Directive 2009/81/EC on the award of contracts in the fields of defence and security

Guidance Note
Offsets

Directorate General Internal Markets and Services

1) Introduction

1. Up until now, many Member States have required compensation (offsets) from non-national suppliers when they procured defence equipment abroad. Offset practices as well as the rules and regulations underpinning them vary considerably in different Member States. In some cases, offsets are of a military nature and concern the subject-matter of the contract directly (for example, industrial participation of local companies in the production of the equipment procured). In other cases, they are indirect, but limited to the military sphere (for example, sub-contracts awarded by the supplier to local defence companies for other military products), or indirect and non-military (for example, the supplier's commitment to mobilise foreign investment in civil sectors of the buying country's economy or to purchase civil goods in that country).

2. Such offset requirements are restrictive measures which go against the basic principles of the Treaty, because they discriminate against economic operators, goods and services from other Member States and impede the free movement of goods and services. Since they violate basic rules and principles of primary EU law, the Directive cannot allow, tolerate or regulate them. At the same time, the Directive takes into account security-related justifications for offsets and offers, via its provisions on security of supply and sub-contracting, a non-discriminatory alternative which allows Member States to protect legitimate security interests and to drive competition into the supply chain of successful tenderers without infringing EU law.

3. As restrictive measures infringing primary law, offset requirements can only be justified on the basis of one of the Treaty-based derogations, in particular Article 346 TFEU. However, these derogations must be limited to exceptional and clearly defined cases, and the measures taken must not go beyond the limits of such cases. They have to be interpreted strictly, and the burden of proof that the derogation is justified lies with the Member State which invokes it. In this context, it is important to note that economic considerations are not accepted as grounds for justifying restrictions to the freedoms guaranteed by the Treaty. Furthermore, Article 346 (1)(b) itself specifies that measures taken by virtue of that Article '*shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes*'.

4. Finally, any decision to use Article 346 TFEU needs to be based on a case-by-case assessment which identifies the essential security interest at stake and evaluates the necessity of the concrete measure, taking into account the principle of proportionality and the need for a strict interpretation of Article 346 TFEU. This need for a case-by-case assessment is not compatible with national rules or regulations

which stipulate offset requirements in a 'catch-all' approach for certain categories of procurement contracts.

2) Legal framework

2.1) Primary EU Law

5. The Internal Market is built on the fundamental freedoms, namely the free movement of goods, persons, services and capital (see Article 26 (2) TFEU). These freedoms are directly related to the basic principles of equal treatment, non-discrimination (Article 18 TFEU) and transparency.

All measures taken by Member States and contracting authorities/entities must comply with the fundamental freedoms and the basic principles of EU Law. Recital 15 of Directive 2009/81/EC restates this core obligation resulting from primary European law by explicitly stating that the award of contracts by contracting authorities and entities '*is subject to compliance with the principles of the Treaty and in particular the free movement of goods, the freedom of establishment and the freedom to provide services, and with the principles deriving there from, such as the principles of equal treatment, non-discrimination, mutual recognition, proportionality and transparency*'.

6. The right of free movement of goods implies in particular the prohibition of quantitative restrictions on imports and exports *'and all measures having equivalent effect'* (Articles 34 and 35 TFEU). According to long-standing case-law, this covers *'all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade'.*[1] Any measures that (a) prohibit or impede the sale of goods manufactured or distributed by economic operators from other Member States,[2] or (b) oblige or induce economic operators to purchase products from domestic producers in general or from specific producers affect the volume of trade between Member States and must therefore be considered as measures with an effect equivalent to quantitative restrictions on imports prohibited under Article 35 TFEU.[3] This includes the mere encouragement by non-binding measures capable of influencing the conduct of economic operators.[4] In fact, by preventing economic operators from purchasing from suppliers based in other Member States, such measures discriminate against products manufactured in other Member States and result in a barrier to intra-EU trade.[5]

7. The freedom to provide services (Articles 56 to 62 TFEU) prohibits not only discrimination on grounds of nationality, but any restriction *'which is liable to prohibit,*

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1 Judgment of 11 July 1974 in Case 8/74 Dassonville, paragraph 5.

2 See, for instance, judgment of 24 June 1992 in Case C-137/94 Commission v Greece, paragraph 8, concerning domestic rules requiring undertakings to purchase exclusively electronic cash registers comprising in their manufacture value added on the national territory.

