



Offsets in the Aerospace and Defence Industry

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Executive Summary

The International Forum on Business Ethical Conduct for the Aerospace and Defence Industry (IFBEC) established a working group on offset, chaired by the Basel Institute on Governance. The working group produced this paper following meetings held from December 2014 to August 2015.

Offsets are required of the defence industry by about 80 countries worldwide when purchasing defence equipment, systems or services. The scope of offsets can vary widely and be related to the main contract or be entirely unrelated to it.

For purchasing countries, offsets offer opportunities to acquire technological know-how, support local industry and other economic benefits. From a defence industry perspective, offsets can play a decisive role in a successful procurement bid, assist entry into new markets, and help strengthen relations with companies in the local supply chain.

According to the OECD, the defining characteristics of industries identified as susceptible to corruption risk in procurement include: strong capital intensity, advanced technology and sophistication of materials, and economic rarity, criteria that characterizes the defence industry. The difficulty with which to make direct comparisons on price, coupled with the number of actors in the procurement process, provides opportunities to insert bribe payments.¹

The working group acknowledged that there are potential risks, including in relation to bribery when engaging in offset activity. Stakeholder opinions diverge on the risks associated with the use of third parties or where the risks lie in the lifecycle of offset activities.

The defence industry representatives on the working group state that offset contracts are subject to the same exposure to corruption as other commercial dealings, and accordingly do not per se automatically raise risk levels.

Country risks include the corruption risk of the country itself, the rules and the country's expectations and capacity relating to offset obligations can create risks, but not only compliance risks, companies may face legal and business related risks as well.

The working group has made a series of suggestions and recommendations to the IFBEC Steering Committee for their review and consideration set out in the final chapter of this paper. These proposals cover the implementation of minimum standards in anti-corruption compliance in offset activities for the industry. In addition, the working group also makes suggestions for further collaboration between the industry and other stakeholders.

¹ OECD, 2007.

1 Introduction

Purchasing defence equipment, systems and services is costly and governments that engage in such expenditures often seek to obtain local investments from defence companies by way of offset agreements. These compensatory arrangements can take a wide range of forms and may include local production of parts that will be needed for the equipment that is being purchased, or they could involve programmes designed to boost employment and supporting the wider economy with industrial projects and the transfer of technological know-how, all of which make offset an attractive option for many countries. From a defence industry perspective offsets can play a decisive role in a successful procurement bid, assist entry into new markets, and help strengthen relations with companies in the local supply chain. Reliable figures about the size of offset obligations are not easily verifiable, though commentators believe that offsets will continue to be required by many governments, and guidelines on how their offset programs operate will continue to be further developed.

Offset arrangements elicit diverse views from industry participants, stakeholders, academics and commentators. Even amongst companies in the industry itself, different opinions are evident; some see offsets as an unnecessary yet frequently unavoidable element of the modern industry due to customer demands, whilst others view them as a means to gain a decisive competitive advantage. A few defence companies agree that certain aspects of offset arrangements can appear to be complex and this can create the impression that they lack transparency. It can also be assumed that perception may differ significantly between defence contractors experienced in offsets, and newcomers for which offset is one of the methods to gain market share. However, most companies that contributed to this paper view offset agreements as being no different to any other business contracts and that proprietary information is not revealed for legitimate reasons. This range of opinions makes it challenging to arrive at consensus on the utility of offsets and the extent of real and perceived business and integrity risks. But whatever the rationale for engaging in offsets, it is apparent that risk mitigation efforts undertaken by the aerospace and defence industry to address integrity risks have been increasing over recent years, and for many companies, specific policies and procedures are now established within their wider anti-corruption programmes.

Some countries treat offsets as commercial opportunities that can promote or even accelerate development goals. There are, however, diverging opinions amongst economists about who ultimately pays for and benefits from offsets: The obligor company with the responsibility to execute the offset, or the government customer that demands them. The public financial reporting of offsets could be harmonized so as to improve the possibility of comparative analysis. The application of confidentiality due to national security concerns sets defence and offset

arrangements apart from other commercial arrangements, purchasers should not however misuse this designation to avoid making non-sensitive information available about offset arrangements.

Whatever the answers to these viewpoints may be, the fact remains that offsets have grown into substantial programmes, often referred to as complex due to heterogeneity from one country to another, and sometimes controversial, also poorly understood and negatively reported upon in the media. There are areas where further research and greater openness by purchasers, would do much to improve their image without undermining competitive advantages or revealing proprietary information. In some areas the development of rules (either soft law or regulations) would help counter potential bribery risks, as well as mistrust of the business and the suspicion of impropriety. In order to make progress in dispelling the myths around offsets a more collaborative effort is needed: Countries, the industry and the third parties involved in offsets each need to contribute to the demystification of these arrangements, promoting an environment of greater transparency and integrity for the undertaking of offset activities. The industry has taken many steps in this direction over the past decade. Greater transparency would further contribute to good corporate governance; improve political public accountability, and address questions around the judicious expenditure of public money.

1.1 IFBEC and the Basel Institute on Governance

The International Forum on Business Ethical Conduct for the Aerospace and Defense Industry (IFBEC) established a working group from amongst its members to consider the mitigation of bribery risk in offset arrangements in the aerospace and defence industry. The working group met regularly over a six-month period between 2014 and 2015. It was agreed that the Basel Institute would facilitate the discussions of the working group and assist in the drafting of this paper which reflects input from the working group and the results of a questionnaire given to IFBEC members and other selected defence companies (chosen for their involvement in offsets). The paper aims to set out the general state of the discussion relating to transparency and corruption risks pertaining to aerospace and defence offsets; secondly, to identify best practices to mitigate corruption risks within defence companies based on the inputs received from the IFBEC member companies; and thirdly, to set out recommendations for further work and activities to address transparency in offsets. IFBEC and the Basel Institute regard this undertaking as a first step in a wider effort with suggested next steps set out in Chapter 6, which could form the basis for further work and actions by government, stakeholders and the industry itself. This paper therefore seeks to make a constructive contribution to the on-going discussions, raise areas for further action and to set out what IFBEC could be willing to do, and what it would like to recommend to its partners and customers.

The International Forum on Business Ethical Conduct (IFBEC) was created by member companies of the Aerospace Industries Association of America (AIA) and

the Aerospace and Defense Industries Association of Europe (ASD) in 2010. It provides an opportunity to exchange information on best practices in the area of ethical business practices and global trends among industry participants. IFBEC members have developed a set of Global Principles of Business Ethics for the Aerospace and Defence Industry, which were endorsed by AIA and ASD in October 2009. The Forum is open to all companies in the sector that are willing to share business practices for sustainable competitiveness. This entails submitting a letter of commitment to the Global Principles and the Charter signed by the CEO of the company; a Public Accountability Questionnaire to assess if the compliance programme corresponds to IFBEC's standards; and a company statement with general information on the size of the company and information on its commitment in other compliance forums besides IFBEC. This documentation is assessed and voted on by the IFBEC Steering Committee. When voting the members take into consideration the purpose of IFBEC which is to promote and foster through the Global Principles the development of industry-wide ethical standards for companies that are active in the aerospace and defence business sector. The IFBEC also is focused on organizing opportunities for industry and relevant stakeholders to exchange information and best practices concerning ethical business challenges, practices and opportunities worldwide.

The Basel Institute on Governance is an independent not-for-profit competence centre working around the world with the public and private sectors to counter corruption and other financial crimes and to improve the quality of governance. The Basel Institute's International Centre for Collective Action (ICCA), which has been working with IFBEC in this endeavour, works with companies and other concerned stakeholders to develop anti-corruption Collective Action initiatives in a variety of industry sectors. The ICCA also supports research and the development of the academic discourse on anti-corruption Collective Action and hosts the B20 Collective Action Hub. In 2015 IFBEC supported the work of the Basel Institute by becoming a sponsor of the B20 Collective Action Hub with a donation of USD 25,000.

1.2 Structure of the paper

This paper is structured as follows: Chapter 2 outlines the relevant definitions and context; Chapter 3 examines the legal and regulatory frameworks with a selected sample of national approaches, with the latter selected by the working group as illustrating a range of approaches towards offset regulation and practice. Chapter 4 identifies potential bribery risks in offset activities, in particular as described in recent commentaries on the subject. Chapter 5 sets out the results of the questionnaire and other industry approaches to mitigate bribery risks. The questionnaire was provided to a selection of aerospace and defence companies, selected individual interviews with industry experts, civil society and legal professionals. The small sample size and response rate to the survey limits the interpretative power of the results; however some insights are reported such as where leading companies in the industry see

common ground concerning offset activities and integrity. Chapter 6 draws some conclusions from the survey with suggestions for further work and possible reforms.

2 Definitions and Context

2.1 Definitions of offset

There does not appear to be a universally agreed definition of offsets among companies: Some distinguish between direct and indirect, others (and some governments as well as the industry) apply terminology such as 'industrial cooperation', 'industrial participation', 'countertrade', 'industrial/economic compensations' or 'industrial benefits'. Certain companies define offsets according to the degree and type of their company's involvement in the contract rather than opting for descriptions of direct or indirect offset. In general terms however, offsets may be said to refer to reciprocal arrangements between governments and the private sector. In most cases a purchasing government requires the foreign seller firm to commit to an offset obligation in the importing country of an amount representing a proportion of the main contract's value towards reinvestment in the importing country, although companies also reported that in some instances the purchasing government may require an offset obligation to address a specific project or work rather than a quantifiable value related to the main contract.

Notwithstanding the industry's diverse approaches to defining offsets, the WTO Government Procurement Agreement under Article 1(l)² has set out a definition in the following terms:

'offset means any condition or undertaking that encourages local development or improves a Party's balance-of-payments accounts, such as the use of domestic content, the licensing of technology, investment, countertrade and similar action or requirement.'

Other examples of definitions are set out in country documentation relating to offsets,³ and whilst these definitions are substantially similar, some commentators have used the development of the terminology as indicative of the evolution of the programmes themselves and the level of maturity or sophistication of the market. This method has been employed to track the development of offsets from

² See further section 3 below on the GPA.

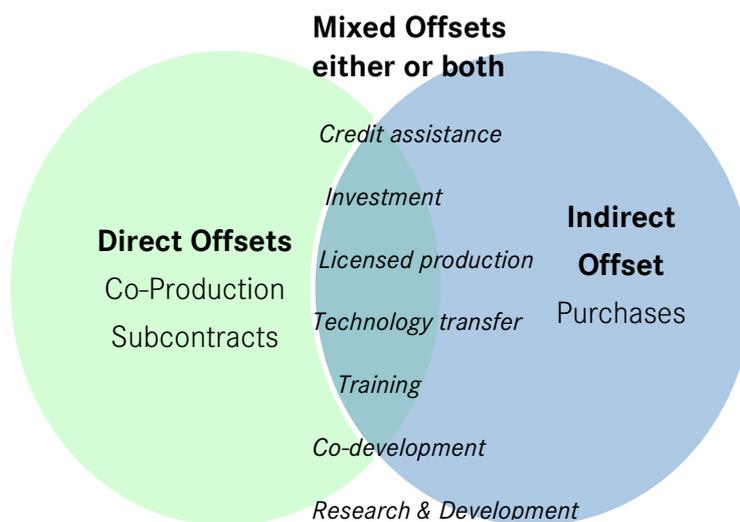
³ For example the US Department of Commerce Bureau of Industry and Security, defines offsets as "Compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as defined by the Arms Export Control Act (22 U.S.C. § 2751, *et seq.*) and the International Traffic in Arms Regulations (22 C.F.R. §§ 120-130)." <https://www.bis.doc.gov/index.php/other-areas/strategic-industries-and-economic-security-sies/offsets-in-defense-trade/54-other-areas/strategic-industries-and-economic-security/181-offset-definitions>.

countertrade through to industrial participation and voluntary engagement without penalties.⁴

Offsets are frequently categorized according to the relationship of the transaction to the main defence contract as either direct or indirect offset transactions. Direct offsets are those which are directly related to the exported goods or services supplied in the main defence contract, whereas indirect offsets are often defined as being unrelated to the goods or services provided under the main contract. Indirect offsets can be further sub-classified as civil-related indirect offsets or defence-related indirect offsets, which can be defence, aerospace or homeland security related but are not connected to the exported goods or services of the main contract, and commonly known in the industry as semi-direct offsets.

From a company perspective the relevance of definitions at the country level arises in more practical terms in relation to the scope of industries that are potentially available to engage with as part of the offset arrangement. Switzerland for example permits civil and defence related offsets and sets out the respective sectors but also has a list of precluded industries that are examples only (e.g. agricultural and pharmaceutical products, consumer goods, consulting, services in banking, tourism and insurance). For anything not explicitly covered there is a case-by-case approach.⁵

Diagram I: Offset Typology



⁴ See The National Strategic Industry Build-Up Plan with Defense Offset Trade in Korea, Won-Joon Jang and Young-Su Ann, Korea <http://www.disamjournal.org/articles/the-national-strategic-industry-buildup-plan-with-defense-offset-trade-in-korea-1526>

⁵ Switzerland's Offset Policy at <http://www.ar.admin.ch/internet/armasuisse/en/home/themen/beschaffung/rustungspolitik.parsys.50930.downloadList.2688.DownloadFile.tmp/offsetpolicyupdate01072010.pdf>.

Source: Adapted from US Department of Commerce BIS Report, 2015.

The activities that a firm must undertake in order to fill its offset obligations can come in a variety of forms. For direct offsets this can include co-production or subcontracting. A number of activities can be classified as either direct or indirect offsets, such as credit assistance, investment, licensed production, technology transfer and training. Purchases, which involve the procurement of an off-the-shelf item from the defence company in fulfilment of its offset obligation, may also be cited as an example of an offset transaction. When an offset transaction, either direct or indirect, is accepted by the customer, the obligor receives offset **credits** that will be deducted from the value of its remaining offset obligation.

The **offset obligation** is often reported as a percentage of the main commercial contract, such as 60% of the **main contract value**, implying that through the valuation of one or more projects or transactions, the offset obligation will be fulfilled.. From the seller's perspective, the cost is the money spent to implement the offset obligation. From the purchasers' point of view, the offset value of each transaction takes into consideration the purchaser's opportunity to acquire intangible assets including technology, know-how, the production of parts and so on. Purchasers therefore use offset programmes as a way of obtaining defence technology, upgrading and transferring expertise and other opportunities perceived as valuable. This potentially renders the offset transaction as therefore having a negotiable value, which in some situations, arguably renders the percentage valuation meaningless, although this will not be the case where no multipliers are applied or where there are very clear valuation mechanisms in the country's offset regulations that are applied. For the obligor however, it is very important to agree the valuation of the offset transaction before the obligation is undertaken.

2.2 Some specific elements of offset programmes

The features explained in this section are deployed by many countries in their offset obligation programmes, though by no means all.

2.2.1 Valuation Methods

As mentioned above, in fulfilment of its offset obligations, a firm seldom spends a sum equal to the value of the offset it is required to deliver. Countries that are purchasing defence equipment use a range of valuation methods. These can include the purchaser's assessment of the 'know-how' that is being created or transferred through the offset programme; the degree of urgency the country attributes to acquiring a particular technology; or how useful it will be in the long term for the country. Multipliers are one method used by some countries to steer offset programmes towards the delivery of goods and services that a country is keen to acquire: Importing governments can differentiate between certain activities undertaken to deliver offset by assigning a multiplier (which can be below 1), that

allows the seller to receive credit values that are different to business transaction values. This can encourage or discourage firms to provide offset transactions of a specific variety, in light of the government's preference and specific policy goals. Switzerland for example assigns a low 0.5-1 multiplier to offset transactions outside the defined industrial sectors. The country applies the multiplier to the offset transaction as part of its assessment of the value of the obligation.

