

## Offsets in Europe: A matter for debate

Keri Smith *Jane's Industry Reporter*

### Key Points

- A 2007 EDA report claims that much of the offset system does not comply with law and that it should therefore be gradually eradicated
- Members of the defence industry disagree with the EDA's claims, stating that they see offsets as "acceptable" and an advantage for Europe

### **The EDA has stated that offsets can distort the defence procurement market and obstruct the creation of a unified European industrial base. *Keri Smith* looks at the issues**

While the European Defence Agency (EDA) has recognised the benefits of some offset agreements, it has also said that "offset should ideally be phased out eventually and that it is "generally difficult to justify any type of offset on the basis of Article 296 [of the Treaty on European Union]".

Offsets - the compulsory inward investments imposed on foreign defence suppliers by a purchasing government - were the subject of an EDA report entitled 'EDA Study on the Effects of Offsets on the Development of a European Defence Industry Market', released on 12 July 2007. In the report, the EDA added that "offset - or at least much of offset - is not consistent with Article 296 and hence, illegal, although pending case law to this effect".

The agency went on to say that "not only do member states have to prove that the offset would promote their essential national security interests, not their economic interests", but they "also have to prove that the offset is necessary to address these essential security interests" and that the "specific rules of the EC Public Sector Procurement Directive - in particular those on the selection of suppliers and service providers and the evaluation of tenders - do not allow taking offsets into account".

However, Roger Bulgin, managing director of [UK](#) company Offsets 2000 - which provides support and runs workshops for companies involved with defence-related offset - said: "If we couldn't engage in offset, Europe would be badly disadvantaged. It's about the opening up of foreign markets. If we abolished offsets, we'd lose that. The EDA should look very carefully at that point."

Regarding the notion of offsets being anti-competitive, Bulgin - who is also the offset consultant for the UK Defence Manufacturers Association - added: "I see it [offset] as completely the other way. It was part of an ancient barter trade, years before the governments wrote it into law."

He also cited offset as "a positive development tool" and a way to engage "local entrepreneurs as part of a strategic marketing plan", adding: "Companies that plan for this are successful and able to investigate the potential for strategic partnerships."

Bulgin explained that each country has different priorities when it comes to offset trends, with some using offset to bolster their defence industries, while others seek technology transfer. "There is no 'one size fits all'.

That would be missing the point. The UAE [[United Arab Emirates](#)] is interested in joint ventures, while [Romania](#), for example, wants to see a transfer of skills and work," he stated.

In a report released in August 2006, entitled 'Background to Industrial Participation', Bulgin described the [UK](#) offset, or Industrial Participation (IP), programme as "focused entirely on leveraging work into the [UK](#) defence sector - the exception being companies whose products are dual use". It is "principally concerned with the employment created", he added.

He also explained that "offset thresholds are decreasing - could now be as low as GBP500,000 [USD1 million] - and that the growth of offset means that it is no longer the sole domain of the prime contractors, but also affects small-to medium enterprises (SMEs).

"Companies need to plan well in advance and look at local requirements. SMEs can do this too. They can be prepared and understand the risks and benefits," Bulgin said.

He explained that large companies prefer fulfilling indirect offsets obligations to outsourcing their core products and that there is a move towards civil offset. "It's about 50/50 [civil versus defence offset] at the moment."

London-based Consensus Business Group, which works with the defence and aerospace community to provide offset solutions, described offsets as "politically acceptable" and said that, by including them in a contract agreement "with high levels of technology transfer, the impact on GDP [gross domestic product] could actually be positive - and not just in defence and aerospace".

Discussing the trend of increasing offset percentages or quotas, Consensus Chairman and Chief Executive Officer Vincent Tchenguiz said: "Offsets can extend to 300 per cent, although the industry average is nearer to 70 per cent", adding that the offset quota required for the Indian multirole combat aircraft (MRCAs) contract - for which there are six bidders: Boeing (with the F/A-18E/F); Dassault (Rafale); Eurofighter (Typhoon); Lockheed Martin (F-16); Russian Aircraft Corporation (RSK)-MiG (MiG-35); and Saab (JAS 39 Gripen) - has increased from 30 per cent to 50 per cent.

