A Directive’s Effect on Offset
Directive 2009/81/EC and its Effects on Offset Agreements in the Defence Sector

Ett direktivs effekt på Offset
Direktiv 2009/81/EG och dess effekter på Offset-avtal inom försvarsindustrin

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Abstract

The public procurement of defence materiel was previously regulated in Directive 2004/18/EC but due to the special character of the defence market, a new Directive has been issued; Directive 2009/81/EC. The purpose of this Directive is to be better suited for the special features of the defence market. Directive 2009/81/EC will now regulate most of the contracts that, due to their sensitive and secret character, were earlier exempted from the rules of the Treaties on the basis of Article 346 TFEU and from Directive 2004/18/EC on the basis of its Article 14. It is, however, still possible to exempt some contracts on the basis of these Articles. Directive 2009/81/EC regulates the procedure for contract awarding and affects the possibilities of the Member State to choose a tender with Offset agreement over one without and therefore the Directive affects the offering company as well.

Earlier a company has been free to shape its contracts concerning public procurement of defence material with little regard to the regulations of the Internal Market. With the implementation of the new directive, the situation has become uncertain. In particular the state of law concerning Offset agreements, commonly offered as a part of a tender in contracts concerning defence procurement, has become uncertain. This as Offset is not explicitly mentioned in Directive 2009/81/EC but several bodies of the European Union have expressed opinions regarding the legality of Offset and whether or not it is a discriminating measure.

We have found that Offset agreements, both related and un-related to the subject matter of the contract, can be exempted on the basis of Article 346 TFEU if they support essential security interest. However, that the procurement concerns the defence sector is not enough for contracts to be exempted if these contracts only support other interests, e.g. industrial or economical, rather than those of essential security. This as the exemption of these contracts would have a distorting effect on the trade on other markets than the one related to defence procurement.

Even though Offset is not mentioned as a criterion for awarding of contracts in Article 47.1(a) Directive 2009/81/EC, this does not exclude the possibility that it could be. If Offset is to be used as an award criterion, it cannot be of significant weight when determining the economically most advantageous tender and can in no case be discriminating. Also, a difference between direct and indirect Offset must be made since indirect Offset agreements do not fulfill the requirements, in 47.1(a) Directive 2009/81/EC, in order to be considered as an award criterion. It is therefore only possible to use direct Offset agreements as an award criterion according to Directive 2009/81/EC if this is done in a non-discriminating way.
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## Abbreviations

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<tr>
<td>DG MARKT</td>
<td>Directorate General Internal Markets and Services</td>
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<td>ECR</td>
<td>European Court Reports</td>
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<td>EDA</td>
<td>European Defence Agency</td>
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<td>EDEM</td>
<td>European Defence Equipment Market</td>
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<td>EDTIB</td>
<td>European Defence Technological and Industrial Base</td>
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<td>EESC</td>
<td>European Economic and Social Committee</td>
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<td>ESDP</td>
<td>European Security and Defence Policy</td>
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<tr>
<td>pMS</td>
<td>Participating Member State (of EDA)</td>
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<td>SME</td>
<td>Small and Medium sized Enterprises</td>
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<tr>
<td>sMS</td>
<td>Supporting Member State (of a Code issued by EDA)</td>
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<tr>
<td>TEC</td>
<td>Treaty establishing the European Community</td>
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<td>TEU</td>
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<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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1 Introduction

1.1 Background

Offset is “anything that counterbalances, compensates, or makes up for something else: a set off”. Offset affairs serve as additional compensations to the sold product given from the seller to the buyer and are frequently used when Member States of the European Union procure defence equipment from non-national suppliers.

Offset agreements are not regulated within the legal framework of the European Union. Public procurement however is regulated in Directive 2004/17/EC and Directive 2004/18/EC and the latter also regulates contracts in the defence procurement area. Nevertheless, Member States use Article 14 in Directive 2004/18/EC and Article 346 in the Treaty on the Functioning of the European Union (TFEU) to exempt the procurement of defence equipment from the regulations of the Directive and the Treaty, even though the Court of Justice of the European Union consistently ruled that Article 346 TFEU “should be restricted to exceptional and clearly defined cases”.

Due to the sensitive character of defence equipment procurement, a new Directive (2009/81/EC) has been adopted to regulate it. In the Guidance Note Offset, by the EU Directorate General Internal Markets and Services (DG MARKT), Offset is said to “violate basic rules and principles of primary EU law”, especially equal treatment, non-discrimination and the free movement of goods and services, this as Offset hampers the freedom of

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9 Ibid. 1.
movement and discriminates non-national suppliers. Because of this, DG MARKT comes to the conclusion that Offset cannot be allowed, tolerated or regulated in Directive 2009/81/EC. Instead, the Directive regulates the procedure of how contracts in the area of defence and security should be awarded.

Directive 2009/81/EC makes the future legal situation uncertain for companies who provide defence materiel within the European Union. This as the conditions for the buying Member States change and consequently, the possibility for companies to offer Offset as a part of their tender.

1.2 Thesis Question

What effects does Directive 2009/81/EC have on companies which sell defence equipment, as far as their possibilities to offer Offset as a part of their tender to a Member State of the European Union are concerned?

1.3 Aim

The aim of this thesis is to clarify the state of law concerning Offset and whether the offering of Offset is allowed or not after the Member States have adopted and implemented Directive 2009/81/EC. We want to analyse the state of law from a company’s perspective, i.e. from the perspective of the offerer of Offset.