The US BIS reports⁶ contain an example to illustrate how multipliers work in practice:

'A foreign government interested in a specific technology may offer a multiplier of "six" for offset transactions providing access to that technology. A U.S. defense company with a 120 per cent offset obligation from a \$1 million sale of defense systems ordinarily would be required to provide technology transfer through an offset equalling \$1.2 million. With a multiplier of six, however, the U.S. company could offer a project valued at only \$200,000 (actual value) in technology transfer and earn \$1.2 million in credit value, fulfilling its entire offset obligation under the agreement.'⁷

2.2.2 Excess credits and banking

The value of offset credits earned by a company from its activities may sometimes exceed the size of the offset obligations that company has in a particular country. Where permitted in that country, these credits can be saved for future use by the company and in such cases they are described as 'banked'. The term may also apply to so-called 'pre-performance' investments undertaken in advance of the main contract coming into force⁸ or where the negotiations are abandoned, as happened in relation to Saab's proposed sale of airplanes to Switzerland, the financing of which was vetoed by popular vote on 18 May 2014. The Swiss offset authority was reported in September 2014 as assessing whether the pre-investments made by Saab, are eligible for future credits. Saab invested some 415 million Swiss francs during the negotiating period, of which the Swiss offset authority recognised 250 million Swiss francs.⁹ In some countries that permit the banking of excess credits they may be subject to limitation periods, after which they expire automatically. Companies would clearly prefer not to have such constraints or at least to make them valid for as long a period as possible. With prior approval of the country's offset authority the banked credit may be transferred or sold to another offset obligor to help satisfy its offset obligation.

⁶ See footnote 2 above.

⁷ See for example the 19th BIS Report at p. 32. The same report defines multipliers thus: '*Multiplier*: A factor applied to the actual value of certain offset transactions to calculate the credit value earned. Foreign purchasers use multipliers to provide firms with incentives to offer offsets that benefit targeted areas of economic growth. When a "positive" multiplier is applied to the price of a service or product offered as an offset, the defense firm receives a higher credit value toward fulfilment of an offset obligation than would be the case without application of a multiplier. Conversely, foreign purchasers apply "negative" multipliers to discourage certain types of transactions not thought to be in the best economic interest of the receiving entity.'

⁸ For critical examples of pre-performance see The Modernization of Bribery: Arms Trade in the Arab Gulf, Shana Williams, Dec 22 2010 at http://www.jadaliyya.com/pages/index/413/the-modernization-of-bribery_the-arms-trade-in-the.

⁹ See <http://www.srf.ch/news/schweiz/trotz-gripen-nein-auftraege-von-saab-fuer-415-millionen-franken>.

2.2.3 Offset credit swapping

A practice has developed around swapping of obligations between companies where contractors may be unable to deliver in one jurisdiction but can do so in another. The agreement of the offset authorities involved in the respective countries would usually need to be obtained prior to any swaps being executed.

2.2.4 Financial penalties for companies

Whilst some offsets are agreed on a 'best efforts' basis in which case the company delivering may have some flexibility as to how much effort is expended in meeting the requirements, balanced against the longer term perspective of developing a sustainable relationship with the end customer, others are stricter and failure to comply with the offset obligation may result in a penalty if it is not properly or fully satisfied. Default termination of the contract or damages for breach of contract may arise and could embroil a company in extensive settlement negotiations. Where an agreement specifies that credits will be awarded solely on the basis of output (namely profits) the company faces increased pressure to ensure the investment is truly sustainable. This information on financial penalties notwithstanding, companies are nonetheless keen to avoid nonfulfillment of requirements due to the reputational implications and the overall desire to deliver a quality product or service.

Some countries require performance bonds, bank guarantees or may have penalty clauses relating to liquidated or non-liquidated damages in the offset agreements.¹⁰ The United Arab Emirates' Offset Program Bureau (Tawazun Economic Council) provides such an example. While the Bureau has enacted several reforms to target priority investment areas through extensive use of multipliers, it has also announced penalties for underperforming programs, such as damages for partially or unfulfilled offset obligations.¹¹ Alternatively, other countries may only require a corporate guarantee to cover the potential penalty amount. In general, companies would prefer certainty and clarity in how financial penalties are applied in order to be able to address risks and make appropriate financial provision.

Companies subject to performance bonds and other similar guarantees include them in their financial reporting, whilst some companies communicate heavily about their obligation commitments. This demonstrates that there is a range of approaches, which do not create compliance issues but may contribute to varying degrees of publicly available information.

2.3 Size of the defence market

Offset activities are but a part of the wider defence market, in which US and European-based firms dominate. The Stockholm International Peace Research

¹⁰ <http://www.economist.com/news/business/21578400-more-governments-are-insisting-weapons-sellers-invest-side-deals-help-them-develop>.

¹¹ Dehoff et al, 2014.

Institute (SIPRI) publishes an annual list of the top 100 military arms-producing and military service companies in the world (excluding China). In its most recent edition (December 2014), companies from the US and Western Europe represented the entirety of the top 10, and 69 of the top 100 – including 84.2 per cent of the top 100's total arms sales.¹² Defense News, a weekly industry publication, produced a similar list of top firms by revenue, again highlighting concentration among North American and Western European firms.¹³

2.4 Size of offset programmes

Data for the entirety of global offset programmes is more difficult to access or to quantify. The US Government is virtually alone in imposing reporting requirements in offset activities for US companies; the obligation is to provide annual reports on offset agreements valued over \$5 million and on each offset transactions which claim credits at values of \$250,000 and above. This information is collected by the Department of Commerce's Bureau of Industry and Security (BIS) and presented in a report submitted annually to the US Congress, and has been done continually since 1996. Until 2006, the reports from BIS included the names of countries with which a company had entered into a defence contract and subsequent offset agreements. As 2007 is the last year that the public reporting requirements included disaggregation by country they are set out in the Table in the Appendix, which show European countries as just in the recent past being the predominant beneficiaries of US offsets,¹⁴ although this contention is regarded as controversial and capable of challenge by some European companies. The report also hinted at the burgeoning changes in the offset market however, noting that contracts and agreements with Middle Eastern and African countries had increased considerably during the second half of this time period (post-1999), as well as increases in the average value of offset agreements with non-European countries.¹⁵

The most recent BIS report from March 2015 states that in 2013, US firms entered into 67 defence contracts with accompanying offset agreements with 18 countries, at a total value of \$5.0 billion. This figure was 52.9 per cent of the \$9.4 billion in sales of defence products and services to foreign governments with offset requirements. Offset agreements were valued between 10 per cent and 104 per cent of the main contract.

Transaction data for European-based firms is less readily available in comparison to US sources. In a 2007 study for the European Defence Agency (EDA) however, it was estimated that the average percentage value of offset agreements from EU member states over the period of 2000-2006 was valued at 135% in relation to the primary defence contract. Furthermore, the types of offset transactions requested by

¹² See <http://www.sipri.org/research/armaments/production/recent-trends-in-arms-industry/Fact%20Sheet%20Top100%202013.pdf>.

¹³ See <http://www.defensenews.com/article/20140803/DEFREG02/308030015>.

¹⁴ US Department of Commerce Bureau of Industry and Security, 12th Report to Congress (December 2007).

¹⁵ US Department of Commerce Bureau of Industry and Security, 12th Report to Congress (December 2007).

governments were divided as 40% direct, 35% indirect military and 25% indirect civilian, with a recognized trend of offset transactions increasing over time.¹⁶

Despite the scarcity of publicly available data surrounding offset arrangements, some estimates suggest that international defence companies have agreed contracts to provide roughly US \$75 billion in offset transactions since 2012.¹⁷ These figures however must be interpreted as estimates and are not universally accepted by the industry who state that these figures must not be understood as business values, but the result of valuation methods applied to various types of transactions (see 2.2.1).

The monetary value, coupled with the increasing number of countries using offsets, such as Mexico (2012) and Indonesia (2013), are some of the reasons why offsets are receiving greater interest.¹⁸ The growth in offset programmes, mirroring growth in the entirety of the defence market, is not globally uniform.

2.4.1 Current trends and implications for offset programmes

The environment for defence offsets, and for the defence industry overall, is changing. According to NATO's defence expenditures data for 2014 and estimates for 2015¹⁹ the NATO Europe members spent USD 270 billion in 2014, and USD 227 billion forecast for 2015. The US spent USD 654 billion in 2014 and is forecast to spend USD 650 billion in 2015. These figures are corroborated by data from various public sources, with year-on-year global military expenditure declining 0.4 per cent in real terms between 2013 and 2014, a third straight year of decline.²⁰ The regional level however exhibited considerable variation, largely consistent with recent regional trends. Military spending continued to fall in North America and Europe, while remaining unchanged in Latin America and the Caribbean.²¹ Disaggregated further, Central European countries appear to be reversing the reductions in spending that have been in effect since the outbreak of the financial crisis. Ukraine, Poland, and the Baltic States are highly responsible for these increases at sub-regional level.²² The continued decline observed in military spending in most Western countries in recent years partly as a result of the crisis however shows no sign of abatement. Italy provides a clear example of this phenomenon, where defence spending has fallen 25

¹⁶ Magahy et al, 2010

¹⁷ Hoyos et al., 2013

¹⁸ Anderson and Moores, 2013.

¹⁹ See http://www.natio.int/cps/en/natohq/news_120866.htm

²⁰ For example SIPRI study Perlo-Freeman et al, 2015. Military expenditures data from SIPRI are derived from the NATO definition, which includes all current and capital expenditures on the armed forces, including peacekeeping forces; defence ministries and other government agencies engaged in defence projects; paramilitary forces, if these are judged to be trained and equipped for military operations; and military space activities. Such expenditures include military and civil personnel, including retirement pensions of military personnel and social services for personnel; operation and maintenance; procurement; military research and development; and military aid (in the military expenditures of the donor country). Excluded are civil defence and current expenditures for previous military activities, such as for veterans' benefits, demobilization, conversion, and destruction of weapons. This definition cannot be applied for all countries, however, since that would require much more detailed information than is available about what is included in military budgets and off-budget military expenditure items. (For example, military budgets might or might not cover civil defence, reserves and auxiliary forces, police and paramilitary forces, dual-purpose forces such as military and civilian police, military grants in kind, pensions for military personnel, and social security contributions paid by one part of government to another.) See World Bank Indicators: <http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS> SIPRI data is based on the data provided by national governments which include the national budget documents, defence white papers and public finance statistics published by ministries of finance and defence, Central Banks and National Statistical Offices.

²¹ Ibid.

²² Ibid.

per cent since 2008.²³ The USA's military expenditure is also forecast to drop further in 2015, capping a real decrease of 19.8 percent since 2010.²⁴ Meanwhile, Asia and Oceania, the Middle East, Eastern Europe and Africa have all increased military spending at the regional level. No top 15 military expenditure country showed a greater increase than Saudi Arabia, which went up by 17 per cent.²⁵ This shift in the defence market towards developing and non-Western countries also has ramifications for future offset obligations.

Countries in the Asia-Pacific region, the Middle East and North Africa region, are committing significant resources to defence investment and procurement, which is coupled by an increased request for offsets.²⁶ A greater formalization of the process is also underway. The defence consultancy IHS estimates that of the 80 countries imposing offset obligations on military service and equipment suppliers, 23 introduced formal, codified offset programmes between 2000 and 2011.²⁷ Determining exact figures for offset obligations remains a difficult task. Attempts by several studies must be interpreted with caution. In a 2013 report, IHS examined 15,000 defence export programmes attributable to 25 buying countries, reaching the conclusion that over the period from 2012-2022 countries in the Asia-Pacific region will require the greatest value of offset obligations, amounting to approximately US \$31 billion. This is followed by Gulf States with US \$27 billion in offset agreements. At the individual country level, the biggest beneficiary is forecast to be Saudi Arabia, followed closely by the United Arab Emirates and India.²⁸ Several other studies have also analysed the expected growth in military offset obligations, sometimes with slightly differing trends highlighted as to which country or region is technically leading in monetary value, however the regions and countries mentioned thus far remain generally common throughout.²⁹

Not only is the geopolitical direction for offsets changing; offsets themselves are more often reflecting a country's changing political, strategic, and – or, industrial policy goals. Indirect offsets are receiving less favour in place of direct offsets, such as co-development, co-production or technology transfer.³⁰ Examples include Brazil, India, Turkey and South Korea, which are establishing preferences for technology transfer, in order to compete better internationally and ultimately with the aim of becoming major suppliers in their own rights or to achieve better access within global supply chains.³¹ India's new defence policy mandates that all defence contracts beyond approximately US \$65 million must include a 30% offset agreement, with clear preferences for using offset to acquire state-of-the-art technology and skills,

²³ Ibid.

²⁴ Ibid.

²⁵ Ibid.

²⁶ Ungaro, 2013.

²⁷ Anderson and Moore, 2013.

²⁸ Ibid.

²⁹ For further examples see Frost and Sullivan, 2013, Ungaro, 2013, Barney et al, 2012.

³⁰ Ungaro, 2013.

³¹ Ibid.

and that solely focusing on assembling equipment within India is no longer sufficient.³² Indonesia, which until recently lacked a formalized offset policy despite decades of experience in offsets, has shown great interest in technology transfer, imposing a minimum offset requirement of 35% that will increase 10% every five years before stopping in 2039 at 85%.³³ Poland, one of the few European countries that is not cutting defence spending, has also stated that companies that promise technology transfer and production work in Poland will be favoured in procurement bidding.³⁴

2.5 Participants and stakeholders

Governments engage in offset activities for a number of reasons, which have evolved over time and often vary across countries. Cost factors play a significant role, as governments must often justify decisions relating to public spending. Defence procurement is a highly expensive endeavour, making the opportunity to recoup a portion of this expenditure through reinvestment at home a very attractive proposition. Furthermore, the post-Cold War environment has seen the arms trade shift from a seller's to a buyer's market, which has made offsets even more appealing to national governments, giving them great discretion to acquire benefits suitable to their preferred policy goals.³⁵

Governments that require some form of offset or industrial cooperation from companies may do so using the capacities of their existing government departments. The UK for example has recently disbanded its offset authority and has re-assigned responsibility for its new policy to be overseen by the Ministry of Defence. Other countries are moving in the opposite direction. Switzerland reorganised its offset authority (Armasuisse) in 2010. Other countries might select the department responsible according to a business or economics focus or the defence ministry itself. In Denmark, offsets are the responsibility of the Danish Business Authority, part of the Ministry of Business and Growth, whereas India has established a Defence Offsets Management Wing within the country's Ministry of Defence. For companies it is important to know which government bodies they will have to deal with in connection with the offset agreement.

The companies involved in offsets are primarily manufacturers and suppliers of defence systems and services, some of whom include the offering of offsets as part of their marketing strategies and engage willingly, others responding almost exclusively to customer demands. The value (for the purchase) of the obligation is assigned by governments to companies' sales contracts, but the actual costs (for the supplier) vary and depend on how each company chooses to fulfil their obligation under the agreement, so according to the industry, this needs to be taken into

³² Wilkes and Govindasamy, 2015.

³³ Davidson, 2014.

³⁴ Cienski, 2013.