"The trend for [India](#) and [China](#), in terms of offsets, is to acquire defence and aerospace technology. The tension will be centred around how much, and whether these technologies will be transferred."

Another offset trend that could be set to increase in popularity and which is linked with climate change - a topic high on the political agenda - is the inclusion of provisions for alternative energy in offset or 'countertrade' agreements - "climate change, as opposed to cockpits," suggested Tchenguiz.

"How can you fight a war if oil is USD200 a barrel? And as most battles are for energy, why shouldn't alternative energy be included in offset?" he added.

Tchenguiz cited the US International Traffic in Arms Regulations as an understandable and justifiable barrier to fulfilling the offset investments desired by some procuring countries, but stated that offering environmentally linked offsets is "politically right" for countries and is "the line of least resistance".

Another industry source cited the "green issue", with regards to offset as "a wonderful idea", but added: "How many governments have put that in their legislation? Not many."

## **Exception to the rule**

The corporate approach to securing contracts through offsets has been varied, with the procuring countries focusing on investment in five key areas: technology transfer; job creation; exports; healthcare; and education. Agreeing to the fulfilment of obligations related to these sectors is an increasingly essential factor in securing contracts with foreign countries.

Defence companies often avoid significant spending on an offset project, prior to the award of the defence contract for an obvious reason; the defence market is characterised by uncertainty - programme delays,

budget overruns and economic problems at national and corporate level are common. However, there are exceptions to the rule, such as in the case of Swedish defence aerospace group Saab.

Saab, which produces the JAS 39 Gripen - the product of collaborative arrangements with [BAE Systems](#) - has seen success in exporting the fighter aircraft in central Europe, which has, in part, been underpinned by ostensibly generous and creative offset agreements. The group itself has described offset in the defence aerospace industry as "an essential part of doing business, with customers becoming increasingly discriminating as to the form and quality of the economic compensation required for their defence investments".

In January 2001, Saab and [BAE Systems](#) together submitted a proposal in response to the Hungarian government's request for information for the modernisation of the [Hungarian Air Force](#). The proposal was based on the supply of up to 24 NATO-interoperable Gripen fourth-generation multirole/swingrole fighters, which were to be delivered from 2005.

When the first contract between the Hungarian Ministry of Defence (MoD) and [Sweden](#) was signed in 2001 covering the lease of 14 Gripen aircraft, an associated offset agreement was concluded between Gripen International - the Saab division behind the export of Gripen - and the Hungarian government. It was agreed that Gripen International would generate offset value worth 110 per cent of the original contract.

Under the deal, [Hungary](#) would benefit from a long-term flexible finance proposal, backed by the Swedish and [UK](#) governments, that could delay the normal initial capital outlay involved with a major acquisition programme. This would be linked to an opportunity to further stimulate Hungarian industry in both the commercial and defence sectors through the development of strategic partnerships with key European companies.

The agreement also included comprehensive operations and tactical training for pilots, which could allow for a number of Hungarian pilots to train with the [Swedish Air Force](#) on Gripen, enabling the early establishment of fully qualified multirole/swingrole operational instructors and pilots.

At the time, Saab-BAE Systems had already registered more than USD575 million in pre-contract offsets with the Hungarian Ministry of Economy, in advance of its Gripen bid.

Significant offset-related activities approved by the Hungarian Ministry of Economy include the opening of a new regional head office and maintenance centre for Swedish car maker Volvo in Budapest and the establishing of new premises for Swedish home appliance conglomerate Electrolux, which opened a vacuum cleaner factory, a chest freezer factory, a research and development (R&D) centre, a new refrigerator factory and a new logistics centre in Jaszbereny.

Additionally, Swedish mobile phone company Ericsson opened a new regional head office and a software-development centre and has intensified its co-operation with the Technical University of Budapest.

In June 2006, the Hungarian Ministry of Economy and Transport approved Gripen International's latest offset arrangement, worth just over SEK1 billion (USD136 million), associated with the lease of 12 Gripen aircraft for the [Hungarian Air Force](#).

Saab said that, at the end of the second quarter of 2006, Gripen's approved offset claim registered at almost SEK6.2 billion. Of this amount, the export value equated to more than SEK4.6 billion and the investment value to more than SEK1.5 billion.