1.4 Delimitations

We will focus on Directive 2009/81/EC and its effects as a European legal instrument, without focusing on the different national implementations. All national implementations can, in some way, affect a tendering company when approaching a Member State with an offer, depending on which changes have been made in national legislation of the Member State in question. Due to lack of time and competence regarding all national legislations in the European Union, this will not be taken into consideration in this thesis.
1.5 Method

To fulfil the aim of the thesis of clarifying the state of law, we will analyse the legal documents that concern Directive 2009/81/EC, such as the Treaties, and the Directive itself. We will also analyse documents issued by different bodies within the European Union such as the Commission, the European Defence Agency and the European Economic and Social Committee even though these documents are not legally binding. Legal literature will also be taken into consideration although this source of information is most likely limited due to the topicality of the subject.

Furthermore a teleological interpretation of our sources will be used, as the matter of Offset is not explicitly regulated by Union law and the Court of Justice of the European Union often uses a teleological approach when interpreting uncertain legal areas.\(^\text{10}\)

The legal system of the European Union differs a lot from national legal systems, especially in terms of the legal value of sources, and we have therefore considered the weight of each of our sources carefully.

1.5.1 Article 346 TFEU

With the entry into force of the Treaty of Lisbon on December 1. 2009, the articles of the Treaty establishing the European Community (TEC) were renumbered. The Article 296 TEC is now Article 346 TFEU. In this thesis however, Article 346 TFEU will be used to facilitate the reading, even when the Article is being referred to in a context prior to December 1. 2009. Naturally, in direct quotes, the exact wording will nevertheless be used.

2 Theoretical Framework

2.1 Definition of Offset

Offset is a general term, used in many different contexts and defined in many different ways. The common definition of Offset is an agreement that effects the development of the local industry on a long-term basis, and is used when selling defence equipment to another country. There are also a lot of other words used for this phenomenon, such as industrial compensations, business development, value development and juste retour. In this thesis, the meaning of Offset is “anything that counterbalances, compensates, or makes up for something else: a set off”\textsuperscript{11} with the definition “(added) activities that involve transfer of resources to the buying country and/or generation of business value in the buying country and that are a part of the international governmental procurement of a large technical system, but not necessary for the use, handling and immediate maintenance of the technical system”\textsuperscript{12}.

Offset can then be divided into two categories, direct and indirect, or in other words, related and un-related. Joint-ventures, local company as prime contractor, subcontracts, licenses and technology transfer are examples of direct Offset, i.e. Offset agreements that are related to the sold product. Local investment, venture capital, co-production, export and trade can be examples of agreements that are not related to the sold product, i.e. indirect Offset.\textsuperscript{13}

2.2 Important points of the Legal System of the European Union

2.2.1 Primary and Secondary Legislation

The primary legislation of the Union consists of the Treaties and annexed Protocols and Declarations which create the foundation of the Union’s legal framework. Protocols and Declarations are not legally binding, but are highly important for the interpretation of the Treaties.\textsuperscript{14}

The secondary legislation, often called legal acts, is regulated in Article 288 Treaty on the Functioning of the European Union (TFEU) and consists of regulations, directives and

\textsuperscript{13} Ibid. Page 17.
decisions, which are legally binding acts. It also consists of recommendations and opinions, which are of importance even though they are not legally binding. The secondary legislation needs to “state the reasons on which they are based” according to Article 296.2 TFEU, and this makes the preamble in regulations and directives an important source for interpretation.\footnote{Ibid. Page 39.}

\subsection*{2.2.2 The Court of Justice of the European Union}

The Court of Justice of the European Union (the Court), hereby used as a collective term for the Court of Justice, the General Court and the Civil Service Tribunal which are the judicial institutions of the European Union, shall according to Article 19 Treaty on European Union (TEU) “ensure that in the interpretation and application of the Treaties the law is observed”.

The Court uses several different methods of interpretation and an interpretation in conformity with how the article literally is written, is often used.\footnote{Hettne, J. & Otken Eriksson, I. (eds). (2005). \textit{EU-rättslig metod}. Norstedts Juridik AB. Page 82.} However, the Court does not only pay regard to the wording of the article being interpreted, but also to its context and the purposes that it seeks to obtain.\footnote{Case C-292/82 Merck. Par. 12. Case C-337/82 St. Nikolaus Brenneri. Par. 10.} This kind of interpretation is more commonly known as a teleological interpretation, and is often used by the Court when interpreting uncertain legal areas.\footnote{Hettne, J. & Otken Eriksson, I. (eds). (2005). Page 89 ff.} The teleological approach makes the use of soft law and general principles of law important, in order to ensure that the articles serve their purpose.\footnote{Bernitz, U. (2010). Page 37.}

\subsection*{2.2.3 Soft Law}

Soft law, such as codes, communications, interpretations and resolutions from the Council and the Commission can hence be important when interpreting Union law.\footnote{Ibid. Page 34.} The Court has stated that soft law is “capable of casting light on the interpretation of other provisions of national or Community law”.\footnote{Case C-322/88 Grimaldi v. Fonds des Maladies Professionnelles. Par. 19.} Although preparatory papers, such as White and Green Papers, are not legally binding sources they can also be highly useful when interpreting Union law.\footnote{Hettne, J. & Otken Eriksson, I. (eds). (2005). Page 92.}
2.2.3 General Principles of Law

The general principles of law are of great importance and Union law is often interpreted in accordance with these general principles. Some of the principles can be found in articles of the Treaties while others are more general.

The principle of sincere cooperation is laid down in Article 4.3 TEU, which imposes the Member States to do everything necessary to ensure that obligations in primary and secondary Union law are fulfilled. This principle also ensures respect for other principles in the Treaty, especially the principles of free movement. The principle of free movement of goods prohibits quantitative restrictions on import and export and all measures having equivalent effect, including “all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade”. Article 56 TFEU prohibits discrimination based on nationality when providing services. The Court has stated that this Article also abolishes any restrictions even if they apply “without distinction to national providers of services and to those of other Member States, which is liable to prohibit, impede or render less advantageous the activities of a provider of services established in another Member State where he lawfully provides similar services”. Article 49 TFEU prohibits all restrictions on the freedom of establishment.