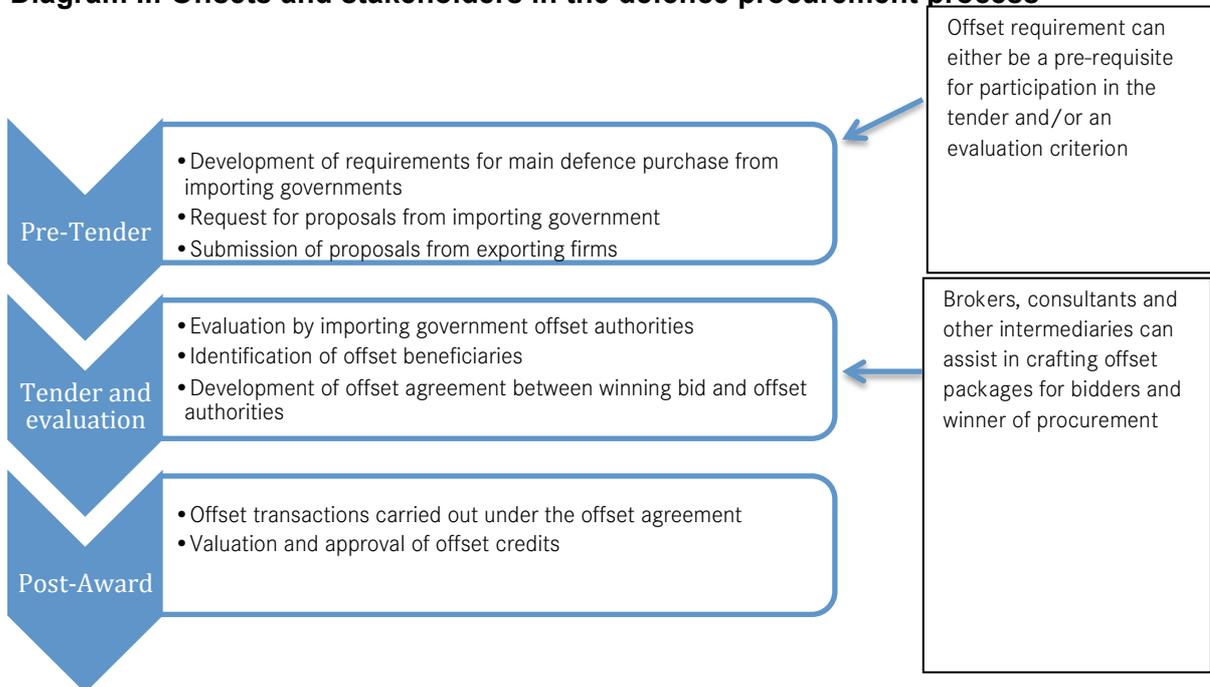
³⁵ Brauer and Dunne, 2011.

consideration. In a newspaper article from 2013 the offset obligations for the top ten defence companies were reckoned to amount to some US \$73 billion with Lockheed Martin with the largest share at US\$27 billion, followed by US\$12.6 billion for Boeing, US\$7.9 Raytheon, US\$ 7.6 EADS (now Airbus), and Saab and BAE Systems each with US\$4 billion in obligations.³⁶ These figures are not confirmed by the industry.

The prime contractor may require the services of third parties to broker deals, consultants or intermediaries to find suitable business partners, give technical or legal advice, or to define, negotiate, and deliver offset programmes. Ultimate reporting and delivery responsibilities remain with the contracting party to the main contract, known as the obligor.

The figure below highlights some of the steps involved in the offset component of international defence procurement and where the aforementioned participants can appear.

Diagram II: Offsets and stakeholders in the defence procurement process



Other stakeholders in the defence offset trade that often receive less attention include the subcontractors of the exporting firm not partaking in the offset transaction; the citizens of both the exporting firm's country as well as those of the importing country; non-military firms of the exporting country; and the citizens of third-party countries that may feel some effect from defence offsets.³⁷ The aims of these groups can at times be in juxtaposition, as opportunities for research and development gained in the importing country could be perceived to be at the expense of firms in established supply chains in the exporting firm's country.³⁸ All of these

³⁶ Defence groups' sweeteners swell to US\$ 75 billion, Carola Hoyos, Financial Times October 9 2013.

³⁷ Brauer, 2004.

³⁸ Ibid.

stakeholders however have an interest in assuring that offset activities are carried out with integrity and transparency.

2.5.1 Industry associations

A number of trade associations and other organisations have grown up over recent years that aim to support members of the industry by facilitating exchange and learning via conferences, training and other opportunities. Some of these associations also permit consultants and other providers of offset related services to join as members.

The Global Offset and Countertrade Association (GOCA) has been in operation for over 25 years and today has a membership over 100 companies worldwide engaged in countertrade and offset.³⁹ The Defense Industry Offset Association (DIOA) was a response to offset requirements that the US defence industry were increasingly facing in sales to foreign governments. Following an initial meeting of 12 US-based companies in 1982, the DIOA was officially established as an industry organization in 1985.⁴⁰ Joint activities between the two associations are not uncommon.

The European Club for Countertrade and Offset (ECCO), based in France, was founded in 2010, though some major European defence prime contractors are not members.⁴¹ Many national-based associations also exist, such as the German-based Deutsches Kompensations Forum (DKF),⁴² the UK's ADS Group Limited,⁴³ and journals such as Countertrade and Offset, in publication since 1983, provide regular reporting on developments within the industry.⁴⁴

2.6 Different perspective on offsets

Offsets are regarded by the defence industry as commercial arrangements and therefore subject to legitimate business confidentiality, allegations of offsets being insufficiently transparent are therefore misplaced. Those elements of offsets that are confidential are usually a result of a requirement imposed by the end customers, which may contribute to misunderstandings and misrepresentations of complex issues.⁴⁵ Examining the basic premises from which the various stakeholders view offsets will lead to a discussion on the question whether the allegations of lack of transparency in some aspects of offset arrangements equates to bribery risk, which is taken up in Chapter 4.

The purchasing country's perspective

³⁹ <http://www.globaloffset.org/>.

⁴⁰ Defense Industry Offsets Association, <http://www.dioa.org/about.aspx>.

⁴¹ European Club for Countertrade & Offset, <http://www.ecco-offset.eu/about-ecco/objectives-and-activities/>.

⁴² <http://www.dkf-kompensation.com/>.

⁴³ <http://www.adsgroup.org.uk>

⁴⁴ <http://www.cto-offset.com/>.

⁴⁵ Matthews, 2014.

From the perspective of a country seeking to develop its economic, industrial and technological capabilities offsets provide a mechanism to support that goal. As most countries lack the capability to produce the entirety of their defence needs domestically, offsets allow countries to avoid channelling the entirety of their procurement 'off-the-shelf' imports by directing resources towards the benefit of their domestic defence industrial base, where it exists. This has been particularly important for many developing countries. Bitzinger (2004) writes that '...offsets – licensed production, coproduction, technology transfer, etc. – as a condition for arms purchases have been perhaps the most important course of action taken by less-developed countries in order to abbreviate and quicken the process of defence industrialization and arms manufacturing.'⁴⁶

For some countries, building up indigenous weapons production capabilities through targeted offset policies has been sought out as a reflection of rising great power status, in addition to national security concerns, as seen in Brazil and India.⁴⁷ Beginning in the 1960s Brazil focused on acquiring technology from Western suppliers through direct offsets, for example with licensed and co-production and joint ventures.⁴⁸

The goal of facilitated entry into international markets and value chains has also spurred offset activities in certain countries. Though national security motivations also played an important role in Singapore's industrialization objectives, the use of offsets, while more limited, helped the country's defence industry in playing to its strengths in certain niche areas, as opposed to seeking complete self-sufficiency in arms production.⁴⁹

Broader economic development goals beyond the defence industry have also been motivating factors in the pursuit of offset agreements for several countries. The majority of emerging markets link defence offset protocols to wider economic objectives.⁵⁰ An example from a US obligor that illustrates this point relates to the introduction of a relatively new welding technology (friction stir welding) into a Southeast Asia country via the shipbuilding industry. The project encompassed the transfer of technology, training and technical assistance to the local shipbuilding industry to increase their capabilities in the construction of ships, as well as to provide material joining services throughout the country to other local industries, such as aerospace, marine, automotive, rail, electronics and construction. The benefits identified by the country and the company included: Improvements in the product quality and weld products, reductions in manufacturing and welding costs, improving productivity and reducing component distortion and minimizing reworking.

⁴⁶ Bitzinger, 2004, p 256.

⁴⁷ Brauer and Dunne, 2011.

⁴⁸ Perlo-Freeman, 2004.

⁴⁹ Bitzinger, 2004.

⁵⁰ Anderson and Moore, 2013

Employment policy also falls under the economic development remit, as many countries explicitly state a job-creation motive behind their pursuit of offsets, such as Saudi Arabia. Though the academic literature has at times cast doubt on the accuracy of these claims⁵¹, the US Government (from the exporter's perspective) has considered the effect of offset transactions on US inputs, finding a potential displacement of jobs and work that could have been conducted within the US.⁵² In annual reports to Congress on US companies' offset activities, there is acknowledgement that while defence export sales can bring positive economic effects and promote foreign policy and economic interests, short-term offset agreements can evolve into long-term supplier relationships between US prime contractors and foreign subcontractors.⁵³ In the long run, the reports note this could result in fewer business opportunities for US domestic contractors. They go further to cite that certain offsets, such as technology transfers, could result in greater competition for US industry should the offset promote increased research and development in these countries.⁵⁴

Governments focus on the potential economic benefits of offsets, and in so doing may overstate or over communicate on the offset programme for political ends, whilst other governments may tend not to communicate about them as widely they could do, which may open them up to criticism. A lack of openness by purchasing governments particularly in countries where political corruption is perceived to be high may contribute to mistrust about offset programmes. Generalizations about openness need to be tempered by the fact that communication levels tend to vary according to the stage of negotiations on the main contract. However, even in countries where bribery is believed to be low, lack of transparency may come at a political price. The Swiss experience may suggest that more openness towards taxpayers on these economic benefits might have had a more positive effect on voters who decided to reject the purchase of a new fighter aircraft in 2014. Switzerland requires 100 per cent offsets, and it was accordingly announced by the Swiss government that the fighter aircraft would be matched in offset obligations to the full value of the purchase price. In an analysis of the reasons why voters rejected the proposed deal, most indicated that they thought the price was too high and the money could be better spent.⁵⁵ In light of this reasoning it might have behaved the government to have been more open about the bidding company's pre-performance offsets and also by revealing more information about the potential beneficiaries (especially if SMEs were to have benefitted) of the offset programme, were the voters to endorse the proposed purchase. It should be noted that the referendum only addressed the financing arrangements of the proposed purchase, and not the selected company or its product.

⁵¹ Brauer and Dunne, 2004.

⁵² US 19th Offset Report.

⁵³ Ibid.

⁵⁴ Ibid.

⁵⁵ See Forschungsinstitut gfs.bern, VOX-Analyse Universität Zürich, Institut für Politikwissenschaft, 2014 <http://www.gfsbern.ch/de-ch/Detail/vox-115-nachanalyse-der-eidgenoessischen-abstimmung-vom-18052014>.

Juxtaposed with the purchasing countries belief that economic benefits accrue through offsets is the position taken by the WTO, EU and the US who declare offsets as stifling competition and distorting trade, but who do not enforce this on their industry when it conducts business outside their respective borders.

The selling company's perspective

Defence companies acknowledge that offset obligations are not isolated from the main contract and are indeed closely interlinked, such as in relation to price, technical specifications, currency exchange rates, taxation, and the capability of the obligor's company to develop its relationship with the country. In this sense offset programmes are complex and companies recognise the demands as well as opportunities presented by offsets, including as a means to differentiate themselves from the competition. These opportunities however do not come without risks. For some procurement procedures offsets are a pre-condition for participation in the bid. Should a company fail to present an offset package that is acceptable, and thereby not meet certain requirements of the importing government, the bid may be disqualified. In addition, a government may include the offset component of a bid in the award evaluation criteria, as a parameter alongside elements including cost, performance, technical elements, and the likelihood that the government considers a potential obligor could deliver on its promises.⁵⁶

Members of the defence industry recognise that for many governments and companies, offset arrangements assist in building mutually beneficial partnerships and economic benefits, yet the industry is also aware of the integrity risks that offset arrangements can pose and are applying measures to mitigate them. In a survey and interviews conducted as part of Transparency International's 2012 report on due diligence in defence offsets, all respondents affirmed awareness in this regard, with the report's authors confirming significant positive change over the years preceding its publication.⁵⁷ In its 2014 Public Accountability Report, 90% of IFBEC members reported having due diligence processes assessing corruption risk on potential offset partners and brokers. In addition, the 10% of companies that responded 'no' in the survey indicated that they were in the process of developing procedures.⁵⁸

An example from law enforcement

In 1995 the US Department of Justice (DOJ) issued a Foreign Corrupt Practices Act (FCPA) Advisory Opinion⁵⁹ in response to a joint request by two companies (Companies A and B) for guidance on potential FCPA liability arising from deals related to offset obligations, which was at the very least an indication of the potential risks associated with some offset arrangements and highlighted the importance of mitigating measures, suggesting that offsets may not be problematic per se but may

⁵⁶ Ungaro, 2013.

⁵⁷ Fluker et al, 2012.

⁵⁸ IFBEC, 2014.

⁵⁹ DoJ Opinion 95-02 at <http://www.justice.gov/criminal/fraud/fcpa/opinion/1995/9502.pdf>.

contain risks that need to be addressed. The DOJ sketched the arrangement in the following terms:

Company A acquired offset obligations through contracts with a foreign government. In the country, an Offset Office within the Ministry of Defense handled offset obligations. Company B, owned by a US citizen, entered into an oral agreement with the Offset Office to receive offset credits in exchange for establishing a new company (Newco) in the country. The majority of the investors in Newco were to be foreign government officials, though no Ministry of Defense officials would be included among the investors. Company B was to receive offset credits from Newco by meeting certain program milestones unrelated to Newco's profitability or success. Under a management services agreement, Company A would provide management services to Newco and would be paid a fee based on Newco's revenues and profit, and Company B would provide financing to Newco. Company A would then compensate Company B out of its management fee.

In the opinion request, Company B certified that it had not paid any funds received from Company A for the sale of offset credits to any investors in Newco or to any government officials. Additionally, the shareholders of Newco, who included government officials, made various certifications to the DOJ, including that they would only be passive investors and that they would recuse themselves from any government decisions related to Newco. Based on these representations, DOJ confirmed to the applicants that it would not bring an enforcement action against Company A's purchase of offset credits from Company B or the proposed management services contract between Company A and Newco.

An example from civil society

Civil society's engagement and critical stance regarding defence offset has been most prominently led by Transparency International (TI), the anti-corruption NGO, and more specifically under the Defence and Security Programme (TI-DSP) of Transparency International UK. The NGO has worked to raise awareness on corruption risks and since 2008 has advocated for more controls on offsets.

The defence industry more broadly has also been consistently cited for corruption risks. This is primarily due to the monetary size of procurement contracts, intense levels of competition among industry players, and high levels of secrecy inherent to the sector, often attributed on national security grounds.⁶⁰ TI estimates that nearly US \$20 billion are lost annually in the defence sector to corruption.⁶¹ In this context, offset activities have increasingly come under scrutiny as presenting corruption risks, not only for the aforementioned reasons in relation to the defence sector overall, but also due to a number of characteristics specific to offset activities.

⁶⁰ See Transparency International work on defence security, http://www.transparency.org/topic/detail/defence_security

⁶¹ Ibid.

In a report from 2010 entitled 'Defence Offsets: Addressing the Risks of Corruption & Raising Transparency', as well as a report on due diligence in offset activities published in 2012, TI-DSP has produced several recommendations for governments, companies and industry associations. For companies, recommendations included that they conduct regular review of best practices, as well as greater clarity on what constitutes deal-breakers and red flags and expected conduct when such phenomena arise. The report also highlights the need for clear delineation of responsibility for due diligence, and the responsibility of sub-contractors, brokers and other intermediaries used in an offset transaction to provide all requisite information concerning the offset to the defence company. Finally, explicit reference to offsets within business policies is also recommended.

Similarly, the recommendations for industry associations again focus primarily on issues pertaining to due diligence. TI-DSP recommends that industry associations provide common verification checklists and information sources among their members, and where legally permitted, to share intelligence. A guidance document on reasonable due diligence for members was recommended, particularly for smaller companies, and elaboration on minimum due diligence depending on the profile of the association member. Finally, the TI-DSP report recommends that associations encourage governments to strengthen transparency and public reporting requirements. TI acknowledges that there is a possibility for offsets to produce beneficial outcomes to importing countries if they are correctly constructed and the true cost of offset is taken into account.⁶²

Chapter 4 will examine in greater detail these risks along with mitigation measures. As will be shown, many companies involved in all stages of the offset value chain already recognise the risks and implement appropriate compliance and integrity standards to all aspects of offset activity.