Other countries that have seen the benefits of offset agreements related to Gripen contracts include the [Czech Republic](#) and [South Africa](#).

In November 2002, after abandoning an original plan to purchase the Gripen, the [Czech Republic](#) made a request for a 12-14 aircraft lease. After evaluating various offers, the Czechs signed a 10-year (2005-15) leasing deal, for 12 JAS 39C and two JAS 39D aircraft in mid-June 2004.

The contract agreement provided the Czechs with 21,000 flight hours, pilot training - including access to training devices - and maintenance equipment and an integrated logistics package.

Additionally, on 13 November, Gripen International said that the South African Department of Trade & Industry (DTI) had announced in its 2007 annual report to parliament that the delivery of the combined Saab-BAE Systems offset - linked to South Africa's joint Gripen and Hawk acquisition programme - was "ahead of schedule with a surplus of economic benefits being delivered by August 2007". The DTI report highlighted a surplus of ZAR108 million (USD16 million) in the Gripen defence offset programme.

## Change of emphasis

In 2005, Saab detected a subtle change of emphasis on procurement policies from countries that have previously been focused on US products and which now prefer dual sourcing.

"World politics have swung in our favour," Bob Kemp, sales & marketing director for Gripen International, said at the time.

It is also likely that Gripen's export success is due to its comparative low cost. It is cheaper, for example, than its competitors on the Indian MRCA contract bid, except for the MiG-35 aircraft, which has an approximate unit cost of between USD55 million and USD60 million. The unit cost of a Gripen aircraft - a single-engine aircraft - is around USD68 million.

This could be also a contributing factor in Saab's ability to offer quotas of over 100 per cent in offset obligations on contracts, as well as the fact that Gripen can be offered on a lease deal, both of which contribute to an attractive commercial package overall.

Additionally, the group has enjoyed the support of a powerful network of global business partners and the full support of the Swedish government, as well that of one of its major shareholders, the Investor Group, and Sweden's Wallenberg Foundation. This could be described as the "industrial muscle" helping the group develop creative business opportunities which please the procuring country's politicians.

Saab aims to sell a further 200 Gripen aircraft over 10 years, with its potential market split into the following three categories: new NATO members (notably [Bulgaria](#), [Romania](#) and [Slovakia](#)); non-aligned nations (such as [India](#)); and forces seeking to replace the F-5 (including [Thailand](#) and [Switzerland](#)). Other target countries include [Denmark](#) and [Greece](#). Of the new export opportunities, [India](#) could prove to be the most lucrative, as it is looking to replace 126 MiG-21s.

One example of creative offsets paving the way for the securing of future contracts is the 2000 signing of a memorandum of understanding (MoU) between the [UK](#) and [Kazakhstan](#) governments, which led to the creation of the BAE Systems/Kazakhstan joint venture Air Astana, which is a civil airline.

The MoU called for [BAE Systems](#) to invest in the aerospace infrastructure of [Kazakhstan](#) and, according to Air Astana, "is seen as a potential stepping stone to wider co-operation". Air Astana was formed as a "first step in the development of a long-term [UK](#) relationship with [Kazakhstan](#)", the airline said.

## Romanian dispute

Offset obligations occasionally lead to disputes, due to the sometimes nebulous nature of leveraging investment into a market. This was recently highlighted by Romania's dispute with [BAE Systems](#) over a Type 22 frigate deal.

In early September, [Romania](#) called on [BAE Systems](#) to enter into a "dialogue" regarding contractual obligations associated with the sale of two Broadsword-class Type 22 frigates. [BAE Systems](#) countered that such an exchange was already happening.

The dispute relates to the Regele Ferdinand and Regina Maria (formerly HMS Coventry and HMS London respectively), which are operational with the Romanian Navy after a GBP116 million deal agreed with the [UK](#) in 2004, with [BAE Systems](#) as lead contractor on the [UK](#) side.

Under the terms of the agreement - concluded with the UK MoD on 19 December 2002 - the offset programme seeks obligations amounting to 100 per cent of the final value of the acquisition over a five-year period, which starting on 26 March 2003 when the accord came into effect.