The principle of free movement is followed by other important principles, such as the equality principle or the principle of non-discrimination as it also is known. Discrimination based on nationality is prohibited according to Article 18 TFEU and it is therefore prohibited to treat non-national actors different than national. The Court has also defined this principle to require “that comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified”. To ensure freedom of goods and non-discrimination the Court has also developed a principle of mutual recognition, stating that products that are lawfully produced or marketed in other Member States must be accepted in others and that national demands on e.g. package, size or content are prohibited.

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23 Ibid. Page 49.
25 Articles 34-35 TFEU.
26 Case 8/74 Dassonville. Par. 5.
27 Case C-3/95 Reisebüro Broede. Par. 25.
28 Case C-127/07 Société Arcelor Atlantique et Lorraine and Others v. Premier ministre and Others. Par. 23.
In Article 5.4 TEU the principle of proportionality is stated and is defined by the Court as “when there is a choice between several appropriate measures recourse must be had to the least onerous, and the disadvantages caused are not to be disproportionate to the aims pursued”\(^{30}\). This principle ensures that before action is taken, alternatives are being considered and that the chosen action is justified.\(^{31}\)

2.3 Situation before Directive 2009/81/EC

2.3.1 Defence Procurement on the Internal Market

In 2004, the 25 Member States of the European Union had a combined defence procurement expenditure of €160 billion whereof one fifth was military equipment, including procurement and Research and Development (R&D).\(^{32}\) Most of the Internal Market was traded upon with the basis of the principles of free movements, but the defence market functioned somewhat different due to its sensitive character and because Offset agreements were frequently used as award criteria in the contract awarding procedure in the field of defence procurement. This use efficiently closed the market for non-national actors, as the criteria for awarding of contracts were purely based on national industrial policy.\(^{33}\) The use of non-harmonised criterions limited the possibilities for Small and Medium sized Enterprises (SME) to compete on the Internal Market and the hampering of the defence market cost businesses over € 400 Million each year.\(^{34}\)

Since the defence market did not follow the principles of the Internal Market, change was needed. A common market for defence procurement between the Member States was desired by the politicians, and movements towards the European Defence Equipment Market (EDEM) were taken.\(^{35}\)

From an economic point of view, EDEM would profit the Member States because the national markets, and national needs of defence equipment, are not sufficient to counterbalance the

\(^{30}\) Case C-331/88 Fedesa and Others, Par. 13.


\(^{33}\) Ibid. Page 4.

\(^{34}\) Press Release IP/07/1860 – Commission proposes new competitive measures for defence industries and markets.

high R&D costs. The creation of a common market, where all companies can compete on equal terms, would lead to growth of businesses. This would allow for the unit production cost to go down, giving a more efficient use of money and ensuring a stronger competitiveness for European enterprises on the global market.36

2.3.2 Legal Situation

Public procurement is regulated in Directive 2004/17/EC37 and Directive 2004/18/EC.38 However, Directive 2004/17/EC mainly concerns entities operating in the water, energy, transport and postal services sectors and therefore has little relevance for procurement of defence equipment. The principles of the Treaty, such as those regarding the Internal Market and the free movement of goods and services, regulate general public procurement.39 Contracts in the defence sector, however, are included in the field of Directive 2004/18/EC according to Article 10 therein. Yet Directive 2004/18/EC is not very well-adapted to the special requirements of the defence sector. Contracts within the field of public procurement have therefore often been exempted by Member States through the use of Article 14 in Directive 2004/18/EC.40 This Article states that the “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”. This derogation gives the Member States the option not to apply Directive 2004/18/EC on contracts in the military sector by referring to national security.

Furthermore, the scope of Directive 2004/18/EC does not cover contracts that are exempted by Article 346 TFEU. The Articles in the Treaties (such as Article 346 TFEU) that allows for exemptions from the basic principles therein must, as laid down by the Court in many

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39 Recital (2) Directive 2004/18/EC.
different cases, be interpreted strictly.\textsuperscript{41} Even more so, when the exemptions regard public safety, the cases need to be clearly defined and exceptional, and because those Articles have such limited character, they cannot be used for a wide interpretation.\textsuperscript{42} However the exemption in Article 346 TFEU is still used frequently and the European Economic and Social Committee has expressed that “what should be the exception is, de facto, often the rule”\textsuperscript{43}.

Article 346 TFEU states that “1. The provisions of the Treaties shall not preclude the application of the following rules:

(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 connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the internal 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 April 1958, of the products to which the provisions of paragraph 1(b) apply“.

Paragraph 1(b) allows exceptions to be made from the principles of the Internal Market if the contract in question regards trade in arms, munitions or war material. However, an important distinction must be made as Article 346 TFEU does not allow for just any exceptions to be made on the basis of security interest, but only those of essential security interest.\textsuperscript{44} Other interests, such as industrial or economic ones, do not justify derogations on the basis of the Article, even if the contracts are related to defence procurement. The derogation in paragraph 1(b) is, according to the Court, “not intended to apply to activities relating to products other


\textsuperscript{44} Interpretative communication on the application of article 296 of the Treaty in the field of defence procurement. COM (2006) 779 final. Page 7.
than the military products identified on the Council's list of 15 April 1958\(^{45}\) and even though this list is generic, it only includes items used for a purely military purpose.\(^{46}\)

Hence, according to the Court, only contracts concerning items used for military procurements can be exempted from the rules of the Internal Market, on the basis of Article 346(1)(b).\(^{47}\) The same prerequisite of military purpose, however, is not laid down in paragraph 1(a) which makes it possible to use Article 346 TFEU for items with dual-use equipment, which has both military and non-military use, as long as the disclosure of information concerning the contracts in question would jeopardize essential security interests of the Member State.\(^{48}\)

Just the fact that a contract is written in the field of defence, does not provide an automatic exemption in accordance with Article 346 TFEU, and the Court has stated this repeatedly in its case law.\(^{49}\) This means that contracts may be exempted, but only if they fulfil the requirements of Article 346 TFEU. However, even then it is a case-to-case consideration. The Court states that Member States must remember that “the exemptions in question do not go beyond the limit of such cases”\(^{50}\).