Responses to the issues raised in the TI reports

A number of stakeholders have countered the TI reports and, while not exhaustive or completely representative, some diverging views can be illustrated in the following selections. The argument that offset encourages corruption is unproven according to Matthews,⁶³ who goes on to state that TI's evidence is based on 'allegations' rather than proof, and that TI's research into the 'link between offset and corruption is flawed because of the superficial methodology employed and the flimsy evidence offered'. Several companies that were surveyed expressed similar views in more general terms – not specifically regarding the TI reports, but were frustrated at the negative media reporting of offsets and point out that the vast majority of offsets are unproblematic from a bribery risk perspective, moreover the allegations and cases are 'old', and many companies have improved their policies and procedures with stronger controls compared to five or more years ago. By way of contrast, Howard

⁶² Magahy et al, 2010 , p.43..

⁶³ Matthews, 2014.

Weissman, former associate general counsel at Lockheed Martin where he worked for many years, recently wrote, 'Based upon my experience, I believe that offset transactions can present potentially high corruption risks for companies in the defense industry for the reasons identified in the TI UK Report...'⁶⁴

Overall the various opinions expressed acknowledge that there are very positive aspects for countries and companies in offset arrangements, at the same time their complexity and apparent lack of transparency contribute to mistrust in the arrangements which are compounded by a lack of agreement amongst scholars and economists on the extent of the benefits they bestow and the costs they incur. As in any business transaction they are not risk free and may present increased risks in certain constellations, which means they need careful scrutiny and should be subject to appropriate due diligence and controls. Greater openness by all stakeholders and participants could help to dismantle concerns.

2.7 Evidence and effectiveness

The increased demand for which governments seek offset opportunities in defence procurement is countered by a level of scepticism as to their actual effectiveness from many economists and within the academic literature. Positive experiences in isolated cases or ex-post justifications for entry into an offset agreement have been used by governments as examples of success, yet in a 2004 volume from Brauer and Dunne (2004), the primary takeaway from the majority of contributions to the study is that offsets have often been less effective than envisioned.⁶⁵ The criticisms have centred on many of the stated motivations and expected outcomes used to justify inclusion of offsets to a defence contract.

In the area of costs, despite government aims to recoup some of the procurement expenditure through offset most studies estimate that an offset contract can be more expensive than an off-the-shelf purchase, adding up to 7 to 10 per cent of contract value according to Brauer.⁶⁶

From an industrial policy perspective, use of offsets as a method to create completely autonomous domestic arms production capabilities runs into difficulties due to varying levels of domestic capacity for absorption.⁶⁷ Not every country can achieve complete self-sufficiency. Focusing on certain elements of production or sectors, and applying a more targeted use of offset by leveraging strengths and core competencies of the procuring country's industrial and research capacities can help to optimize chances for long term benefits of the offset programme. The example of Singapore in building its defence industrial base was mentioned earlier in this regard. Technology transfer is another favoured objective which, like overall industrial policy

⁶⁴ Weissman, 2014.

⁶⁵ Brauer and Dunne (2004); The publication, *Arms Trade and Economic Development*, featured contributions from authors of a variety of affiliations, including military academies, military and civilian research institutes, and universities.

⁶⁶ Brauer, 2011.

⁶⁷ For a critique of India's capacity to absorb technology transfers and the overall aims of the offset regime, see Defence Acquisitions and the Road Ahead, Karanpreet Kaur, Centre for Land Warfare Studies, New Delhi 2013.

goals, must take into account capacities of local resources to absorb the technology offered.

Using offsets with the goal of employment-creation has also run into pitfalls. This is partly due to a failure to calculate whether the jobs created are truly 'new' and not the result of work that would have been sourced to the country regardless of the offset requirement. Some estimates state that only 25 to 50 per cent of the work is genuinely new in developed countries, which also does not take into account the sustainability of the expected jobs.⁶⁸ Evidence from the Philippines in the 1990s points to the import of armed personnel carriers from a British exporter, whereby a majority of the goods were manufactured in the Philippines, thus providing local employment. The closure of the factory and assembly line shortly after completion demonstrates the importance of looking at long-term employment sustainability when seeking to achieve maximum benefit.⁶⁹ The initial claims of an offset agreement in South Africa at the turn of the century also demonstrate the risk of employment creation goals. Even though an expected 65,000 jobs were to result from the offset transactions, calculations showed that these jobs would be achieved at a cost of nearly 20 times the average for the defence industry in South Africa.⁷⁰ Industry members recognize these challenges from the past; however, they affirm that both end customers and the industry have become more cognizant with regard to the implications of requirements focused on job creation.

Monitoring and auditing of offset activity differs from country to country, with varying processes depending on applicable regulations, policies and procedures of the customer country. Brauer (2004) suggests that governments establish arms trade offset audit teams which may lead to a more standardized approach over time, though some in the industry would consider this as somewhat controversial as the alignment would likely tend towards more stringent conditions for the industry..

Even without a body of evidence showing unambiguous, economy-wide net benefits from offset programmes, there are a few important elements to consider that may enhance mutual chances for success. Matthews (2004) identified a few points in this regard. Companies and offset authorities should avoid short-termism when looking at the potential for cooperation through an offset agreement. To take advantage of technology transfer or increased employment, a good technology policy must be in place along with the required technical and human capital in order to fulfil the offset transactions requested. The overall business environment must be considered when evaluating the potential for success of certain transactions. Licensed production, when conducted in countries with more mature defence industrial capacities, is also highlighted as an area of success. Brauer (2011) touches on these points as well, in finding that at a minimum, in order to achieve success in indigenous arms production

⁶⁸ Brauer, 2011.

⁶⁹ Matthews, 2004.

⁷⁰ Dunne and Lamb, 2004.

efforts, existing civilian industry should be in existence that can then take up the military work that arrives through offset.

In sum, despite the scepticism with which offset activities are seen in most of the academic literature, as well as from the WTO, US government and EU, there is little to suggest that this has had or will have immediate influence in reducing the growing scale of offset agreements and expected growth in future obligations, particularly in emerging markets. For importing governments there remain opportunities to shape flexible offset policies that meet the needs and forecasting capabilities specific to their individual country's circumstances. Firms understand that offsets are going to be a factor of the industry for the foreseeable future and can also serve as a competitive advantage when bidding on procurement. For companies, this will entail acquiring a solid understanding of the purchaser's absorption capacities in addition to the stated offset requirements and legal environment. Together both parties should verify that offset agreements are crafted in a spirit of cooperation with realistic and attainable goals, transparent fulfilment requirements and measurable performance indicators, to ensure that mutually beneficial results are achieved. Adequate preparation, transparency and a commitment to measurable results can also play an important role in reducing the risk of non-achievement of the offset plan or appearance of unethical behaviour in offset activities.

3 Laws and Regulations

It is estimated that approximately 80 countries currently engage in defence related offsets in one form or another. There is no comprehensive international regulation covering offsets. Where regulations do exist they send what can appear to be conflicting signals: On the one hand they explicitly prohibit offsets as being a restraint on competition, whilst on the other hand they contain broad exceptions that permit offsets to flourish, contrasting with the stated policy goals of these legal instruments. At the country level, the regulatory approaches to offsets include specific laws, rules or guidelines that permit flexible interpretations, and in some jurisdictions there may be ad-hoc approaches based on government policy. In these latter cases this can involve a lack of specified offset framework however an expectation of inward investment.

Given that offsets are used to counterbalance the diminution of domestic economic activity or domestic industrial capability and therefore constrains competition, it is unsurprising that the World Trade Organisation and the EU have both prohibited offsets through their rule making powers as being contrary to the basic principles they espouse and promote.

3.1 World Trade Organisation (WTO)

The WTO addresses offsets in its Government Procurement Agreement (GPA), signed in 1994 and revised in 2014. The GPA comprises 15 State Parties including the EU, taking its current membership to 43 countries.⁷¹ The WTO describes the cornerstone principles of the GPA as being non-discrimination and transparency:

‘The GPA established an agreed framework of rights and obligations among its Parties with respect to their national laws, regulations, procedures and practices in the area of government procurement. An important cornerstone principle in this regard is non-discrimination (...), accord to any other Party to the Agreement treatment “no less favourable” than they give to their domestic products, services and suppliers (Article III:1(a)). In addition, each Party is required to ensure that its entities do not treat domestic suppliers differently on the basis of a greater or lesser degree of foreign affiliation or ownership as well as to ensure that its entities do not discriminate against domestic suppliers because their good or service is produced in the territory of another Party (Article III:2).’⁷²

The use of offsets including counter trade or similar requirements are explicitly prohibited in the GPA under Article IV(6):

‘a Party, including its procuring entities, shall not seek, take account of, impose or enforce any offset...’

Many governments therefore regard offsets as undesirable, and have banned them almost entirely in all other areas of international procurement except defence, which is covered by two exceptions: First under Article V as it relates to developing countries, which at the time of their accession to the GPA may negotiate conditions for the use of offsets provided these are used only for the qualification to participate in the procurement process and not as criteria for awarding contracts. This exception is stated as only being permitted during a transition period.⁷³

There are no WTO definitions of “developed” and “developing” countries. Members announce for themselves whether they are “developed” or “developing” countries. Other members can, however, challenge the decision of a member to make use of provisions available to developing countries.⁷⁴

⁷¹ The GPA is a plurilateral agreement within the framework of the WTO, meaning that not all WTO members are parties to the Agreement. Currently it covers 43 WTO members: Armenia, Canada, EU, Hong Kong, China, Iceland, Israel, Japan, Korea, Lichtenstein, Netherlands with respect to Aruba, Norway, Singapore, Switzerland, Chinese Taipei, US. The accession terms of Montenegro and New Zealand were approved on 29 October 2014 and are awaiting domestic ratification. Other WTO members that have started the process of acceding to the GPA are: Albania, China, Georgia, Jordan, Kyrgyz Republic, Moldova Oman and Ukraine. A further 5 members have provisions regarding accession to the GPA in their respective protocols of accession to the WTO, namely FYR Macedonia, Mongolia, Russia, Saudi Arabia, Tajikistan.

⁷² WTO Website reference at www.wto.org

⁷³ Article V:3(b): ‘Based on its development needs, and with the agreement of the Parties, a developing country may adopt or maintain one or more of the following transitional measures, during a transition period and in accordance with a schedule, set out in its relevant annexes to Appendix I, and applied in a manner that does not discriminate among the other Parties: an offset, provided that any requirement for, or consideration of, the imposition of the offset is clearly stated in the notice of intended procurement;’

⁷⁴ According to the World Trade Organisation at: https://www.wto.org/english/tratop_e/devel_e/d1who_e.htm

The second exception to the prohibition of offsets is based on national security and set out in Article III:

‘Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information that it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defence purposes.’

In the event that a supplier from a State Party believes that the Agreement has been breached they are encouraged to seek a solution with the procuring entity to resolve the problem. If the issue cannot be resolved through negotiations then each State Party is expected to provide non-discriminatory, timely, transparent and effective procedures that would enable suppliers to challenge alleged breaches of the Agreement. Suppliers may be required to initiate a challenge procedure within a specified period (no less than 10 days) from the time when the basis of the complaint was known. Challenges must be heard by a court or by an impartial independent review body with no interest in the outcome of the procurement. Challenge procedures are to be completed "in a timely fashion".⁷⁵

Where a State Party believes that its rights under the GPA are being nullified or impaired by another signatory, it can request the initiation of WTO dispute settlement procedures to resolve the issue. To date, no such procedures have been initiated with respect to the offset related provisions.

As regards the relationship between EU regulations (outlined below), and the WTO rules: the EU regulations do not change the situation for defence related trade with non-EU countries, which is governed by WTO rules, and in particular EU countries decide whether or not to open competition to non-EU suppliers, in compliance with the GPA. EU authorities responsible for awarding defence contracts are free to invite EU companies exclusively, or to include non-EU companies.

3.2 EU Regulations

The EU refers to offsets as ‘economic compensation from non-national suppliers for the purchase of defence equipment abroad that aim to foster the local industry of the purchasing country’. Offsets therefore entail discrimination by their very nature and stand in direct contrast to the EU’s primary law.⁷⁶ Notwithstanding this clear stance based on the fundamental principles of the EU, the defence and security interests of the individual Member States provide the basis for exceptions to the primary law.

EU countries are permitted to exempt defence and security contracts if the application of European law would undermine their essential security interests:

⁷⁵ GPA Article XVIII.

⁷⁶ EU Treaties can be found at: http://europa.eu/eu-law/decision-making/treaties/index_en.htm.

Article 346(1)(a) Treaty on the Functioning of the EU (TFEU),⁷⁷ allows EU countries to keep secret any information the disclosure of which they consider contrary to the essential interests of their security. Whilst Article 346(1)(b) TFEU allows Member States to:

‘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 common market regarding products which are not intended for specifically military purposes.’⁷⁸

Derogation from Article 346 is described as a ‘serious political and legal issue’. The Treaty contains strict conditions for its use, balancing member countries’ security interests with EU principles and objectives. According to the Court of Justice, the use of the derogation must be limited to clearly defined and exceptional cases and interpreted in a restrictive way.⁷⁹

Whilst EU countries are responsible for defining and protecting their essential security interests, and for defence procurement, the Commission is responsible for ensuring that EU law is correctly applied, and may ask EU countries to justify the exemption of a procurement contract, or bring a matter before the Court if it considers that the exemption has been abused.

The interpretation of the phrase ‘specifically military purpose’ was at issue in case C-615/10-*Ins Tiimi*. In this case, it was argued by the Finnish government that the equipment in question was procured for military purposes. *Ins Tiimi*, a company that lost the tender, claimed that the equipment was dual use and therefore had civilian applications as well, in which case it would not fall under the exception set out in Article 346.

The Court held that to assess whether material is intended for specifically military purposes must be on the basis of an objective determination of the material itself, and referred to the ‘intrinsic characteristics of a piece of equipment specially designed, developed or modified significantly for those purposes.’ An objective test is therefore to be applied to the characteristics of the product and not the use to which it will be put by the military.⁸⁰

As to the second condition in Article 346, the ‘essential security interests’, the Court gave more scope to national courts to make their own assessment. It reiterated that the Member State needs to demonstrate that ‘it is necessary to have recourse to the derogation provided for in that provision in order to protect its essential security

⁷⁷ Formerly Article 296 TEC.

⁷⁸ Examples of cases decided by the EU CJ in relation to TFEU 346: Case C-414/97 *Commission v. Spain*; Case C-252/01 *Commission v. Belgium*; Case C-337/05 *Commission v. Italy*; Case C-409/05 *Commission v. Greece*; Case C-239/06 *Commission v. Italy*.

⁷⁹ See http://ec.europa.eu/internal_market/publicprocurement/docs/defence/guide-offsets_en.pdf and further below in footnote XX.

⁸⁰ At paragraphs 40 and 41 of the judgment in case C-615/10.

interests' as well as to show 'whether the need to protect those essential interests could not have been addressed within a competitive tendering procedure such as that specified by Directive 2004/18/EC'. This is a matter for the national court to determine. According to the Advocate General in the *Ins Tiimi* case there was no evidence of essential security concerns on the part of the Finnish authorities, and Finland did not demonstrate that it wished to avoid dependence for its arms supplies on non-member countries.

In short, therefore, Article 346 is to be interpreted narrowly and the burden of proof is on the EU Member State seeking to rely on the exception to prove the 'necessity' and 'proportionality' of the measure. Defence offset requirements will be subject to the same approach and those that seek to foster defence industrial capabilities that are not directly connected to any specific military purpose will be extremely difficult to justify.

The secondary law of the EU is set out in Directives; relevant to offsets is the Directive issued in 2009 on defence and security procurement.

Directive 2009/81/EC - Coordination of Procedures for the Award of Certain Works, Supply and Service Contracts Awarded by Contracting Authorities in the Fields of Defence and Security.

Directive 2009/81/EC aims to open up defence procurement to EU wide competition and to redress the preference for using national suppliers. It was developed by the European Commission to put an end to Member States' abuse of the national security exemption under Article 346 TFEU.⁸¹ According to the Commission the protection of local industries contributes to inefficiency, duplication and fragmentation of the EU defence industrial base. The Directive addresses advertising of contracts; with generally a minimum of three bidders required;⁸² contract awards on the basis of best value; specific provisions on Security of Supply and Security of Information. Other provisions cover the thresholds according to which the Directive will be applicable and the range of exclusions that include certain contracts, international agreements or arrangements and cooperative programmes. The Directive does not, however, explicitly prohibit offsets. Instead there are references to performance conditions and award criteria permitted in contracts as well as clauses on sub-contracting which set out alternative solutions to prevent contracting authorities from imposing a local supplier on foreign suppliers, or from requiring other percentage-linked local investments. The Directive also states that 'in any case, no performance conditions may pertain to requirements other than those relating to the performance of the contract itself.' This clause together with articles 20 and 47 render indirect- and other non-military offsets, illegal.