According to a 12 November statement to Jane's regarding the deal, the Romanian MoD said: "At the present time, the fulfilment stage of contractual obligations by [BAE Systems](#) is way too long lagged behind."

Under the initial contract, most of the commitments concerning the offset refer to the indirect compensatory operations (between 80 per cent and 90 per cent), while the "main objectives in this respect focus on the Romanian defence and aerospace industry", said the country's MoD.

Direct offset obligations related to the contract include the provision of rigid inflatable boats, diving equipment and training for the Romanian Navy.

In January 2006, meanwhile, Patria Vehicles filed a protest with the Czech MoD concerning its failed tender for the supply of armoured personnel carriers. The CZK25.3 billion (USD1.4 billion) international contest to supply the Army of the [Czech Republic](#) with 234 wheeled armoured vehicles was won by Austrian company Steyr-Daimler-Puch, offering its latest-generation Pandur II 8 x 8 wheeled armoured vehicle. Patria had offered its Armoured Modular Vehicle (AMV).

At the time of signing of the deal, sources close to the tender process told Jane's that the Steyr consortium was selected because it had submitted a superior offset package - a suggestion that was played down by Steyr, which claimed the win was due to technical merit and low support costs.

Just over a year later, Patria withdrew its protest against the Czech MoD, declining to comment on reasons for the decision. In October 2007, Patria and Croatian armoured vehicle manufacturer Duro Dakovic Special Vehicles signed an agreement with the Croatian MoD to provide 84 Patria AMV 8 x 8 vehicles for the Croatian Army.

The Croatian media reported that the bid was won ahead of Steyr's Pandur II vehicle and it was claimed that Patria offered a better offset deal. At the time, Jorma Wiitakorpi, chief executive officer and president of Patria said: "Through the offset included, Patria offers potential to the Croatian economy as a whole. The vehicles will be produced through direct participation of local co-operation partners."

## Important role

Many involved in the defence sector are in no doubt as to the increasingly important role that offsets play when it comes to winning contracts.

In his Offsets 2000 report, Bulgin describes offset as "quickly becoming of great political importance to governments in the assessment of defence contracts".

He advised contractors not to ignore the "implications that offset presents, not simply because of financial risk implications, but because a good offset proposal can be a deciding factor in a competition". Bulgin did warn, however, that in choosing a supplier, there should be no "trade-off", adding: "Offset should not diminish the product."

## OFFSET LEGISLATION IN EUROPE

### [Austria](#)

The minimum value of the contract is EUR26 000 (USD1.1 million) and the minimum offset quota is 100 per cent (the maximum is 200 per

cent). Multipliers are negotiable but are usually between 3 and 10. Penalties are usually between 4 per cent and 10 per cent of the unfulfilled offset value, although there have been penalties of over 10 per cent. The focus of offsets is on direct investment, R&D, technology transfer and subcontracting.

#### [Belgium](#)

The minimum contract value is usually EUR11 million, while the minimum offset required is 100 per cent. Termwise, pledges should be closed within two years after supply, but this can be negotiated. Multipliers come into play only for acquisitions above the EUR11 million threshold. Penalties incurred stand at 10 per cent plus of non-fulfilled obligations. The focus is on high technology and new or additional business flow.

#### [Czech Republic](#)

The minimum value of the contract is CZK500 million (USD28 million), with a 20 per cent direct offset requirement. The minimum offset quota required is 100 per cent, over a 10-year term. Multipliers are not used. Penalties usually stand at between 5 per cent and 10 per cent of export contract value. The focus of obligation is on new technology co-operation and technology transfer.

#### [Denmark](#)

The minimum contract value required is DKK25 million (USD4.96 million), with a minimum offset requirement of 100 per cent. The stipulated term covers comprises the fulfilment of at least 30 per cent within four years. Multipliers are not normally considered, but can be for R&D and technology transfers on a case-by-case basis. If 30 per cent is not fulfilled within the four-year term, the contractor is obliged to pay the amount outstanding.

#### [Estonia](#)

Offset policy has not been made law, although the country seeks a significant measure of countertrade, which must account for about 5 per cent of the allocation criteria in the procurement process.