Article 348 TFEU states that “If measures taken in the circumstances referred to in Articles 346 and 347 have the effect of distorting the conditions of competition in the internal market, the Commission shall, together with the State concerned, examine how these measures can be adjusted to the rules laid down in the Treaties”, and the very existence of this Article proves, according to the Commission, that the Member States do not have absolute freedom when applying Article 346 TFEU and that measures can and will be taken if Member States use it improperly.\(^{51}\)

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\(^{45}\) Case T-26/01 Fiocchi Munizioni v. Commission. Par. 61.


\(^{47}\) Case T-26/01 Fiocchi Munizioni v. Commission. Par. 59 & 61.


\(^{49}\) Case C-273/97 Sirdar. Par. 15-16.

Case C-285/98 Kreil. Par. 16.

Case C-186/01 Dory. Par. 30-31.

\(^{50}\) Case C-414/97 Commission v. Spain. Par. 22.

2.3.3 Initiative to new Legislation

In 2003, the Commission issued a Communication\(^52\) that was meant to improve the effectiveness of public spending on defence procurement and increase the value for money in the area of public spending.\(^53\) This paper would be the one of the first steps to act on the field of defence procurement, in the line of regulating the market. It suggested a number of measures to be taken, in order to reach the goal of creating EDEM.

The Commission considered three ways to take action; no Union action, non-legislative action and legislative action. The first was ruled out directly and, as a sole option, so was the second.\(^54\) Even though non-legislative actions may be useful, the Commission argued that this was not enough as it would not by itself prevent the frequent use of Article 346 TFEU and Article 14 of Directive 2004/18/EC and the transparency would not increase.\(^55\)

A Green Paper\(^56\) on defence procurement was issued in 2004. It asked for appropriate measures within the area; clarification of the existing legal framework and new legislative measures. The Commission decided thus to take action in form of;

1. An Interpretative Communication of the Article 346 TFEU\(^57\) to help clarify, for all the Member States, the exact use of the Article, and

2.3.4 European Defence Agency and the Code of Conduct on Offset

2.3.4.1 European Defence Agency

As another step towards EDEM, the European Defence Agency (EDA) was created after an initiative by the Council, with the mission “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”\(^58\). Participating Member States


\(^{53}\) Ibid. Page 3 ff.


\(^{55}\) Ibid. Page 5.


(pMS) are all Member States of the European Union, except Denmark, which has chosen not to participate in EDA.  

Amongst other things, EDA has created several Codes of Conducts, which are optional for the pMS to subscribe to. The Codes are legally non-binding documents that set up common policies in the area of defence procurement, free for the subscribing Member States (sMS) to follow or not. The first code was the Code of Conduct on Defence Procurement that was signed by Norway and all pMS except Romania. This was a mean to strengthen the European Defence Technological and Industrial Base (EDTIB), and by different key principles it was to help Member States cooperate in achieving this goal. A Code of Best Practice in the Supply Chain was also agreed upon with the Industry with the ambition of achieving the goal set up in the Code of Conduct.

2.3.4.2 Code of Conduct of Offsets

On July 1 2009 a new Code of Conduct took effect, the Code of Conduct on Offsets, which is applicable for all compensation affairs when purchasing defence materiel. Also this Code was signed by Norway and all pMS except Romania, and the Code is, by these sMS, applied equally to all bidders from sMS, non-sMS and third countries. The Code recognizes Offset as “a global phenomenon, required and offered for many purposes, and unlikely to abate in the foreseeable future”. A 100% cap on Offset, in order to ensure that the Offset agreement is not worth more than the original agreement, is prescribed in the Code as well as the need to stipulate Offset requirements in the contract notice. The Code also points out that Offset shall “be considered of a less significant weight (or used as a subsidiary criteria in case of offers with the same weigh) in order to ensure that a procurement process is based on the best available and most economically advantageous solution for the particular requirement”. A complementing tool to the Code is the Offset Portal where all sMS provide and update their national policies on Offset.

60 Approved on November 21. 2005.
62 Approved by the Association of Defence & Aerospace industries of Europe (ASD) and agreed by the Member States participating in the European Defence Agency on April 27. 2006.
64 Ibid. Page 3.
2.3.5 Interpretative Communication and a new Directive

In December 2006, the Commission issued an Interpretative Communication\textsuperscript{66} with the aim to clarify the state of law concerning the Article 346 TFEU. The Interpretative Communication states that the use of the Article is problematic because it provides a possibility to alter from the rules of the Internal Market and because there is a difficulty to define which contracts that qualifies as being of essential security interests.\textsuperscript{67}

The Interpretative Communication also notices that the only legislative instrument available on the area at the time, Directive 2004/18/EC, has not been very well fitted for contracts in the defence sector. Moreover, the Interpretative Communication notes that Article 14 of Directive 2004/18/EC has mostly been used on contracts concerning items for security purposes that are non-military.\textsuperscript{68} However, the distinction of which items belong in the military field and which do not has become more complex and harder to differ, as the military and security sectors are evolving.\textsuperscript{69}

