very fact that these initiatives have been undertaken by the Commission is in itself a positive development. In policy terms, any progress made along the way is bound to be **positive** beneficial for to the competitiveness of the defence industries as well as the effectiveness of ESDP. Currently, the defence procurement market accounts for a large share of EU public procurement (it is estimated at about €80 billion out of a combined State defence budget of € 170 billion).⁷⁴ More generally, the initiatives discussed in this Chapter suggest that the momentum build from the process from the process of drafting the Constitutional Treaty regarding the development of ESDP is not only maintained but also develops a new focus on the practical aspects of that policy which had been overlooked in the past. This development illustrates a shift from the rhetoric about the effective role of the European Union as a security and defence actor to the actual requirements for this role to be carried out.

Comment [TC10]: This is the second 'positive' in two lines.

Finally, the pace of the shift outlined in this Chapter will be determined pursuant to as many and diverse factors as the policy needs which underpinned its genesis. After all, none of the initiatives discussed and the measures proposed may be assessed in isolation. They need to be understood as parts of a gradually shifting, constantly evolving, multi-faceted legal and political space. It is their combined effect which would shape the position of defence industries in the Community legal order and the Union framework.

⁷⁴ See debate at the European Parliament on 19 June 2007 on Oral Question 0-0022/2007.