#### [Finland](#)

The minimum contract value stands at EUR10 million, with a minimum offset requirement of 100 per cent over a negotiable term. Multipliers are between 0.3 and 3.0 for the export of Finnish products, while technology transfer multipliers and penalties are usually negotiated. Finland's focus is on the participation of its domestic defence industry, along with technology and export.

#### [France](#)

[France](#) has no formal countertrade and offset policy, but has a countertrade and offset bureau within the Ministry of Economic Affairs & Finance and another in the MoD. [France](#) is largely self-sufficient in military supply but major acquisitions from overseas suppliers have occasionally been subject to offset requirements. In terms of multipliers, [France](#) tends to prefer transactions with small and medium-sized industrial companies.

#### [Germany](#)

The official position of the German MoD is that offset arrangements are economically counterproductive when used in defence procurement. The MoD has formally stated that it will continue to work with allies and partners in the EDA in order to mitigate what it sees as the negative effects of compensation arrangements.

#### [Greece](#)

The minimum contract value is EUR10 million, with a minimum offset requirement of between 80 per cent and 120 per cent. The term period equals that of the procurement contract term and the inclusion of multipliers depends on the value of offset and the recipient, but most fall into the 1.0-9.0 range. Penalties are 10 per cent of unfulfilled benefits. The focus in [Greece](#) is to reinforce its armed forces, reduce procurement costs and to upgrade its production and technology infrastructure.

#### [Hungary](#)

The minimum contract value is HUF1billion (USD5 million) with a minimum offset requirement of 100 per cent. While the fulfilment term is negotiable, it is usually one year longer than the contract term. Multipliers are 1.0-2.5 for preferred activities, investment areas and export and export products, while the penalty of non-fulfilment is that a bank guarantee must be opened for 6 per cent of the contracted value. Hungary's priority areas for investment include its defence industry; biotechnology; nanotechnology; environmental protection; renewable energy; electronics; information technology; and telecommunications.

### [Italy](#)

The minimum contract value is EUR5 million with a preferred minimum offset requirement of 100 per cent, but it must be no less than 70 per cent. Multipliers are negotiable and are a maximum of 3.0, while the maximum penalty is 10 per cent. Italy's focus is to provide export opportunities for Italian defence companies.

### [Lithuania](#)

The minimum contract value is LTL5 million (USD2 million) with a preferred minimum offset requirement of 100 per cent, which is negotiable. The term is 10 years with a minimum of 50 per cent of offset fulfilment to be completed within five years. Multipliers are unclear and penalties are variable. Priority areas are the protection of its defence industry and national security.

### **The Netherlands**

The minimum contract value is EUR5 million with minimum offset requirement of 100 per cent and a term of between five and seven years from the date the agreement comes into effect, although this must not exceed 10 years. Multipliers are negotiable. Penalties - which are also negotiable - are worked out as a percentage of the late fulfilment portion, while the supplying company must still fulfil its obligation. The focus in the [Netherlands](#) is on technological innovation and marketing support for innovative products.

### [Norway](#)

Norwegian guidelines set a minimum contract value of NOK75 million (USD12 million) requiring offset, but this is not mandatory. Typically, 50 per cent of the offset commitment is required for strategic projects that are considered to be important to both the armed forces and the defence industry and the offset obligation must, as a minimum, correspond to the procurement price of the actual defence product. The focus is to acquire continuing indirect defence-related contracts within the priority areas, as opposed to one-off contracts. There are no direct offset requirements specified within the guidelines.

### [Poland](#)

The minimum contract value is EUR5 million, with a 100 per cent offset quota. The multiplier range stands at between 2.0 and 5.0, while the fulfilment period cannot exceed the 10-year timeframe. Penalties are negotiable. The contractor may be asked to provide a bank guarantee. The investment focus of the offset agreement for [Poland](#) is on the participation of foreign suppliers in the restructure and development of the economy, particularly for the country's defence industry; the opening of new export markets; technology transfer; R higher education and facilities for R and the creation of employment.