⁸¹ Communication from the Commission COM/2013/0542 final/ at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52013DC0542>

⁸² With some exceptions, see Art. 29 and Art 38 of the Directive.

The sub-contracting provisions that offer an alternative to offsets are designed to give increased bidding opportunities to sub-tier suppliers established in countries other than that of the procuring country. There are three options with different choices for the calculation of the portion of the contract that is destined for sub-contracting and the comparative procedures in order to choose sub-contractors. Bidders cannot be required to discriminate against certain sub-contractors on grounds of nationality. A Recital⁸³ obliges the contacting authority to specify all contract performance conditions within the contract documents, so as to avoid separate offset contracts.

According to the 2012 Transposition Report⁸⁴ there were 18 Member States that required offsets and the Commission worked with them to revise or abolish their rules prior to the Directive's final transposition date, August 2011. But most Member States were late in taking the necessary steps to adapt their laws and regulations with the result that Poland, Luxembourg, Slovenia and Netherlands were referred to the European Court in 2012 on account of their delays. The Transposition Report also stresses the Commission's intention to phase out offsets which diverge from the basic principles of the Treaty and describes the 'major risk' they present to the correct application of the Directive.⁸⁵ The Commission will monitor closely the use of exclusions and derogations as well as the phasing out of offsets and will deliver a second report on 21 August 2016, paying particular attention to the impact of the Directive on the openness of the Defence market and the strength of the European Defence Industrial Base.⁸⁶

The full effects of Directive 2009/81/EC and how the individual Member States adapt their positions on offsets will likely take some time until an assessment can be made. The UK has already adapted its approach and is discussed as a potential model for other EU countries in a Report issued in 2014.⁸⁷

3.3 Examples of laws and regulations in selected countries.

Over the years since the end of the Cold War offsets have replaced barter and countertrade particularly in the defence sector with some 80 countries (the number is open to adjustment), having developed some kind of formalised regulation. One method to categorise these different approaches is according to national laws, guidelines, requirements, policy all the way through to no regulation at all.⁸⁸ Another analytical framework depicts the spectrum of existing models in terms of their

⁸³ Recital (45) of the Directive.

⁸⁴ COM/2012/0565 final at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52012DC0565>

⁸⁵ The Commission's views on offsets and their compatibility with the TFEU are set out in various documents such as the Guidance Note on the Directive (which is not legally binding). Offsets can only be justified as derogations from Article 346 TFEU if they are limited to exceptional and clearly defined cases. The burden of proof that the derogation is justified lies with the Member State that invokes it. The Note also states that economic considerations cannot justify offset requirements. See http://ec.europa.eu/internal_market/publicprocurement/docs/defence/guide-offsets_en.pdf

The 2008 European Defence Agency (EDA) Code of Conduct on Offsets which was observed by some 25 states was only ever voluntary, non-legally binding and applicable only to non-essential contracts, was withdrawn in March 2014 having served its purpose of setting the stage for the eradication of defence offsets in the EU.

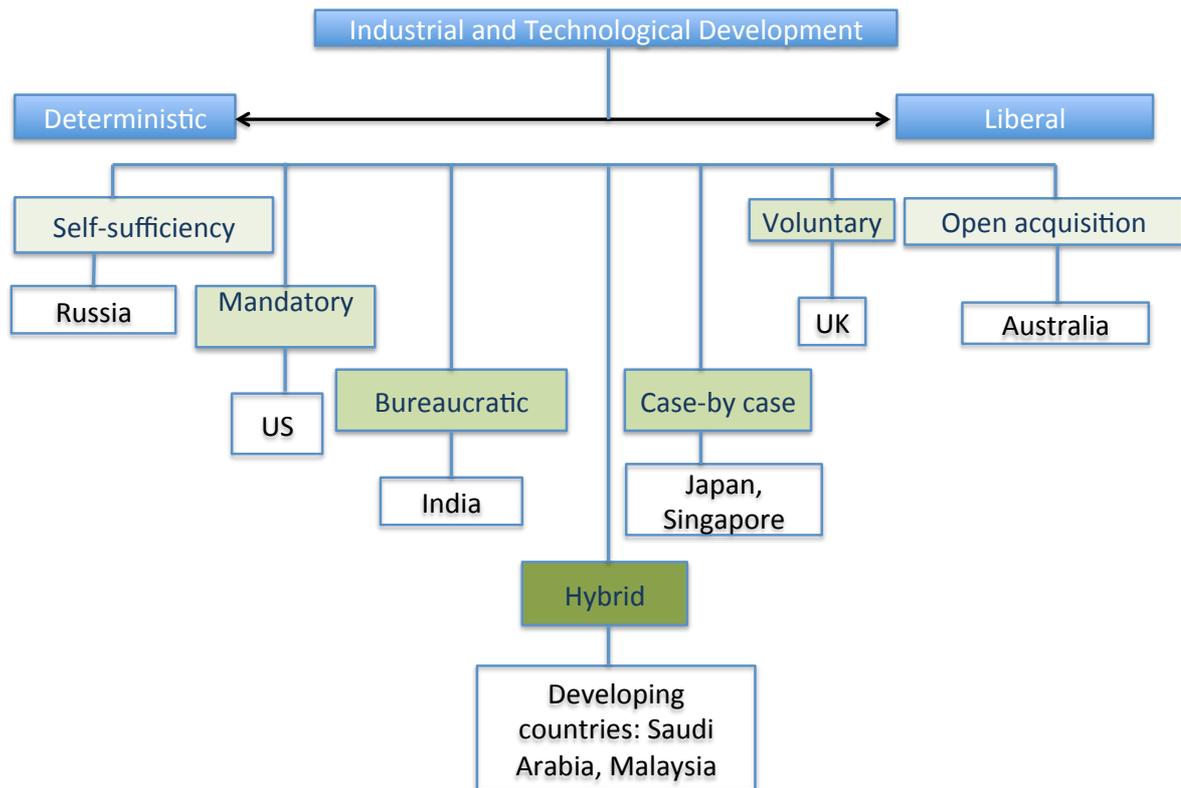
⁸⁶ Ballester, 2013

⁸⁷ Matthews, 2014.

⁸⁸ ECCO internal documentation.

openness.⁸⁹ This provides a useful overview of the various approaches that countries can and have taken in their management of offset activities, before examining in further details the specific policies of countries from across the spectrum of models.

Diagram III: The National Offset Policy Spectrum



Matthews’ model describes the national offset policy spectrum as having ‘two extremes: the ‘closed’, protectionist model represented by Russia with almost 100 per cent self-sufficiency in arms production (...) and secondly, the ‘open’, flexible partnership model, symbolised by Australia’s liberal approach, which saw offset abandoned in the late 1990s and replaced by industrial co-operation rather than coercion.’ In between are a variety of strategies that span the range of variability and flexibility in terms of prescriptive requirements. The Matthews model starts from the premise that industrial and technological development is the goal of offset from the buying country’s perspective, and describes examples within the spectrum stating: ‘Although this categorisation is somewhat imprecise, it nonetheless offers a conceptual framework for analysing discrete offset strategies. It is an approach that is arguably more useful than the current practice of generalising the offset

⁸⁹ Matthews, 2014, p. 23, with the source given as: Ron Matthews, ‘Defence Offsets: An Exercise in Futility?’ Speech given at the School of Policy Studies, Queen’s University, Ontario, Canada, 10 November 2010.

mechanism, as if a one-size-fits-all interpretation is applicable to every defence-economic environment.’

The countries in the ‘bureaucratic / hybrid / case-by-case’ categories present a wide range of approaches from the Singapore model that operates without any formal offset policy permitting a high degree of specificity in its requirements from suppliers, to India with its voluminous policy and highly directed strategy. These categories with their discretionary elements combined with other factors may pose increased corruption risks, though it should also be added that no country is entirely immune from the risks of bribery. In reviewing this model, some industry participants commented that in practice the requirements that countries include in their offset programme or industrial co-operation are not premised on the type of regulatory framework, and in reality can be extensive irrespective of where the country is positioned in this model.

The next section examines the policies of a selection of countries, which have been chosen to illustrate the spectrum of possible approaches to regulating offsets, as well as for their significance in the defence industry, defence procurement and offset.

United States of America

The US government is officially opposed to offsets and therefore prohibits government officials and employees, as well as government agencies, from involvement in any offset business. The Buy American statute⁹⁰ however is considered by many countries to be an equivalent to offset policies in other countries. The Buy American Act applies to partners or defence sub-contractors of US prime contractors and its purpose is to provide preferential treatment for domestic sources of supplies, manufactured goods, and construction material for public use unless a specific exemption applies. The statute requires the federal government to purchase domestic supplies for use in the United States, when certain thresholds are met. In certain circumstances the requirement purchase can be waived if the domestic product is more expensive than an identical foreign-sourced product by a certain percentage, if the product is not available domestically in sufficient quantity or quality, or if doing so is in the public interest.⁹¹

United Arab Emirates

The UAE’s offset programme is governed by Policy Guidelines that come into effect for government supply contracts of a cumulative value exceeding USD 10 million in any five-year period. A defence contractor is informed of the requirement to enter into an offset agreement during the bidding process, so that the procurement and offset processes are started in parallel with the contract award process linked to the signing of an offset agreement. The contractor is required to add economic and commercial value to the UAE’s economy to 60% of the supply contract value. This requirement is

⁹⁰ Buy American Act, 41 U.S.C. §§8301-8305.

⁹¹ See 08 UKTI DSO Priority Market Brief: The USA.

qualified by a level of discretion: “The level of obligation does not directly correspond to investments made in an offset venture but to the value created by an offset venture in terms of contributions and profits generation over time.”⁹² The UAE has published its Guidelines and a model Offset Agreement which incorporates these conditions.

Although UAE has an easily accessible set of information relating to its offset regime available online, and an apparently straightforward approach, it is also not without some challenges. In common with many countries, UAE does not routinely publish the names of local companies that are awarded contracts under offset arrangements, which is not dissimilar to many other countries often with national security cited as the reason.

India

The aim underpinning the Indian government’s defence acquisition strategy and offset policy is to achieve self-reliance in defence equipment, and in doing so ‘it will demonstrate the highest degree of probity and public accountability, transparency in operations, free competition and impartiality’.⁹³ India’s Defence Procurement Policy of 2011 was aimed at developing the private sector’s involvement in realizing self-reliance, including measures to involve more small and medium sized enterprises in the indigenisation programme to foster local competence in producing state of the art defence products and services. The Policy is realised in part through the government’s Defence Procurement Procedures (DPP) which first came into effect in 2002, and have been regularly updated since then. The current guidelines include approximately 40 pages on offsets, incorporating the August 2012 Defence Offset Guidelines as well as including incentives for the integration of the private sector into the indigenisation goal. Currently, Indian companies have signed over 20 offset contracts estimated to be worth over USD 5 billion, although the status of most of the contracts is not known in any detail. The Indian government announced some years ago its plans to implement a fully automated system to monitor, account for and audit offsets in real time, however, to date this system has not been realised.

The scope of offset obligations was widened under the 2012 Guidelines to include transfers of technology according to a wide ranging list developed by the DRDO, though whether India has the capacity to absorb offsets involving high-end technology has been questioned by commentators,⁹⁴ and whether foreign companies are willing to engage in this type of offset or are sufficiently incentivised to do so, still remains to be seen. At the same time, the government also introduced the use of multipliers to the transfer of technology, although, according to anecdotal reports, no company has ever received confirmation of its obligation credit confirmed by the Indian authority.

⁹² See UAE website in its Industrial Development Program:
<http://www.idp.ae/en/Menu/index.aspx?PriMenuID=8&CatID=8&RefID=0&mnu=Cat>

⁹³ Government of India, Defence Procurement Procedure 2013, p.3

⁹⁴ Kaur, 2013.

The revised policy also increased the time for banking of offset credits and extended the discharge time. With the opening up of Direct Foreign Investment in 'kind' the scope of potential offsets has been widened to include homeland/costal security, civil aerospace products and services amongst other areas. This represents a shift in policy away from developing self-reliance in defence, and potentially provides a greater range of options to foreign companies offering offsets.

The Supreme Audit Institute has conducted two evaluations of India's offset regime. The first audit by the Comptroller and Auditor General (CAG) reported his findings to the Indian Parliament in November 2012.⁹⁵ The remit of the CAG was limited to ascertaining whether: (a) The provisions of the Defence Procurement Procedure (DPP) were duly adhered to; and, (b) a proper mechanism was in place to monitor the implementation of offset contracts.

Notwithstanding the narrow scope of the audit, the CAG noted that: "Despite India being one of the largest importers of defense hardware, the benefits of offsets could not be reaped to the extent envisaged due to lack of uniformity in interpretation of extant offset provisions." The report also sets out the details of five offset contracts worth 34 billion rupees (USD 62 million) in which waivers were granted contrary to the policy. The CAG report states that the selection of Indian offset partners was 'not valid' and the 'monitoring mechanism' for the implementation of the offset policy was 'weak'. The report also notes that there were instances where the Indian offset partners were in fact wholly owned subsidiaries of the foreign vendor.

The second CAG audit⁹⁶ addressed the purchase of AgustaWestland helicopters and included an assessment of the offset arrangements which comprised seven programmes identified by AgustaWestland, and which the CAG stated were not compliant with the DPPs applicable at that time. The infringements are analyzed in some detail and cover; the ineligibility of one programme that included, the 'build or refurbishment of hangars, stores and office areas as a Direct Foreign Investment (DFI) in infrastructure. As per DPP-2006, construction of civil infrastructure was not a valid offset for discharge of offset obligation.' The CAG sets out its interactions with the Ministry of Defence in its report including the fact that it did not receive answers to all its requests for information. Further criticism highlighted the inclusion of already completed work in the offset contract, and the lack of clarity in the drafting of the original terms and the inclusion of a project unlikely to be completed within the contract period.

It is an open question whether the current version of the DPP is likely to succeed where the previous version did not. It is clear though that the Indian offset regime is complex and open to interpretation, subject to slow and bureaucratic practices and

⁹⁵ For the details see Report No 17 of 2012-2013 of Air force and Navy, at: http://saiindia.gov.in/english/home/Our_Products/Audit_Report/Government_Wise/union_audit/recent_reports/union_compliance/2012_13/Defence/Report_17/Overview.pdf

⁹⁶ See the CAG Report October 2013: http://www.saiindia.gov.in/english/home/Our_Products/Audit_Report/Government_Wise/union_audit/recent_reports/union_compliance/2013/Defence/10of2013.pdf

likely to be subject to changes in future. The forthright findings in the CAG reports and the analysis of the weaknesses and failings of the policy or those that are supposed to implement it are helpful in setting out the actual practice and interpretation of the rules.

United Kingdom

In order to comply with the requirements set out in Directive 2009/81/EC the UK revised its definition of offset to enable a new policy focus, the goals of which were set out in a 2012 White Paper.⁹⁷ The implementation of the revised Defence and Security Industrial Engagement Policy (DSIEP) was transferred to the Ministry of Defence from the Business Innovation and Skills Department in April 2013, and in a speech in February 2015 the Minister for Defence said the government is: ‘...extolling the benefits of investing in the UK to overseas domiciled primes. Promoting the UK as a key location to engage in research and development investment and technology transfer... and encouraging them to extend opportunities for UK companies to become part of their supply chains.’⁹⁸ In response to a Parliamentary question as to how the new policy is developing in practice, a written answer was given by the Minister for Defence who stated in October 2014: ‘The DSIEP has made good progress since it was launched in the National Security Through Technology White Paper in February 2012. DSIEP tracked over £400 million of inward investment by overseas companies during 2012. This rose to nearly £500 million during 2013. With eight companies now signed up to DSIEP and discussions under way with several others, we hope that this figure will continue to rise. This compares favourably with the previous policy of Industrial Participation. In addition to this quantitative assessment, the Department is in the early stages of a Qualitative assessment of DSIEP and will be engaging with the DSIEP signatories and Defence academics to ensure this is robust.’⁹⁹ The eight companies mentioned by the minister are: Boeing, L-3 Communications, Saab, Rockwell Collins, Rheinmetall, RUAG, Airbus and Raytheon.