Furthermore, the Interpretative Communication discusses how contracts, including Offset agreements, can be derogated on the basis of Article 346 (1)(b). The Article states the prerequisite of essential security interest, which excludes the possibility to exempt contracts that are not of essential security interest. Even if the contracts are of military nature, they cannot be exempted if they only serve other interests, such as economical or industrial.\textsuperscript{70}

Article 346(1)(b) also stipulates that any derogation made in the accordance 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”. The Interpretative Communication points out that this can be the case for Offset agreements within the area of defence procurement. The Member States must therefore respect this provision when demanding Offset agreements.\textsuperscript{71}

\textsuperscript{67} Ibid. Page 2.
\textsuperscript{68} Ibid. Page 6.
\textsuperscript{69} Ibid. Page 5.
\textsuperscript{70} Ibid. Page 7.
\textsuperscript{71} Ibid. Page 8.
In the means of making the new Directive with the purpose to regulate public procurement in the area of defence and security, the Commission issued a proposal. This document drew the outlines for the new Directive. The European Economic and Social Committee (EESC) issued its opinion about the proposal. This points out EESC’s views regarding the measures taken in the Directive and recognizes that the Commission has avoided to concretely regulate the matter of Offset in the new Directive. This much due to the fact that legislation would not be productive and might even disorder the market, but also because of the differing points of view on this matter among the Member States. The EESC also identifies that Offset is in use, but asserts that in a well functioning EDEM there would be no need for Offset.

2.4 Directive 2009/81/EC

2.4.1 Scope and Interpretation

Directive 2009/81/EC is based on Directive 2004/18/EC, but provides further adjustments to ensure the security of the Member States’ national security interests during the contract awarding procedure concerning equipment of sensitive character, such as within the area of defence and security. EESC clarifies that there is only one procuring body in each Member State, namely the government of that state, and hence Directive 2009/81/EC concerns the governments in each Member State.

The scope of Directive 2009/81/EC is, according to Article 2 in said Directive, “contracts awarded in the fields of defence and security for:
(a) the supply of military equipment, including any parts, components and/or subassemblies thereof;
(b) the supply of sensitive equipment, including any parts, components and/or subassemblies thereof;
(c) works, supplies and services directly related to the equipment referred to in points (a) and (b) for any and all elements of its life cycle;

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73 2009/C 100/18.
74 Ibid. 1.9.
76 2009/C 100/18. 1.5.1.2.
(d) works and services for specifically military purposes or sensitive works and sensitive services” except if they are excluded by Articles 36, 51, 52, 62 and 346 TFEU.

There are also certain other contracts that Directive 2009/81/EC does not apply to, including contracts awarded according to international rules and government to government contracts related to military or sensitive equipment.

Recital (3) in the preamble of Directive 2009/81/EC states that Member States “should take into account the Commission’s Interpretative Communication of 7 December 2006 on the application of Article 296 of the Treaty in the field of defence procurement and the Commission Communication of 5 December 2007 on a Strategy for a stronger and more competitive European defence industry”. This Recital also states that the Member States agree on the need to develop EDTIB. This need is discussed in the second Communication mentioned in Recital (3). The Communication notes that Offset agreements “are often said to help sustain defence spending, and to some extent reflect weaknesses in the present structure of the European defence industry and markets”. However, the Commission recognizes a danger that procuring Member States award their contracts based on the attractiveness of the proposed Offset instead of the competitiveness of the sold product.

The Directorate General Internal Markets and Services (DG MARKT) states in their Guidance Note Offsets that the issue of Offset is not, and cannot be, directly addressed in Directive 2009/81/EC. However the provisions made in the Directive intends to ensure that the contract award procedure and the requirements during this procedure are in accordance with Union law.

In order to ensure that primary law principles and requirements are followed, the principle of non-discrimination applies to the whole Directive 2009/81/EC. The principle is visible in several articles, e.g. Article 26.2, by prescribing equal treatment to all tenderers during negotiation as well as Article 21.1 and Article 53 concerning tenderers’ supply chains. Furthermore, Article 4 ensures this principle by prescribing that economic operators must be treated equally by the Member States and that they cannot be treated in a discriminating way.

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77 Article 12 Directive 2009/81/EC.
78 Article 13 Directive 2009/81/EC.
81 Ibid. Page 5.
83 Ibid. 2.2.1.
The principle of non-discrimination is also manifested in the preamble of Directive 2009/81/EC, e.g. in Recital (40) and (41). Recital (40) states that subcontractors should not be discriminated on the bases of their nationality and Recital (41) states that conditions for the performance of a contract are not compatible with Directive 2009/81/EC if they are discriminating, directly or indirectly.

2.4.2 Contract Awarding

In the preamble of Directive 2009/81/EC, Recital (15) expresses that “the award of contracts ... 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 therefrom, such as the principles of equal treatment, non-discrimination, mutual recognition, proportionality and transparency.” To ensure the effect of these principles, and to ensure the competition in procurement, the Recital states that it is advisory to draft provisions in the area.

The following Recital, (16), states that it is possible to exempt contracts from the use of Directive 2009/81/EC by the use of Article 346 TFEU if this is necessary for the Member State’s essential security interest. Recital (17) however, points out that the Court’s case law has limited the interpretation of Articles that provides for exemptions to be made from the Treaties, and that these should be interpreted in a strict way so the effect of their application does not go beyond the interest they uphold. Therefore, if Directive 2009/81/EC is not to be applied, the non-application must be in proportion to the sought after aims, and must cause a minimum of disturbance on the free movement of goods and the freedom to provide services.