3 See judgments of 24 November 1982 in Case 249/81 Commission v Ireland ('Buy Irish'), paragraphs 23 to 29, of 5 June 1986 in Case 103/84 Commission v Italy, paragraph 24, and of 20 March 1990 in Case C-21/88 Du Pont de Nemours Italiana SpA, concerning a national legislative provision reserving a proportion of public supply contracts to undertakings located in a particular region of the national territory.

4 See Case 249/81, paragraphs 27 to 28.

5 See Case C-21/88, paragraph 11.

impede or render less advantageous the activities of a provider of services established in another Member State'.[6] This includes all measures that reserve certain services to providers located in the relevant Member State[7] or set up conditions favoring local service providers. In the context of public procurement, the Court held that the direct award of a public service contract to an undertaking located in the same Member State as the contracting authority infringes the right of free movement of services, since it results in the exclusion of all service providers located in other Member States.[8] It follows that measures obliging or inducing economic operators to conclude service contracts with local service providers infringe the right of free movement of services since they exclude or restrict access to the market for service providers from other Member States.

8. Finally, Article 18 TFEU contains a general prohibition of *'any discrimination on grounds of nationality'*. This applies to all situations within the scope of the Treaties that are not already covered by special freedoms such as the basic freedoms.

2.2) Directive 2009/81/EC

2.2.1) Basic principles

9. Directive 2009/81/EC is the legal instrument intended to secure respect for these basic provisions of the Treaty in the specific field of defence and sensitive security procurement. Given the clear legal position under primary EU law, the Directive does not directly address the issue of offsets. However, it contains a number of provisions that are intended to ensure that contract award procedures under the Directive in general, and all requirements put on candidates, tenderers and successful tenderers in particular, are fully in line with primary law principles and requirements.

10. Article 4 of the Directive sets out the basic principle of non-discrimination of candidates and tenderers in contract award procedures: *'Contracting authorities/entities shall treat economic operators equally and in a non-discriminatory manner and shall act in a transparent way.'* This principle prohibits all measures which imply a discrimination against participants in a procedure, for instance, by providing compensation obligations only for tenderers from abroad. This prohibition also covers discrimination targeting tenderers' supply chains (Article 21 (1)).

2.2.2) Selection criteria

11. Articles 38 to 42 include provisions on criteria for qualitative selection of candidates and tenderers. In this context, recital 61 states that *'verification of the suitability of candidates and the selection thereof should be carried out in transparent conditions. For this purpose, non-discriminatory criteria should be indicated which the*

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6 Long-standing case-law, see, for instance, judgment of 12 December 1996 in Case C-3/95 Reisebüro Broede, paragraph 25.

7 See judgment of 7 February 2002 in Case C-279/00 Commission v Italy, paragraph 17.

8 See judgments of 21 July 2005 in Case C-231/03 Coname, paragraphs 17 to 20, and of 13 November 2007 in Case C-507/03 Commission v Ireland, paragraphs 29 to 32.

contracting authorities/entities may use when selecting competitors and the means which economic operators may use to prove they have satisfied those criteria….'.

Furthermore, Article 38 (1) points out that the extent of the information to be provided by candidates and tenderers and the minimum levels of ability required for a specific contract *'must be related and proportionate to the subject-matter of the contract'*.

Hence, selection criteria may not lead to direct or indirect discrimination against candidates and tenderers. They cannot refer to capacities, abilities or other elements that are not related to the subject-matter of the contract to be awarded.

2.2.3) Contract performance conditions

12. Article 20 on conditions for performance of contracts states that *'contracting authorities/entities may lay down special conditions relating to the performance of a contract, provided that these are compatible with Community law...'*. This clearly excludes any requirements that are contrary to primary European law.

Recital 41 confirms this, specifying again that *'contract performance conditions are compatible with this Directive provided that they are not directly or indirectly discriminatory….'.*

In this context, it is also worthwhile referring to recital 45, which states that *'no performance conditions may pertain to requirements other than those relating to the performance of the contract itself.'*

2.2.4) Subcontracting

13. Articles 21 and Title III (Articles 50-53) of the Directive contain provisions allowing contracting authorities/entities to require successful tenderers to subcontract a certain share of the main contract and/or to put proposed subcontracts into competition. Contracting authorities/entities may use these provisions to open the supply chain of successful tenderers to EU-wide competition, but they may not impose local suppliers as sub-contractors.