The UK’s engagement model is a variation on its previous industrial participation policy, and a satisfactory alternative according to the current government. This model may suit the UK due to the size of its defence industry and its export capacities, whether it is capable of being replicated in other EU countries remains to be seen.¹⁰⁰

⁹⁷ UK Ministry of Defence, 2012.

⁹⁸ UK Defence Minister Philip Dunne - Speech at the UK Trade and Investment Defence and Security Organisation Symposium, Tuesday 3 February 2015.

⁹⁹ Parliamentary question answered on 17 October 2014: <http://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2014-09-26/209331/>

¹⁰⁰ Matthews, 2014 p.87 -96.

4 Bribery Risks

The significance of transparency as a tool to counter corruption in the public sector has been described over many decades and throughout a range of academic disciplines.¹⁰¹ As Klitgaard wrote in 1998, “Corruption tends to be reduced by transparency (...) clearly defined roles, responsibilities, rules, and limits (...). Corruption loves multiple and complex regulations with ample official discretion.”¹⁰² Transparency refers to the qualities of being clear, honest and open, and in the context of public procurement this entails ‘the idea that procurement procedures should be characterized by clear rules and by the means to verify that those rules were followed.’¹⁰³ In the context of procurement this also implies publicity of contract opportunities as well as rules that govern each step and in particular the disclosure of all award criteria. This ensures equality among all economic operators enabling them to prepare their bid proposals when deciding to participate in a tender. Thus, one of the most important effects that transparency can have on a procurements system is that it ensures that procurement decisions are based on legitimate criteria and rule-based decision making that limits the discretion of public officials. In short, it reduces the possibility of corruption.

The level of transparency that is needed is open to debate. After all, the implementation of the principle can create costs, which could weaken procurement economic objectives. Open procedures could carry higher costs in preparation and evaluation, with negative effects for the contracting authority and for competition in the market. In countries where value is placed on avoiding corruption and on accountability in decision-making, transparency in public procurement is a criterion that has to be observed, while also ensuring other factors necessary for securing the legitimacy of public decisions. This legitimacy is fostered through due processes in awarding public contracts even if those processes represent higher economic costs (less economic efficiency).

Offsets are an acknowledged part of the defence market and can play an important role in defence procurement. Given the close proximity of the offset obligation to the main contract, they may also share some of the risk traits associated with the main contract. As offsets are closely linked to the main defence contract some would argue they share the same risks. Some commentators on offset arrangements have therefore raised the possibility that if the main defence contract is procured as a result of improper payments (or the promise of such), then the offset obligation could be used as the method to pay the bribe. Alternatively, corrupt payments could occur during the negotiation, and/or, execution of the offset obligation, or in connection with the granting of credits, but all occurring quite separately from the main defence

¹⁰¹ Ackerman, 1999.

¹⁰² Klitgaard, 1998.

¹⁰³ Arrowsmith, 2003.

procurement contract (and much as any commercial arrangement can be misused for bribery).

It is therefore relevant that the defence industry has been identified by organizations including TI and the OECD as high risk in terms of its vulnerability to corruption.¹⁰⁴ This is based on a number of characteristics, described as the lack of transparency under which defence procurement is carried out (often for national security reasons); the complexity of the acquisition process; the poor competitiveness of the local industry; and the large monetary value of defence procurement deals.¹⁰⁵ In situations where: country corruption risk is an issue; the rules and regulations relating to offsets are not publicly accessible and sometimes complex; there is discretion for the purchasing government to determine the value of offset delivered under the obligation; and negotiations are conducted according to confidentiality and/or national security considerations and therefore may not be subject to public scrutiny; the opportunities for bribery to occur are increased.

A properly designed offset program can be a key factor for a company in winning a tender and can also make a legitimate contribution to the purchasing country's industrial and economic base, so that the country's citizens derive real value from the offset arrangement. According to some companies, the potential bribery and corruption risks in offset arrangements should be relativized in the context of the number and volume of successful contracts, and the paucity of convictions for corruption in relation to offset. In the opinion of some companies and commentators, bribery is less likely to be perpetrated in today's anti-corruption legal and regulatory environment, and allegations and case examples are now out-dated and no longer indicative of the level of maturity of anti-corruption compliance programmes in the defence sector. Whilst this may hopefully be the case, and defence companies investigated for bribery in future will be able to show that it is down to the errant behaviour of a 'rogue employee' who is determined to circumvent internal rules and the compliance programme, the fact remains that there are perceptions, and even strongly held opinions, that offset arrangements are susceptible to misuse for bribery, because in some instances they are insufficiently transparent.¹⁰⁶ This chapter discusses offsets in the context of bribery risks, how such risks are currently mitigated by companies and sets the scene for Chapter 6, where additional efforts to further reduce the risks are outlined.¹⁰⁷

Many companies (and the defence sector is no exception) use corruption risk assessments as part of their compliance programmes to gauge their potential exposure to bribery and to focus their compliance resources efficiently. In conducting

¹⁰⁴ See TI-UK work; OECD, 2007 references to risk in arms procurement.

¹⁰⁵ Hardoon and Heinrich, 201.

¹⁰⁶ Feinstein, 2011.

¹⁰⁷ Transparency International defines corruption as the 'abuse of entrusted power for private gain.' The reasons why individuals engage in bribery, which is the form of corruption dealt with in this paper, are outlined as follows: 'For access to a scarce benefit or avoidance of a cost; for receipt of a benefit (or avoidance of a cost) which may not be scarce, but over which state official exercise discretion: not for a specific public benefit itself, but for services associated with that benefit, such as speedy service or inside information: paid (a) to prevent others from sharing in a benefit or (b) to impose a cost on another party. In addition to bribery, corruption can manifest itself through the exertion of undue influence.'

such an assessment, the company's exposure to specific risk factors often include an examination of: country corruption risk, with reference to the markets where business is being transacted; customer and other third party risks; transaction and services risks. In determining how to address those risks, companies by necessity, apply a risk based approach which informs, for example, the level of due diligence on business partners and other third parties, the thresholds for enhanced due diligence as well as approval levels, and the imposition of controls and monitoring systems. In some instances the level of risk will be determined as being so serious that the proposed business or market may not be viable and will have to be rejected or withdrawn from. In order to avoid such a scenario, one company described how it seeks out offset opportunities that encompass work that they are already contemplating due to wider business reasons that can then be linked into the offset requirement, or are commercially viable so that they can be continued after the offset obligation has been fulfilled, and these decisions are made in the context of the company's risk appetite and applicable due diligence procedures.

Risks associated with third-parties

Offset arrangements can require a number of third parties to facilitate the identification and implementation of offset transactions. This merits attention due to the frequency with which third parties present some of the highest risks for a company's exposure to bribery and corruption. The 2014 OECD Report on Bribery, which analysed foreign enforcement actions between the entry of the OECD Anti-Bribery Convention into force (15 February 1999) and June 2014, noted that 75 per cent of cases involved payments through intermediaries.¹⁰⁸ Companies including in the defence sector as well as other industry sectors are increasingly taking active measures to reduce reliance on third party agents in order to reduce risks in these areas.¹⁰⁹

Third parties that interact with government officials as an agent on behalf of a company bidding for contract present increased risk for the principal. Some countries require the engagement of a local agent as a pre-condition to bid for business. Due diligence on such entities and individuals may reveal close ties to the government itself, in which case mitigation measures will have to be implemented to address possible conflicts of interest and to ensure transparent dealings. In all cases, risk based due diligence on all third parties is a minimum approach to mitigate these risks.

Monetary value

Almost all respondents to the questionnaire accompanying this report indicated that the monetary values of offset agreements will likely increase bribery risk, partly because larger deals will involve more parties to execute the obligations. In some

¹⁰⁸ OECD, 2014.

¹⁰⁹ Stroz Friedberg Presentation, March 2015, "Global Trends in Due Diligence", Zurich, Switzerland.

cases, the main defence procurement deal can be matched by a required 100% (or more), credit value in offset transactions. Each individual offset transaction necessary to meet such obligations, even at fractions of the main procurement contract value and with the inclusion of multipliers, can be of considerable value and therefore presents some level of risk. Furthermore, the numbers of contracts required in a contract of such large volumes increases the opportunities for some offsets to be misused, either as false contracts created to complete a bribery cycle as a kickback for securing the main deal; or, exposing the exporting firm to third party risks, as the company may need to resort to brokers or consultants in order to identify a sufficient number of projects. Finally, the volume of transactions in a particularly high value offset agreement may create considerable pressures to discharge offset transactions over the long duration of a contract, particularly after the main defence contract has been paid for and completed. This could then result in offset credits gained by way of illicit payments demanded or accepted by an authority.

Pressures on the industry

The competitive landscape of the defence industry since the end of the Cold War has become a 'buyer's market', with purchasing governments having the upper hand and increasing the demand for offsets as part of a defence purchase.¹¹⁰ Recent shifts in purchasing patterns in international arms transfers as outlined in this report have seen a surge in demand from countries in the Middle East and Asia. Questionnaire respondents also consistently cited the Middle East and Asia as regions driving global demand and developing increasingly complex offset demands. From 2010-2014, of the 153 weapons-importing countries, the top five - India, Saudi Arabia, China, the UAE and Pakistan - together made up 33 per cent of global arms importing.¹¹¹ Many of these and other countries where this recent and forecast growth is taking place are prioritizing offset activities within their procurement calculations.

With price, technical requirements and quality offering less flexibility for differentiation among competitors, the relatively wider range of options for crafting an attractive offset proposal can be essential in raising a company's prospects for winning the deal. This confluence of increased industry competitiveness and demand for offset, flexibility in its role within the bid calculation, and regional patterns in demand creates several opportunities for offset to be exploited for improper purposes, particularly when combined with other risks already mentioned. Many of the regions where competition will be the most concentrated are among the poorer performers in recent editions of the Transparency International Corruption Perceptions Index (CPI), a measure of perceived public sector corruption.¹¹²

¹¹⁰ Brauer and Dunne, 2011.

¹¹¹ SIPRI, 2015.

¹¹² The Corruption Perceptions Index ranks countries and territories based on how corrupt their public sector is perceived to be. It is a composite index - a combination of polls - drawing on corruption-related data collected by a variety of reputable institutions. The index reflects the views of observers from around the world, including experts living and working in the countries and territories evaluated.

In some countries, offset regulations and country requirements are designed to ensure the defence company's firm commitment to an offset obligation, even if it is unrealistic from an objective perspective in terms of the country's local capabilities to absorb the services or technical transfer. In such a scenario the industry notes that potential gaps are being created between actual achievement and what the expectation as to what is to be delivered. Companies note that if it cannot be demonstrated that a proposed offset partner has the requisite capability to be able to take on a project, this will be a red flag and will require further review and forthright discussions with the country concerned will also likely be needed.

Diversity of offset policy goals

The diversity of policy goals that drive governments to demand offsets include economic, political and security reasons, which may be specific to their national situation and thus subject to change over time. The mix of reasons put forth and the lack of coherence that can ensue could create challenges in identifying the legitimacy and success of the offset transaction, and sustainability of a project may become a secondary or negligible concern.¹¹³ Where offset policies become goals in themselves, this can lead to misaligned incentives and open paths for potential corruption issues.¹¹⁴ In practice some companies commented that they seek to deliver offset obligations in as short a timeframe as possible but that this is increasingly not aligned to end customers' expectations as these may be focused on the longer term, leading to potential conflict.

Indirect versus direct offsets in the risk assessment

In discussions with legal experts and practitioners, as well as in results from the questionnaire, indirect offsets were frequently identified as having a potentially greater corruption risk, in comparison to direct offset transactions. Firms acknowledge that they have less control over various aspects of indirect offset fulfilment, raising potential gaps from a compliance and business operations risk perspective. In addition, because the indirect offset can at times be beyond the core competencies of the obligor, completing the offset transaction can require engaging a third party in the form of a broker or consultant to identify the offset projects available, which could then involve a third party or other agent responsible for implementing the offset transaction. Many of the advisers and consultants may be local experts with a military or political background, possessing connections and knowledge to assist in the process of execution yet also bringing potential conflict of interest concerns, and close relationships and interactions with government officials, further raising the risk profile for companies.¹¹⁵

<http://www.transparency.org/cpi2014/>.

¹¹³ Markowski and Hall, 2004.

¹¹⁴ TI 2010. Magahy et al, 2010.

¹¹⁵ Duthie and Bartusevicius, 2015.

The designation of indirect versus direct and greater focus on indirect offset as an increased risk should not obscure the fact that the specifics of offset in question may play a more deciding factor. For example, an indirect offset that nonetheless forms part of the company's area of expertise in aerospace and engineering may pose fewer risks than a direct offset. Direct offsets can also raise issues for further examination from a third-party due diligence angle. This is particularly apparent in arrangements that involve sub-contractors nominated or required by the importing government, or a requirement to enter into a joint venture relationship.

4.1 Red flags

Red flags that indicate bribery risks can arise during the course of a business relationship or beforehand during due diligence; either way, further investigations need to dig down to ensure that corruption risks are adequately identified and mitigated. The existence of red flags does not automatically imply that a firm should cut off engagement with a third party or the deal in question, but a response and/or mitigation is needed.

Many of the red flags that companies identify during standard business practices relating to third parties and intermediaries, joint ventures, suppliers and other relationships are equally relevant when entering into offset agreements and transactions. This was confirmed by several questionnaire responses, whereby companies stated that offset activities, from a risk assessment as well as a mitigation perspective, are subject to many of the same company-wide procedures in place for other business activities.

A number of organisations have provided lists of red flags of particular interest for companies engaging in procurement or employing third parties and intermediaries.¹¹⁶ Common examples that may be of particular interest in the context of offsets include:

- A history of corruption in the area and/or poor performance on international corruption and transparency indices (i.e. Transparency International Corruption Perceptions Index);
- Reputation concerns surrounding the third party, or of individuals/enterprises that a third party has represented previously;
- Refusal by a third party to sign a company's anti-corruption clause or to grant audit rights;
- Lack of adequate books and recordkeeping;
- Refusal by a third party to disclose the identities or beneficial owners of those involved;
- Use of shell companies or blind trusts

¹¹⁶ For example, see ICC Guidelines on Agents, Intermediaries and Other Third Parties (2010), OECD Principles for Integrity in Procurement (2009); discussions with Offset Working Group and questionnaire responses.

- Use of the third party is suggested or required by a government official or agency/individual with decision powers in awarding of the contract (or offset transactions/credits);
- Third party has formerly been a government official or has significant contacts with government;
- The requirement for the third party arises just before or after the contract is awarded;
- Lack of significant business presence, experience and/or residency in the country of fulfilment
- Questionable fee structures and monetary concerns – requests for advance payments, payments in cash, bank accounts not located within the country of performance, multiple bank accounts, fees disproportionate to services rendered, lack of clarity between services and fees (business case questionable).

In addition to the above-mentioned red flags which should be included when performing due diligence on offset activities, offset-specific red flags can include the following:

- An Offset delivery requirement exceeding 100% of the supply contract value when an appropriate justification of such weighting cannot be provided, and;
- Ambiguity in the customer's Offset valuation mechanisms;

Discussions with the IFBEC Offset Working Group, as well as what could be gathered from the questionnaire responses, showed a certain degree of harmony between the red flags listed above and those identified within company policies on the topic.