The conditions for the performance of a contract is stated in Recital (45) of the preamble and these can only be related to the performance of the contract itself and in no case related to anything but this. According to Article 47 Directive 2009/81/EC, there are only two criteria upon which the awarding of contracts shall be based. Either “(a) when the award is made to the most economically advantageous tender from the point of view of the contracting authority/entity, various criteria linked to the subject-matter of the contract in question: for example, quality, price, technical merit, functional characteristics, environmental characteristics, running costs, lifecycle costs, cost-effectiveness, after-sales service and technical assistance, delivery date and delivery period or period of completion, security of supply, interoperability and operational characteristics;
(b) or the lowest price only”.

If Article 47.1(a) is used, the weighing of the different criteria must be specified in the contract documentation according to the second paragraph of the Article. This Article connects to Recitals (69), (70) and (71) that all concern the procedure of contract awarding. Recital (69), in which the principles of Recital (15) are repeated again, states that the awarding of contracts shall be based on objective criteria that ensure these principles to guarantee effective competition. In addition, Recital (70) lays out how the principle of equal treatment should be ensured in the award of contracts by the specification of the weight of each criterion. It also says that case law has established an obligation to ensure transparency regarding all criteria and the weighing of them to all tenderers.

If a contracting authority chooses to use the award criterion “most economically advantageous offer”, Recital (71) lays down an obligation to choose the criteria that together adds up to the most economically advantageous offer. Depending on the object of the contract, these criteria will differ since it must be possible for a contracting authority to evaluate the technical performance of each tender in relation to the object of the contract and the price.

2.4.3 Subcontracting

Article 20 of Directive 2009/81/EC gives the contracting authorities the possibility to decide special conditions regarding the execution of the contract. The conditions must however meet the provision of Union law and must be presented in the contract documentation. Subcontracting is mainly regulated in the Article 21 Directive 2009/81/EC, but also in Articles 50–54. Article 21.1, states the successful tenderer’s freedom in choosing its subcontractors and that the tenderer “shall in particular not be required to discriminate against potential subcontractors on grounds of nationality”. However, the freedom to choose subcontractors does not apply to subcontracts that fall under Article 21.3 and 21.4 of Directive 2009/81/EC. According to these paragraphs, the contracting authority may oblige the tenderer to apply the awarding procedure set out in Title III (Article 50–54) of Directive 2009/81/EC for all subcontracts the successful tenderer intends to give to third parties.

The procedure in Article 50–53 controls the awarding of contracts when the successful tenderer is not a contracting authority/entity. Article 50 ensures that subcontracting to a third party follows the obligations set out in Articles 51 to 53. The basic principles of

\[84\] Defined in Article 1.17. Directive 2009/81/EC.
subcontracting in Article 51, states that “the successful tenderer shall act transparently and treat all potential subcontractors in an equal and non-discriminatory way” and Article 52 regards the thresholds and rules on advertising. Article 53 however, concerns the “criteria for qualitative selection of subcontractors”. The criteria shall not be discriminating but objective and consistent, and the capabilities shall also be “directly related to the subject of the subcontract”. If the successful tenderer, on the other hand, is a contracting authority or entity, subcontracting should follow the same procedure as the main contracting according to Article 54.

2.4.4 Implementation

Necessary amendments in national legislations to ensure compliance with Directive 2009/81/EC shall be made before the 21 of August 2011. After that, the Commission shall review the amendments made by the Member States. As stated in Article 73.2, the evaluation shall “evaluate in particular whether, and to what extent, the objectives of this Directive have been achieved with regard to the functioning of the internal market and the development of a European defence equipment market and a European Defence Technological and Industrial Base, having regard, inter alia, to the situation of small and medium-sized enterprises.”

2.4.5 Amendments in Directive 2004/17/EC and 2004/18/EC made by Directive 2009/81/EC


This means that Directive 2004/17/EC will no longer be applicable to contracts on the defence and security markets. Articles 8, 12 and 13 in Directive 2009/81/EC, referred to in the new Article, concern contracts with a value of less than certain threshold amounts, contracts awarded pursuant to international rules, and other specific exclusions such as contracts awarded to a third country, government to government contracts etc. These sorts of contracts

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85 Article 72 Directive 2009/81/EC.
are not to be regulated by Directive 2004/17/EC either.

Article 71 in Directive 2009/81/EC states the amendment in Directive 2004/18/EC, as the former Article 10 is to be removed and replaced by “Subject to Article 296 of the Treaty, this Directive shall apply to public contracts awarded in the fields of defence and security, with the exception of contracts to which Directive 2009/81/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of procedures for the award of certain works contracts, supply contracts and service contracts by contracting authorities or entities in the fields of defence and security (*) applies. This Directive shall not apply to contracts to which Directive 2009/81/EC does not apply pursuant to Articles 8, 12 and 13 thereof. (*) OJ L 217, 20.8.2009, p. 76”.

This Article is different from the former Article 10, as it instead of including “all contracts awarded by contracting authorities in the field of defence”\(^\text{87}\) now only includes contracts not covered by Directive 2009/81/EC. According to this Article, as well as the one added to Directive 2004/17/EC, contracts falling under Article 8, 12 and 13 of Directive 2009/81/EC are excluded from the application of both Directive 2009/81/EC and Directive 2004/18/EC.

\(^{87}\) Article 10 Directive 2004/18/EC.
3. Analysis

3.1 Offset in Directive 2009/81/EC

As the implementation of Directive 2009/81/EC does not have to be made before the 21 of August 2011 naturally no case law from the Court concerning the Directive will be issued before this date. Therefore there is no given answer to the question of how a matter of Offset would be judged by the Court with Directive 2009/81/EC as a legal source, but we will nevertheless try to elucidate the state of law concerning this issue.