14. When contracting authorities/entities require a certain share of the main contract to be subcontracted, in accordance with Article 21 (4), the successful tenderer remains free to decide which parts he wants to subcontract to fulfil this requirement, and all subcontracts concerned must be awarded according to the rules laid down in Title III.

15. According to Article 21 (3), contracting authorities/entities may also require successful tenderers to put proposed subcontractors into competition; in this case, the successful tenderer would also have to award the subcontracts concerned in accordance with Title III of the Directive.

16. In all of these cases, companies located in the purchasing Member State can participate in the award procedure for subcontracts organised by the successful tenderer under the same conditions as economic operators located in any other Member State.

For all subcontracts that are not covered by the requirement referred to in paragraphs 3 and 4 of Article 21, '*the successful tenderer shall be free to select its subcontractors'* (Article 21 (1))*.*

This means that, whatever contracting authorities/entities decide to require with respect to subcontracting, they may never require successful tenderers '*to discriminate against potential subcontractors on grounds of nationality (Article 21 (1))'.*

2.2.5) Contract award criteria

17. Finally, according to Article 47, it is up to the contracting authorities/entities to decide whether they want to award the contract to the tender offering the lowest price or to the most economically advantageous tender. When the award is made to the most economically advantageous tender, the contracting authority/entity may determine *'various criteria linked to the subject-matter of the contract'* to assess the tenders to determine which offers the best value for money.

The limitation to criteria linked to the subject-matter of the contract results from ECJ case-law.[9] It means that supplies, services, investments or other aspects that are not directly related to the subject-matter of the contract must not be taken into account in the award decision.

Moreover, recital 69 highlights again that *'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 a transparent and objective manner under conditions of effective competition…'*.

3) Consequences for offsets

3.1) Offset requirements and Directive 2009/81/EC

18. Whether they are civil or military, direct or indirect in nature, and whatever their legal connection with the main contract is, offset requirements are restrictive measures which go against the basic principles of the Treaty, because they discriminate against economic operators, goods and services from other Member States and impede the free movement of goods and services. Since they violate basic rules and principles of primary EU law, the Directive cannot allow, tolerate or regulate them.

19. Consequently, contracting authorities/entities may not require or induce, by whatever means, candidates, tenderers or successful tenderers to commit themselves to:

[9] See, in particular, judgments of 17 September 2002 in Case C-513/99 Concordia Bus Finland, paragraph 62, and of 4 December 2003 in Case C-448/01 EVN AG und Wienstrom AG, paragraph 57.

- purchase goods or services from economic operators located in a specific Member State;
- award sub-contracts to operators located in a specific Member State;
- make investments in a specific Member State;
- generate value on the territory of a specific Member State.

This applies to all kind of works, supplies, services and investments, whether they are military, security-related or civil in nature or purpose, and irrespective of whether they are directly or indirectly related to the subject-matter of the procurement contract in question. Furthermore, tenderers, candidates and successful tenderers may not be required to mobilise other undertakings, be they related to them or not, to make such purchases, subcontracting or investments.

3.2) Offset requirements and Article 346 TFEU

20. Restrictive measures infringing primary law can only be justified on the basis of one of the Treaty-based derogations. For defence and security procurement, the most relevant derogation is laid down in Article 346 TFEU.

21. According to settled ECJ case-law, the derogation under Article 346 TFEU is limited to exceptional and clearly defined cases, and the measures taken must not go beyond the limits of such cases.[10] Like any other derogation from fundamental freedoms, it has to be interpreted strictly,[11] and the burden of proof that the derogation is justified lies with the Member State which invokes it.

This means that, if a Member State intends to rely on Article 346 TFEU to make requirements such as those mentioned above under point 2.1 (be they officially labelled 'offsets' or not), it must be able and ready to demonstrate that these requirements are necessary to protect its essential security interests.[12] More specifically, the Member State in question must be prepared to specify the essential security interest that makes the specific requirement necessary, to demonstrate that this requirement is an appropriate means to protect that interest, and to explain why it is not possible to achieve the same objective by less restrictive means. Mutual abatement may be an appropriate means to do away with offset obligations taken in the past; with regard to future offset arrangements, however, abatements could be interpreted as evidence that the required offsets were not necessary for the protection of essential security interests.