4.2 Risks and red flags within the lifecycle of offset activities

From a functional perspective, the methodology can generally be divided into two primary categories whereby offset misuse can occur. The first typology surrounds the actual offset agreement itself and mechanics surrounding its construction, management and oversight from which actors obtain undue benefit.¹¹⁷ Examples in this form can include offers or solicitations for bribes in order to obtain credit for an unfulfilled offset transaction; steering an offset transaction to specific companies with conflict of interests vis-à-vis the decision maker. Companies note that the review processes for offset activity would identify such conflicts of interest, and if the relationship were improper it would not be approved. If there were legitimate reasons for working with a partner where a conflict had been identified, suitable mitigation steps would have to be put in place.

In the second typology, the offset itself is not the main focus of the corrupt practices but is instead more a vehicle for delivering a bribe or undue favours within a

¹¹⁷ Magahy et al, 2010.

corruption cycle.¹¹⁸ In an example of this, the offset can take the form of a fictitious or sham transaction, used to repay a bribe made at an earlier point within the procurement process. Some companies however question whether this is a significant issue in reality, and rather characterize this as a perceived risk.

In addition to the aforementioned red flags, Diagram IV looks at these and other examples of red flags that are more focused on the procurement process, methodologies and risk patterns for offset in connection with corruption, and where they are most likely to occur. The information is categorized across three stages within the lifecycle of procurement tender. The list is not exhaustive however should provide areas for companies to consider when performing risk assessments in offset activities.

Starting before any procurement process is even in sight, risks for a company can be increased where **pre-performance** of offsets is permitted. A company that executes business or creates economic value in the expectation and hope of generating offset credits for future projects can be in a relatively weak position if the government has not acknowledged or defined whether such pre-performance is acceptable for future credits. Unscrupulous government officials may solicit bribes in order to profit from discretionary decisions about awarding credits to the company. A company would however, usually seek to establish that the work it is undertaking will be eligible to receive offset credits before the work is undertaken and is likely to require this confirmation in writing.

The **pre-tendering phase** can be improperly influenced by political decision-makers seeking to obtain illicit benefits. These can be achieved either by steering the offset business to specific beneficiary companies and subcontractors, as kickbacks, or acquiring the money intended for the offset transaction themselves.¹¹⁹ In the definition of specifications for the tender, the value of the offset in the award criteria may be subject to manipulation in order to favour a specific defence contractor that has promised bribes through the offset. Alternatively, another tender specification can be manipulated in order to allow for the entry of a company that will then make use of a future offset transaction, be it a fabricated one or inflated in value.

Where countries disregard their own policies or regulations during **negotiations** relating to the offset package and deviate from the stated goals or designated industrial sectors, the company may be in uncharted territory as regards future liabilities and face a dilemma about continuing those negotiations. Leverage to oblige the government to abide by the proposed divergence from the stated policy in the offset contract may not be possible, creating opportunities for bribes either at this stage or later on.

¹¹⁸ Ibid.

¹¹⁹ Ibid.

Countries usually make known their offset requirements through laws, regulations, policies, guidelines, etc. so the contractor should know beforehand if the country requires offset. Governments that require an offset package but only announce this late in the procurement process or even once the main contract has been awarded, may do so as a result of poor planning or a lack of communication, but in some instances this may also be seen as an opportunity to exert pressure on a company to demand additional deliverables.

Depending on how robust the procurement procedures are, opportunities for corruption to influence the **assessment** and **selection** of the bids during evaluation can occur, involving the bidding firms and the offset authorities (if they exist), such as through the entry into the process of third parties.

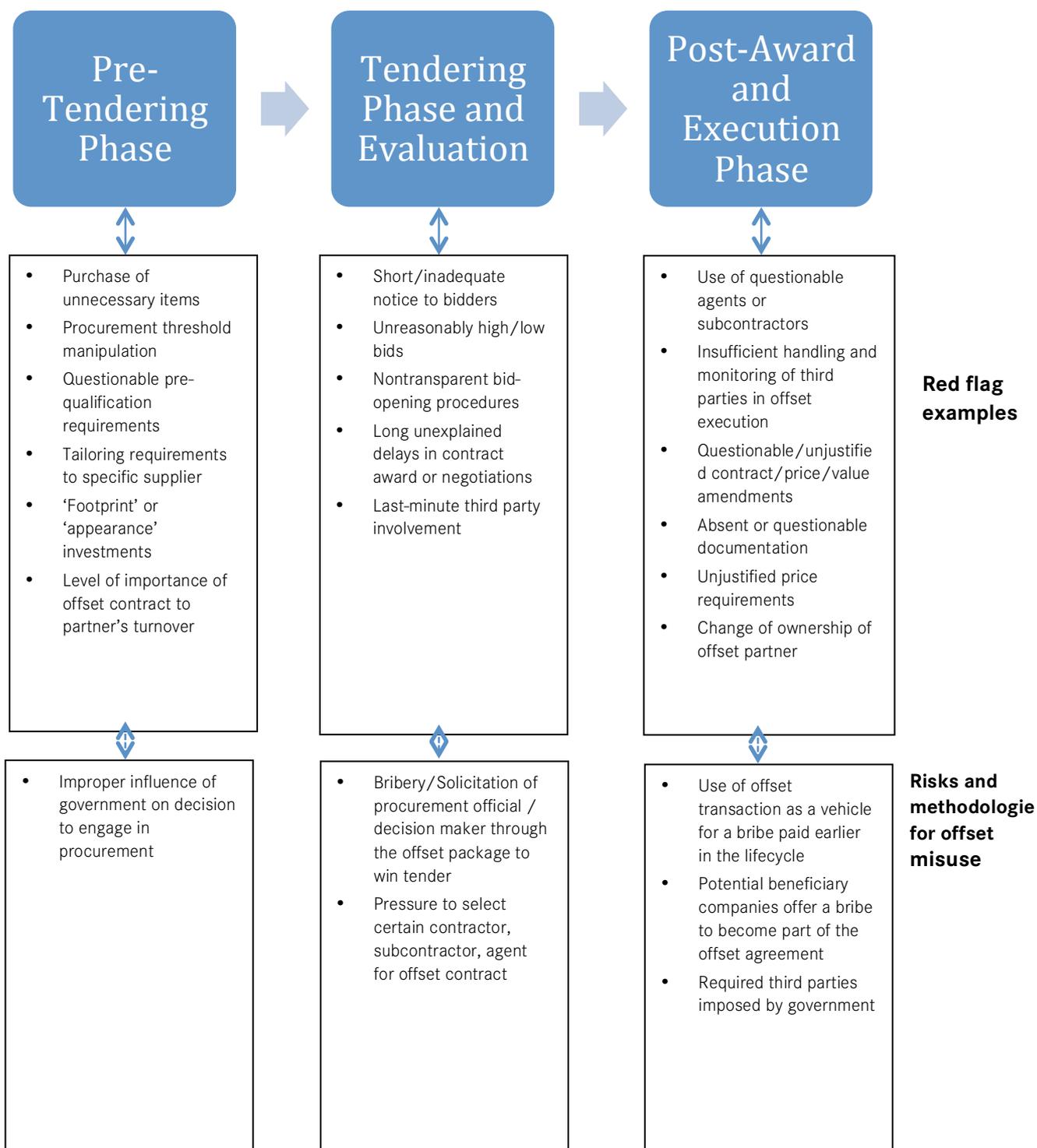
When **negotiating** the design of the offset agreement during the award phase, offers or solicitations for bribery may be deployed to influence the selection of subcontractors, agents and other third parties. Solicitation or bribery can occur when selecting from among potential offset beneficiaries. Conflicts of interest can enter into the decision-making processes of offset agency bureaucrats or senior government officials when proposing offset beneficiaries.¹²⁰

The **post-award phase** also presents opportunities for bribery, as this may be the period when earlier arrangements regarding illicit payments can be paid, such as through phony offset transactions. The discharge of offset obligations can be an entry point for bribery as well. Many of the offset characteristics and trends addressed thus far – increasing number and complexity of transactions, introductions of penalties for non-performance – may further increase the pressures and opportunities for the demand for bribes from the offset beneficiary carrying out the transaction or government agency responsible for disbursement of credits. Conversely, an obligor under pressure to receive offset credits may offer a bribe to the beneficiary or to the responsible government agency. The manipulation of valuation methods for an offset transaction before disbursement of offset credits can also provide an avenue whereby obligors can face solicitation from offset officials.

In the questionnaire responses most respondents noted that corruption risks are fairly evenly spread throughout the process, however, it can be difficult to generalise as risks also depend on the country and procurement tender at issue.

¹²⁰ Dunne and Lamb, 2004.

Diagram IV: Bribery and corruption risks red flags¹²¹



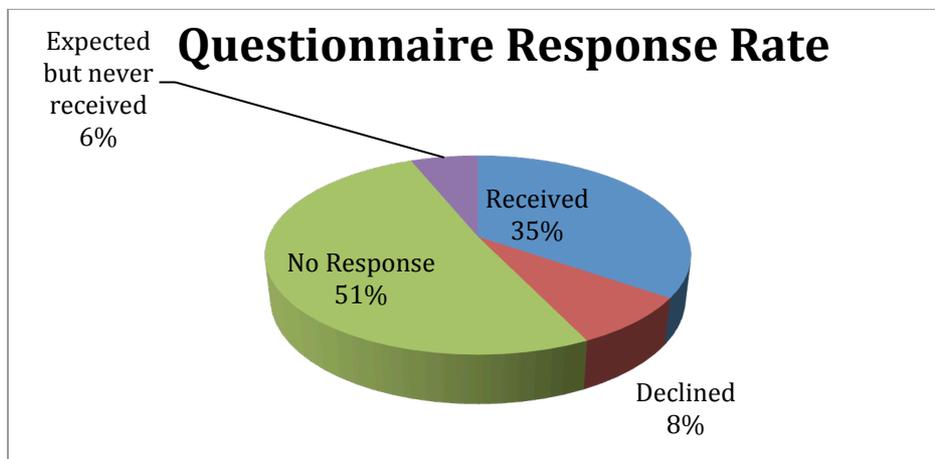
¹²¹ OECD, 2009; Magahy et al, 2010 ; Heggstad and Froystad, 2011

5 Industry responses to bribery risks

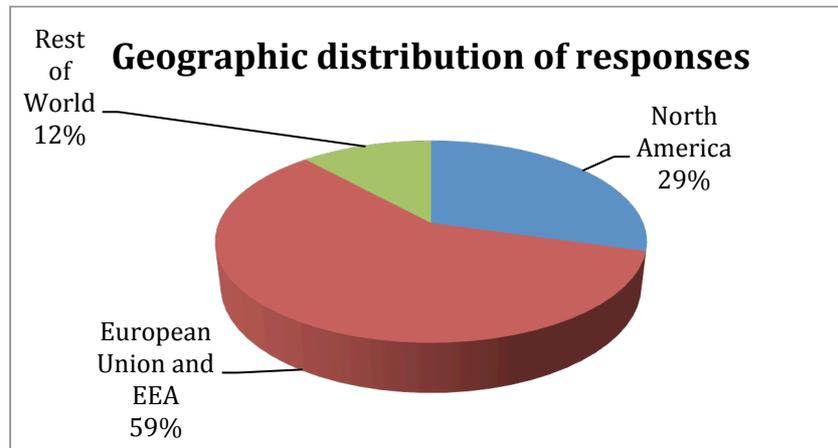
5.1 Questionnaire methodology and results

5.1.1 Methodology

The report was supplemented by responses to a questionnaire that was provided between February and April 2015 to a selection of aerospace and defence companies, as well as selected individual interviews with industry experts, civil society and legal professionals. The questionnaire was developed by the Basel Institute on Governance and the IFBEC Offset Working Group. The aims of the questionnaire focused on identifying the drivers of offsets; bribery and corruption risks in relation to offset activities; management of those risks by obligors and others; and areas where companies could be prepared to address issues of common interest to further mitigate any identified risks.



In total the questionnaire was sent to 49 companies, with 17 providing responses and varying degrees of detail in the answers given. The majority of the recipients (31) were IFBEC members. A further 18 external companies were identified by the IFBEC Offset Working Group and invited to complete the questionnaire, of which two provided responses. As a whole, the companies invited to complete the questionnaire represented a geographic balance largely reflective of the leading industry companies by annual turnover. Twenty companies were headquartered in North America, 22 in the EU and European Economic Area (EEA), and the remaining seven from across South America, Asia and the Middle East. Overall slightly more than half of the companies did not respond to requests to complete the questionnaire. A further four companies declined to participate, on account of having limited or no business in offset activities, and three expressed interest in participating but did not finally submit responses. Of the 17 completed questionnaires received by the Basel Institute five were from US-based companies, ten were from Europe, and two from the rest of the world.



Implications for the results

The sample size, coupled with the overall limited response rate to the questionnaire, necessitates careful interpretation of the results. It is not possible to represent that the responses can be reflective of the defence offset industry as a whole. With IFBEC member companies providing the overwhelming majority of completed questionnaires (15 of 17), this may bias responses towards a higher standard that the entirety of the industry has yet to achieve, as membership within IFBEC already demonstrates a company's commitment to ethical business practices. Finally, as those companies which have chosen to provide responses may have done so due to greater-than-average interest in integrity measures and confident assessment of their own internal programmes, this makes it even more difficult to attest that the responses can be said to be indicative of standard industry practice vis-à-vis offset activities. These classic elements of limited sample size and selection bias thus hinder attempts to form a more complete picture of the industry as a whole on offset activities. When interpreting the results these constraints should always be kept in mind.

Nevertheless, the responses to the questionnaire provide some insights into where leading companies in the industry see common ground on areas of offset activities and integrity. These preliminary findings can provide further areas for discussion within IFBEC and among the aerospace and defence industry overall.

5.1.2 Results

This section summarizes some of the responses provided to the questionnaire. It does not examine the responses to each question individually but instead approaches them thematically, under the headings used within the questionnaire itself, focusing on the key findings and areas of convergence. The actual questions can be found in Appendix II. In addition, findings from the survey have been incorporated within the main body of the report either through explicit reference or implicitly acknowledged, such as in the recommendations for further action in Chapter 6.

The drivers of offset activity

For the majority of the companies responding, offsets are generally a customer-driven phenomenon, with a few respondents explicitly stating that they only provide offsets when required by the customer or is written in policy or legislation. Even though very few companies responded that they proactively seek opportunities for offset, several recognized it as an area of expertise which could support business during the bid process, serving as an advantage in some markets. One respondent noted that it can be an opportunity to build goodwill and partnerships, whereas a few recognized offset as a chance to expand their company's footprint and markets.

Concerning the growth in demand for offsets, although a few companies stated that there were no discernible geographical trends, the majority acknowledged that they were seeing greater demand for offsets from countries of the Middle East and Asia. Latin America was also highlighted as a region witnessing greater offset demand. When naming specific countries, Saudi Arabia and India were the most often mentioned.

The bribery and corruption risk in relation to offset activity

Third-party risk

The use of third parties – offset service providers, brokers, agents, consultants, intermediaries and others providing services towards fulfilment of an offset obligation – shows little uniformity from among the responses received in the questionnaire. Only a third stated clearly that they do make use of third parties, with a few others stating that they do so but only under specific circumstances. Purchasing credits from or offloading credits to offset brokers, consultant services to identify suppliers and perform local country analysis, assistance with indirect (but not direct) offsets, were some of the reasons highlighted from all of the companies acknowledging their use of third parties. For the rest of the respondents, answers varied from 'rare' use, or 'not as a rule', or not very often. Similarly on the topic of third parties, nearly every single respondent noted that their companies have processes in place concerning the remuneration of third parties (when employing their services). Only two respondents stated that they do not use third party services at all.

Lifecycle risk

There was little consensus on when within the lifecycle of offset agreements that bribery and corruption risks are the greatest, with a slightly greater number of responses pointing to the pre-bid and bidding phases. Other responses included the period just before an agreement has been reached, or when certain milestones are in danger of being missed, as areas when corruption risks could be elevated. Three respondents wrote that the risks are the same at any time in the process, while several others noted that it can be difficult to generalize, on account of differences across countries, bid processes and specific campaigns.

Conflict of interest

All companies address conflict of interest risk factors, though not always defined in a specific manner for offset activities. They are generally subject to the same broader risk-based due diligence processes and compliance procedures as any other element of the business.