As can be noted when reading Directive 2009/81/EC and the preparatory papers to the Directive, and in the opinion of EESC, the matter of Offset has been actively avoided in the Directive and is therefore still not directly regulated. DG MARKT argues that this is because Offset is impossible for the Directive to regulate since Offset discriminates the basic principles of the European Union. EESC, on the other hand, reasons that the Commission has avoided regulating the area because the Commission is of the opinion that legislation would be non-productive and disrupt the Internal Market. EESC, also reasons that Member States and the industry have different opinions and experiences with Offset and that the Commission realizes that views on the matter differ.

The matter of public procurement contracts in the defence sector will in the future fall under the legislation of Directive 2009/81/EC instead of the Directive 2004/18/EC. The change will alter the state of law in this area and it is important to note that Directive 2009/81/EC does not affect a tenderer directly as the Directive concerns public procurement. As EESC states, there is only one procuring part in each Member State, the government of that State, and these are the ones affected by the Directive. We think that if the possibility to require Offsets as a part of a tender or to rank the offers thereafter is affected by the Directive, so are the tenderers as they must adjust to the requirements of the buyer.

3.2 Offset’s Discriminating Nature

The principle of non-discrimination is highly important within Union law and consequently also in Directive 2009/81/EC. Both in Articles and in the preamble of the Directive, the importance of this principle is stated and the need to respect it when defence equipment is procured. The assumption that an interdiction of discrimination in the Directive would mean
per se that Offset is prohibited is based on the idea that Offset is discriminating by its very nature. This opinion is strongly supported by DG MARKT. However, there is another general opinion, pointed out by the Commission in the Communication of a Strategy for a stronger and more competitive European Defence Industry. This is that Offset can also, as an additional compensation, be said not to be discriminating and instead important to help sustain defence spending. This would, in our opinion, mean that the use of Offset is not prohibited by Directive 2009/81/EC.

However one of the problems with Offset, also noticed by the Commission in the same Communication, is that the use of Offset might lead to a situation where the contracting authority chooses a tenderer based on an attractive offer of Offset instead of the competitiveness of the sold product. We think that this use could be discriminating, but it would then be the use, and not the nature of Offset that is discriminating. A non-discriminating use of Offset would not be prohibited.

### 3.3 Offset as a Contract Award Criterion

Article 47 of Directive 2009/81/EC regulates the contract award criteria allowed, and the list in 47.1 (a) is exemplifying. Therefore, the fact that other award criteria than the ones mentioned in the Article could be regarded as valid is not excluded as long as the criteria are “linked to the subject matter of the contract”. The award criterion “most economically advantageous tender” requires the best value for the price offered.

Offset is not mentioned as an award criterion, nor has it earlier been mentioned as award criteria in any of the older directives concerning public procurement. The fact that Offset is not included in the list of award criteria in Article 47 does not, in our opinion, exclude the possibility that Offset could be considered a criterion to support that a tender is the most economically advantageous. However, only direct Offsets can be considered for this as the criteria, according to Article 47, needs to be linked to the subject matter of the contract. We think that this efficiently excludes indirect Offsets, since they are not related to the sold product.

In the Code of Conduct on Offset, EDA recognizes Offset as an existing phenomenon, not likely to decrease in the future. It is stated in the Code that Offset cannot be used as a sole criterion and when used together with others, it should be considered of less weight. As the
Code of Conduct of Offset was signed in 2009, one can note how close this is to the issuing of the new Directive. If EDA would have been of the opinion that Offset was prohibited by the new Directive, the creation of such a code with measures and regulations of this sort would have been very peculiar. If they on the other hand would have been of the opinion that the Directive did not change the regulation of Offset, a measure such as creating a code to harmonize the policies of the Member States is much more logic.

For the use of Article 47.1(a) with the prerequisite “most economically advantageous tender”, many different criteria must be taken into consideration. Article 47.2 states that the procurer shall weight these criteria depending on their importance to ensure the most economically advantageous tender. The wording of Article 47.1(b) with the use of the word only states that the only criterion allowed to be used as a sole criterion is the lowest price. If it was possible to use another criterion alone, the word only would not be needed in the Article. Offsets can therefore not be used as the only criterion when deciding which tenderer is the most economically advantageous, nor can any other criteria than the lowest price be considered alone.

Even though the Directive clearly does not regulate Offset, one might consider that several small steps still have been made to prevent and regulate it. The Articles concerning subcontracting can exemplify this. A contracting authority has the right to prescribe special conditions regarding the execution of the contract, however, with the condition that the tenderer cannot be required to discriminate potential subcontractors on the basis of their nationality. When subscribing conditions regarding subcontracting and to whom tenderers are allowed to subcontract, the buyer could be demanding Offset. The requirements must however, according to Article 53, be “directly related to the subject of the subcontract”. As long as Offset agreements are direct, they can hence be said to be allowed in the subcontracting area. This is still as long as they are non-discriminating.

3.4 Legal Value of Sources

In the interpretation of our sources, we have taken into account in which purpose they are written and which legal weight they have. For example communications and other documents issued prior to legislation in the European Union do not have the same legal value as preparatory work have in Swedish law. Documents such as Green papers and proposals before directives are of some guidance, but they do not hold the only answer to how to interpret a
directive. Communications written by the Commission hold its opinions, and not the actual will of the Member States, but can be an important source for interpretation. Documents written by bodies such as the DG MARKT are also only opinions.

The DG MARKT’s purpose is to find and attempt to remove obstacles to the trade on the Internal Market. Their opinions on a matter such as Offset are thus not objective, but more of a mean to try and remove the existence of Offset, which might explain their strong opinion on Offset as an obstacle to the trade on the Internal Market.