### [Portugal](#)

The minimum contract value or threshold is EUR10 million, with a 100 per cent offset quota, of which at least 30 per cent of offset projects are to be fulfilled in the area of R&D. There is no particular preference with regard to direct or indirect offsets. At least 15 per cent of work should flow to subcontractors in order to provide opportunities for niche SMEs.

### [Romania](#)

The threshold is EUR3 million and the minimum offset required is 80 per cent with a maximum fulfilment term of two years after the procurement contract completion. Multipliers are usually between 1.2 and 1.9, although up to five is possible. [Romania](#) is focused upon technology transfer and improving its defence, and aerospace industries, as well as establishing a long term defence infrastructure.

On the indirect side, Romania's priorities are ecology, shipbuilding and automotives.

### [Slovakia](#)

Contract thresholds vary from EUR130,000 to EUR5 million. The offset quota is negotiable, although 100 per cent is usually expected. The offset programme period is usually between five and 10 years and at least 20 per cent of the value of the contract must be direct offset, with higher multipliers awarded for direct offsets. Slovakia's offset policy is designed to encourage foreign investment and technology transfer. The country also seeks direct participation in the production of supplies related to the procurement to create new markets for domestic businesses and to encourage foreign direct investments. [Slovakia](#) also focuses upon participation programmes in education and healthcare. Unless an extension is given to the foreign partner's completion deadline and unless a substitute fulfilment of the offset transaction has been agreed, a penalty of up to 5 per cent of the value of the incomplete offsets can be imposed.

### [Slovenia](#)

The minimum contract value required is SIT100 million (approximately USD607,000), alongside a minimum offset quota requirement of 100 per cent, although there have been indications that this has now been relaxed. The term is for between one and five years from the contract date, with multipliers of 7.0. Penalties are not specified in the guidelines. Slovenia's offset priority is the creation of new employment

opportunities through long-term economic ties and capital investment. It also seeks to attain high technology and investment in R&D.

#### [Spain](#)

Guidelines on the offset contract threshold are not available; the Spanish MoD relies upon an internal directive provided by the Secretary of State for Defence. The minimum offset quota is usually 100 per cent but is negotiable, while the fulfilment falls into the supply contract term. While not generally applied, multipliers are between 2.0 and 5.0 and penalties are negotiated individually; usually between 5 per cent and 10 per cent. The concentration is on technology similar to the product purchased, improving the armed forces and defence industry and increasing R&D and employment.

#### [Sweden](#)

The threshold is SKR100 million (USD15 million) with a minimum offset requirement of 100 per cent and a fulfilment term that corresponds with the timeframe of procurement programme. The sum of all multipliers that are greater than one are limited to a maximum of 10 per cent of the offset commitment and penalties are 5 per cent of the unfulfilled requirement for each milestone goal. Sweden's focus is to gain technical knowledge, as well as encourage exports and the internationalisation of its domestic defence industry.

#### [Switzerland](#)

The minimum contract value is CHF20 million (USD18 million), which is on a case-by-case basis with a minimum quota of 100 per cent. The term must be no later than three years after completion of the defence contract and the multipliers are between 2.0 and 3.0, with a penalty of 5 per cent of the unfulfilled obligation, although a negotiated solution is usually preferred to imposing the penalty. [Switzerland](#) prioritises the bolstering of its manufacturing industries, the transfer of technology and co-operation with universities.

#### [Turkey](#)

While Turkey is not an EU member, it has been included as a result of its interesting reliance on offsets. The minimum contract value threshold is USD5 million with a minimum offset requirement of 50 per cent and a maximum two-year fulfilment term. Multipliers are between 1 and 6, with penalties of 10 per cent of the result of multiplying the percentage unfulfilled by the monetary value of the unfulfilled portion. Turkey's focus is to increase its defence exports and strengthen its industrial infrastructure and expand investment and R&D co-operation.

#### [UK](#)

The minimum contract values are GBP10 million (USD17.2 million) and GBP50 million for French and German companies respectively in conformity with bilateral agreements (reciprocal waiver agreements). There is no minimum offset quota, but the target is 100 per cent over a term that covers the contract period. There are no multipliers and no penalties - there is just a strict enforcement of the IP programme. The UK's focus is on sovereign capability, a competitive and leading-edge domestic industry and added overseas business.