These principles are also emphasised in recital 17 of the Directive which states that '*the possibility of recourse to such exceptions should be interpreted in such a way that their effects do not extend beyond that which is strictly necessary for the protection of the legitimate interests that those Articles help to safeguard. Thus, the non-application of this Directive must be proportionate to the aims pursued and cause as little disturbance as possible to the free movement of goods and the freedom to provide services*.'

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10 See judgment in Case C-414/97 Commission v Spain, paragraph 22, and judgments of 15 December 2009, for instance Case C-239/06, paragraph 68.

11 See judgments of 15 December 2009, for instance Case C-239/06, paragraph 69.

12 See judgments of 15 December 2009, for instance Case C-239/06, paragraph 72.

22. In this context, it is important to recall that economic considerations are not accepted as grounds for justifying restrictions to the freedoms guaranteed by the Treaty. Measures liable to infringe the prohibition of discrimination on the basis of nationality can be permitted only if they are justified on one of the non-economic grounds listed in Articles 36, 51, 52, 62 and 346 TFEU. This means that the restrictive measure in question must be necessary for security interests, not for economic or employment-related interests. Hence, (economic) return on investment made abroad is not sufficient to justify use of the derogation.

23. The restrictive interpretation of Article 346 TFEU also means that the justification must always concern the specific measure in question directly. Hence, justified derogation from the Directive for other security reasons does not automatically open the door to requests for compensation. A defence or security procurement contract may be exempted for reasons of security of information, for example, but this exemption does not imply permission to require offsets for the procurement covered by the exempted contract. On the contrary, the offset requirement would be another (additional) measure, affecting intra-EU trade in a different way, and would thus have to be justified separately.

Therefore, if a Member State intends to rely on Article 346 TFEU in order to make requirements which infringe the basic freedoms and principles of the Treaty, it must always be able to prove that this specific requirement is itself indispensable to protect its essential security interest.[13]

24. The same logic also applies to defence and security contracts which are excluded from the Directive by virtue of one of the provisions of Articles 12 or 13. These exclusions also have to be interpreted restrictively. Hence, government-to-government sales, for example, are excluded from the Directive, but possible offset requirements related to such sales would have to be justified separately as necessary for the protection of the essential interests of the purchasing Member State.

25. Furthermore, it has to be pointed out that Article 346 (1)(b) itself specifies that measures taken by virtue of that Article '*shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes*'. This would also apply to offset requirements, if the latter could be justified as necessary for the protection of essential security interests.[14]

26. Finally, any decision to use Article 346 TFEU needs to be based on a case-by-case assessment which identifies the essential security interest at stake and evaluates the necessity of the concrete measure, taking into account the principle of proportionality and the need for a strict interpretation of Article 346 TFEU. This need for a case-by-case assessment is not compatible with national rules or regulations which stipulate offset requirements in a 'catch-all' approach for certain categories of procurement contracts. Consequently, any legislation and/or policy which makes

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13 See judgments of 15 December 2009, for instance Case C-239/06, paragraph 72.

14 See Interpretative Communication on the application of Article 296 of the Treaty in the field of defence procurement, COM/2006/0779 final.

offset requirements mandatory for all or certain defence and/or security procurement contracts, for example above a certain threshold, constitute an infringement of the Treaty.

3.3) EDA Code of Conduct on offsets

27. On 1 July, a Code of Conduct on Offsets administered by the European Defence Agency (EDA) came into effect. The Code is a voluntary, non-legally binding intergovernmental instrument, which sets out overarching principles and guidelines for the use of offsets in defence procurement. 25 Member States plus Norway signed up to the Code.

28. Both in its introduction and principles, the Code stipulates that its provisions have to be implemented within the framework of EU law. Moreover, the Code is part of the Intergovernmental Regime on Defence Procurement to which participating Member States subscribed 'without prejudice to their rights and obligations under the Treaties.' However, it is important to note that the application of the Code does not of itself make offset requirements compatible with EU law. In every award procedure, contracting authorities/entities first have to ensure that all their requirements comply with the provisions of the Treaty and/or the Directive. On that basis, they may then decide to apply the Code on offsets, provided that this does not put the award procedure in conflict with the Treaty and/or the Directive. In other words: The only legal criterion for the assessment of offset requirements is compliance with EU primary and secondary law.

This guidance note reflects the views of the services of DG MARKT and is legally not binding. Only the Court of Justice is competent to give a legally binding interpretation of EU law.