Opinions of bodies such as EDA and EESC are of help to understand the legislation made, and the legislation avoided in the area concerning Offset. As an advisory committee, EESC’s opinion about Directive 2009/81/EC can give guidance as to how to interpret it even though the Opinion is a legally non-binding document.

Regarding EDA, neither its opinions nor codes are legally binding documents, but they show a united action from Member States and express a shared opinion about the EDEM, Offset and other phenomenon on the defence procurement market. The Code of Conduct on Offset was issued in 2009 just before the issuing of Directive 2009/81/EC and gives an idea about the sMS’ opinions on the matter of Offset.

EESC also recognizes that if a functioning EDEM were in place, Offset would not be needed. The interpretation that EESC makes about the Commission’s ways to avoid the matter of Offset in Directive 2009/81/EC shows, in our opinion, that the Commission recognizes the existence and use of Offset.

3.5 Interpretation of Article 346 TFEU

The Articles in the Treaties, such as Article 346 TFEU, that allow for exemptions from the basic principles of the Treaties, also allow for exemptions from the law derived from these principles. This means that they allow for exemptions from secondary legislation such as directives. Therefore, contracts that qualify for an exemption from the Union law regarding the Internal Market on the basis of Article 346 TFEU are automatically excluded from the jurisdiction of Directive 2009/81/EC. If a contract regarding Offset agreements were to qualify to fall under Article 346 TFEU, the use of the contract would not be affected by the issuing and entry into force of Directive 2009/81/EC.
As discussed under 2.7, Recital (3) of the preamble of Directive 2009/81/EC states that the Member States “should take into account” the Commission’s Interpretative Communication regarding Article 346 TFEU. The wording of the Recital with the word *should*, instead of *shall*, implies that the Communication is not in itself legally binding. However, as the preamble of Directive 2009/81/EC referrers to the Interpretative Communication, we are of the opinion that it is an important instrument when considering which contracts that fall under the Directive and which are to be exempted on the basis of Article 346 TFEU.

The Interpretative Communication distinguishes that contracts can only be exempted from Union law by the Article 346 TFEU if they defend essential security interests. As the Commission points out, no other interests can support the use of this Article. This means that Offset agreements only can be exempted if they defend essential security interests. In addition, the exemptions cannot be made if they distort “competition in the internal market regarding products which are not intended for specifically military purposes”. Contracts are not allowed to be exempted by the use of Article 346 TFEU unless these conditions are met.

The exemption of contracts within the defence sector from the rules of the Internal Market with the use of Article 346 TFEU has been frequent up until today. The new legislation in form of Directive 2009/81/EC cannot and does not change the meaning of Article 346 TFEU. Nor the Interpretative Communication issued by the Commission can change the meaning of the Article. The Directive and the Communication can only clarify the state of law laid down by the case law of the Court concerning the Article. Even though this state of law has not changed, Directive 2009/81/EC creates a legal framework in an area where there earlier was a not very well adapted one, and therefore many exemptions that earlier might have been falsely made on the basis of Article 346 TFEU will now instead be covered by the scope of Directive 2009/81/EC.

**3.6 Directive 2004/18/EC**

The use of Directive 2004/18/EC should no longer be as frequently used for contracts in the defence sector after the implementation of Directive 2009/81/EC as it has been. The new Article 10 exempts all contracts that fall in the scope of Directive 2009/81/EC. Security contracts and defence contracts that are not covered by Directive 2009/81/EC will however still fall within the scope of 2004/18EC. From Article 10, Article 14 still provides an exemption with the regard of “Secret contracts and contracts requiring special security
measure”. We think that this exemption will be scarcely used on contracts on the defence market in the future since Directive 2009/81/EC is better adapted than Directive 2004/18/EC.

3.7 Conclusion

To sum up our opinions about how Directive 2009/81/EC affects the case of Offset; A company that offers Offset as a part of their tender to a procuring Member State is not directly affected by Directive 2009/81/EC. The Directive nevertheless affects the possibilities of the Member State to choose a contract with Offset agreement over a tender without and therefore it affects the offering company as well.

There is still a possibility for the Member States to exempt contracts in the defence sector from the Directive on the basis of Article 346 TFEU. In order to do this, the prerequisites of the Article must be fulfilled. Hereby, direct and indirect Offset agreements can be exempted on the basis of this Article. The use thereof should however be scarcely used in the future as more contracts in the defence sector will fall under the scope of Directive 2009/81/EC.

If an exemption from the public procurement rules of the Internal Market would not be possible to be made on the basis of Article 346, Directive 2009/81/EC is most likely to be applicable because of its scope. Even though Offset is not regulated by Directive 2009/81/EC, we think that the Directive would lose part of its effect if all Offset agreements were said to be allowed due to the non-regulation. The award criteria allowed in this Directive are only those that are "linked to the subject-matter of the contract in question”. This excludes indirect Offset agreements as they are often linked to other things in the buying Member State’s economy.

Direct Offset agreements are, on the other hand, linked to the subject matter and therefore not prohibited if used in a non-discriminating way. Direct Offset cannot be the sole criteria and should not be valued as the highest award criteria when weighed with others. We support the idea that Offset, in its nature, is not discriminating but that the current use of it might be and hence Offset is not prohibited because of its nature. In our opinion, Offset might be frowned upon by the Commission and DG MARKT, but very much used among the Member States and the issuing of Directive 2009/81/EC does not change the state of law concerning the legality of the existence of such contracts. Offset agreements are still allowed, but in the future, if the creation of an EDEM is successful, instruments such as Offset may not be necessary.
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