Processes and responsibilities in review and approval of proposed offset arrangements from an anti-bribery/anti-corruption perspective

This question could be seen as a precursor to the section on how obligors address corruption risks in offset activities, and was a question that showed considerable variation in the level of detail provided in responses. Nonetheless, several common elements emerged among the companies responding. Detailed due diligence processes are standard, with input required from legal, compliance, the business/sector area involved, and financial departments. In general approval is required from the top management of these departments, and in a few instances, this can go to CEO and Board level, or the Chief Compliance Officer as representation of the Board. Very few companies provided detailed information on how these processes and procedures are carried out in a step-by-step fashion.

How obligors address corruption risks

The majority of respondents noted that their companies have policies managing offset activities and risk. The manner and type of risk that is covered shows a certain degree of variation, however a few common responses included business related risk, reputational risk, performance/implementation risk, third parties, export control, joint ventures, and conflict of interest. Explicit reference to anti-bribery and corruption risk was also included in the responses of several companies. Two responses also mentioned situations in which customers nominate preferred suppliers as a risk factor. Red-flag checklists for offset activities are also employed by some companies within their offset policies.

For the minority of companies without specific offset risk policies, they responded that offsets are subject to the same company-wide anti-bribery, ethics and compliance procedures as all other business operations.

The manner in which companies monitor ongoing offset activities for compliance risks varies greatly. Many responses were not very specific, with references to 'continuous monitoring', 'reporting', and 'ongoing' or 'periodic reviews,' with the majority acknowledged some form of monitoring or review. When specifics were detailed, there were often considerable differences in the frequency, methodology and the specific items under observation. For example, from the responses provided, due diligence on an ongoing offset transaction can be conducted every two years, three years, or ongoing 'as necessary', depending on the type of transaction

involved. One company wrote that it does not do monitoring specifically related to anti-corruption.

Similarly, some companies noted that monitoring would depend on the level of involvement of third parties such as advisers and intermediaries, in one case with increased monitoring requirements (quarterly) whereas others acknowledged monitoring in these circumstances but no specific frequency. One response noted that monitoring would take place at specific points in the transaction, such as near payment for completion. Companies were less forthcoming with the policies and procedures in place for on-going monitoring, with one responding explicitly that the methods are proprietary information and not open for the public. One respondent mentioned electronic tools and watch lists however provided no further detail.

Survey respondents on the whole asserted that intermediaries in offset activities must commit to specific anti-bribery provisions and clauses, which can include audit rights.

Companies were asked if they had stopped a negotiation relating to the main contract due to corruption risks identified in an offset requirement. None responded in the affirmative; there could be various reasons for this, including as one company pointed out, the possibility that most companies have not actually encountered such a situation.

Focus areas for action

The question as to whether or not there is a level playing field in the aerospace and defence industry when competing for business requiring offsets elicited a wide variety of differing responses. Roughly a third of the respondents stated that there is a level playing field, with several of these stating explicitly that since all companies must follow the same rules and guidelines concerning offset activities, then there is in fact a level playing field, or at least no more or no less than in any defence procurement bid. On this second point, in claiming that there was (not) a level playing field, one respondent stated unequivocally that a level playing field should not necessarily be the goal, and that offsets are and should be a competitive factor in winning business, no different than building a superior airplane. Some respondents noted that whether or not there is a level playing field varies depending on the country involved. Clear and transparent requirements and evaluation criteria were again mentioned as a deciding factor in this case.

Laws and policies at the national and regional dimension as a contributing factor to creating an uneven playing field was a point raised by two respondents, one from each side of the Atlantic. A US-based company noted that they may be competing at a disadvantage compared to European firms, due to greater government support that some of these companies receive. From the European side, one EU-based respondent pointed to EU regulations that restrict the ability of Member States to request offsets from EU members, a constraint that non-Europeans do not face. By

forcing EU purchasers to make an exemption based on Article 346, this could lead to more requirements of direct offsets that could be difficult for some companies to satisfy. Similarly, one company wrote that companies with a greater supply chain scale and diversified geographical facilities have an advantage over smaller ones in this regard.

Finally, some companies noted that political decisions can play too great a role in undermining competition, such as through favouritism displayed towards domestic suppliers.

On the question of whether or not offsets could be made more transparent, the vast majority of respondents answered in the affirmative, with the purchasing State being seen as the driver in this regard. The most suggested methodology by which this could be achieved involved a preference for clearly defined, publicised rules and guidelines. From the requirements in the tender, evaluation mechanisms through the award phase of offset contracts and publicly available information once projects are audited and finished, these suggestions arose to varying degrees throughout the responses provided. Two respondents acknowledged that commercial confidentiality and legitimate State interests would hamper some demands for transparency, however even in these cases it was not seen as a complete barrier towards increasing the current level of transparency where possible. For example, one of the respondents saw no reason why an indirect offset transaction, which would presumably have fewer potential national security concerns, could not be made fully transparent. The commercial elements of the transaction meanwhile could remain confidential. Finally, a few respondents stated that international standards could play a key role towards increasing transparency.

A minority of companies held the opinion that offsets could not be made more transparent, with one respondent questioning the need for increased transparency at all.

Virtually all companies had much to say on the quality in the interactions they have with offset authorities and how they could be improved. This ranged from speeding up decision making processes to making them more transparent generally in particular with regard to online publishing of all relevant government offset policies and procedures including criteria to award credits and the application of multipliers. Many raised concerns about the lack of general business expertise and acumen amongst government officials as well as their level of technical knowledge when tasked with approving projects and awarding credits. A respondent raised the example where offset personnel in a particular country are so worried about being accused of corruption that they fear approving any transaction. In some countries government officials regularly change functions as a matter of policy. This may be prudent, but it does mean that expertise and experience is lost, and companies involved in longer-term projects are confronted with the problem of starting over when a change of personnel occurs within ministries and offset authorities. Given the

highly specialised nature of some industrial and technological projects this should be an area of concern for countries seeking to leverage benefits from their offset agreements.

The question on areas related to offsets that companies would like to see addressed when discussing with their industry peers provoked a wide array of responses, some of which have been incorporated with the recommendations of this report. Continued sharing of best practices in anti-corruption measures, due diligence on third parties, conflict of interest issues, employee training, and how offsets are structured and valued were just some of the examples raised. Many of these comments were shared by several respondents. At the national and international regulatory levels, there was a desire for initiatives that would enhance the quality of offset regulations, making guidelines and policies public and audited with review from a body such as the OECD or UN, and harmonization of national guidelines and policies.

5.2 Policies and procedures

In reviewing offset related policies and procedures from amongst the IFBEC working group members, it appears that whether or not a company has developed a dedicated offset policy as such, their uniform zero tolerance of corruption extends to their offset arrangements, just as the zero tolerance applies to all their operations and subsidiaries, joint ventures and third parties engaged to support offset delivery.

Where companies deploy a risk based approach to offset arrangements this determines the level of due diligence to be applied and red flags have to be addressed appropriately. In some instances red flags may cause a company to cease negotiations entirely whilst others are risk factors that have to be actively mitigated. Due diligence is generally according to a prescribed approach which is conducted partly by the business and partly by compliance and is generally detailed and part of the early phase of entering into a relationship, and can be by way of an internal tool or according to manual procedures. Due diligence applied to offset partners may include an overall appraisal phase to gather general information followed by a corruption risk assessment and an opinion on the capacity of the partner to deliver the requirements related to the offset. The internal due diligence procedures are also quite often supplemented by external support, which may take the form of a report from a specialised company or even approvals of the appointment of an offset partner through more than one external lawyer. In order to address potential conflicts of interest good practice includes ascertaining the ultimate beneficial owner of all entities that are being engaged in connection with an offset obligation as well as determining whether any of the management of a partner company are connected to a relevant politically exposed person.

Applicable internal policies often specifically require visits to the premises of any third party hired to support the delivery of offset and must be documented accordingly. Renewal times for due diligence vary and can arise on an ad hoc basis such as when

a red flag is suddenly manifested to two, three or every four years, though the details of what such renewal encompasses may be correlated to the initial risk assessment.

Documenting the business case when it comes to the hiring of third parties such as consultants to support the delivery of offsets is an important factor mentioned in many internal offset policies, for some companies the business must also record the rationale and submit this to their compliance team for further review. Fee models for third party consultants and others include commissions or retainers as well as hourly or daily rates, and may be described as having to be reasonable or market conform or in some cases a proportion of the overall value of the offset obligation. Whether ceilings are applied to fee levels tend to be confidential or not stipulated in the policies addressing risks.

The approvals for entering into an offset obligation tends to be at senior levels within companies, ranging from the use of specialised boards to the CEO or even the board of the company itself.

Standards with regard to monitoring during the lifecycle of the delivery of the offset include continuous monitoring of activity by some companies, while others conduct regular reporting on a monthly, quarterly or annual basis or a combination of these timeframes. The nature and scope of the offset obligation may also determine the frequency and degree of monitoring, for example an obligation to deliver one-off training may not require any monitoring compared to the delivery of a complex technology transfer project for example.

6 Conclusions and Next Steps

Offsets appear likely to remain on the international aerospace and defence agenda for many years to come. Despite being characterised as distorting competition and therefore prohibited by some countries as well as the EU, other countries value them as integral to achieving economic, industrial and social policy goals. Similarly, many defence companies and other stakeholders associated with offset agreements hold their offset capacities in high regard and praise the value that they deliver to end customers through offsets. Market observers all forecast that offsets will continue to grow dramatically in value terms in the next five to ten years. Correspondingly, almost all companies surveyed note that the demands for offset are increasing in complexity and detail in requirements. Despite the business and integrity challenges that this can pose, companies express confidence that they have mitigated bribery risks so that their offset programmes will continue to be conducted with integrity. Defence companies are aware however of the risks of complacency about anti-corruption compliance even when applied to the entire lifecycle of the offset arrangement. Integrity standards and regulatory expectations continue to evolve,

added to which, prosecutors are increasingly exchanging information across borders. In particular, in arrangements where the offset execution is subcontracted to a non-closely held third party via an intermediary or broker, this scenario may present elevated bribery risks in some jurisdictions.

6.1 Next steps: Areas for further work

In recent years there have been calls for a wide variety of actions to be taken by governments and the industry itself, perhaps most visibly by TI. On the one hand many companies have developed standards and implemented them in areas such as third party due diligence and TI notes an improving trend in this respect, on the other hand there is still much to be done and many companies are still in the early stages of developing their anti-corruption programmes such that they are properly implemented. The majority of companies also report that they now have specific offset policies and that they would be willing to share them with their peers insofar as no proprietary commercial information is disclosed. The topics set out here are based on the responses from the companies surveyed, and may be seen as first steps to establishing a more collaborative approach between various stakeholders in selected areas. The IFBEC working group proposes to IFBEC that further work be undertaken to integrate these points into a set of minimum standards in anti-corruption compliance in offsets for the industry:

- Application of the company's ethics and compliance programme to its offset business, with additional measures where increased risks may arise.
- Application of the company's ethics and compliance training and awareness raising programme to all staff involved in offset business including senior management and additional tailored training to functions /staff members as necessary.
- Training of internal audit on offset arrangements and related corruption risks to develop internal audit capabilities related to offset activities.
- Tracking of payments related to offset performance (including payments) to third party brokers and how to perform this effectively.

Establish an internal offset/countertrade/industrial participation policy which should include criteria for engaging in offsets/countertrade/industrial participation; specific roles and responsibilities within the offset offering, approvals and planning processes; designated approvals and sign-off levels including senior management approvals for all offset offers and contracts, and/or an approvals escalation process for unusual contractual requirements or other features that may increase risk; due diligence requirements; payment procedures; cross references to other relevant policies and so on.

- Proceed with risk based due diligence on any party supporting the delivery of an offset obligation.

- Include appropriate anti-corruption representations and warranties in contracts with parties delivering offset obligations and consider audit clauses as appropriate.
- Companies will establish a sufficiently detailed policy on conflicts of interest such that it is clearly understandable where risks can arise and how they must be mitigated.
- Review the maturity of the compliance programme of offset partners and include training as appropriate.
- The appointment of monitors as appropriate (can be internal or external as long as no conflicts of interest) to each offset obligation to conduct periodic assessments to identify possible corruption risks as they may arise during the execution of the obligation. Corresponding procedures to follow up and address risks as identified, and document the response.
- Include offset related corruption risk assessment in acquisition of companies or operations (M&A).

In response to the diversity of rules, guidelines and laws that regulate offsets at a national level, further consideration could be given by IFBEC to independent actors to develop criteria to risk rate countries and their offset authorities as part of its risk based approach, using publicly available data in combination with other information, though it should be noted that some companies do not see any difference between existing country risk ratings and country offset risks from a compliance perspective. This could be a reference document for companies when developing their own internal country risk lists or potentially be developed into an optional country risk index for the industry.

Another area for further consideration would be for IFBEC to compile detailed typologies of offsets arrangements to support the industry in developing appropriate due diligence and identifying the party responsible for carrying it out. This could be issued as guidance by IFBEC to the industry.

In terms of areas for possible future collaboration between the industry and others, the following points are noted from discussions and the questionnaire responses:

- IFBEC companies have a wealth of experience and expertise in offset arrangements; sharing this know-how with offset authorities in a forum such as a conference could be a step towards a longer term and more detailed focus on areas of common interest in relation to preventing corruption and promoting integrity, and leading to the:
- Establishment of a working group of volunteer IFBEC representatives to engage with willing governments (or even as a pilot with just one or two countries), to explore where offset authorities could address the points made by the industry in the questionnaire responses. The possible areas for further work should not necessarily be pre-determined, but should draw upon the ethical commitments that IFBEC members have undertaken to observe. The

aim would be to develop a dialogue between the industry and end customers on anti-corruption issues.

Additionally, IFBEC could consider encouraging Offset authorities or the responsible government departments to take it upon themselves to publish all policies, due diligence procedures and any standard contract documentation they rely on when inviting the private sector to bid for, or otherwise engage in offsets, and make this documentation freely accessible online.

If actions are taken by the industry and governments to engage with the issues laid out in this Chapter, the perceived bribery risks associated with offsets may be reduced.

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7 Appendices

Appendix I: US Defence Industry Exports: Top 25 Countries by Contracts, 1993-2006

Country	# of Agreements	Export Contracts	Offset Agreements
United Kingdom	47	\$12,812,901,286	\$10,509,292,643
Taiwan*	42	\$11,391,270,700	\$2,510,242,030
South Korea	67	\$9,215,188,892	\$5,386,723,454
Greece	51	\$7,464,342,343	\$8,522,872,271
Canada	28	\$4,627,362,694	\$4,488,332,872
Israel	49	\$4,356,730,606	\$2,102,176,627
Saudi Arabia	Withheld	\$4,091,600,000	\$1,427,400,000
Turkey	20	\$3,860,043,000	\$1,837,850,000
Poland	3	\$3,731,600,000	\$6,259,600,000
Australia	17	\$3,499,462,000	\$1,603,885,000
Italy	9	\$2,680,257,000	\$2,515,257,000
Switzerland	11	\$2,557,612,040	\$2,017,612,040
Netherlands	48	\$2,149,566,176	\$2,522,126,176
Spain	26	\$1,955,992,588	\$1,743,813,004
Norway	31	\$1,347,751,824	\$1,372,651,824
NATO	Withheld	\$989,749,000	\$552,000,000
Denmark	35	\$874,619,000	\$874,629,000
Kuwait	11	\$871,353,822	\$284,537,066
France	4	\$785,200,000	\$664,200,000
Malaysia	4	\$759,100,000	\$283,500,000
United Arab Emirates	9	\$733,300,000	\$424,200,000
Portugal	4	\$615,961,000	\$297,293,000
Thailand	6	\$539,729,463	\$143,696,539
EPG - European Participating Group (Belgium, the Netherlands, Norway)	Withheld	\$539,500,000	\$150,200,000
Czech Republic	Withheld	\$312,600,000	\$62,500,000
Total	529	\$82,762,793,434	\$58,556,590,546
All Countries	589	\$84,300,929,656	\$60,008,016,768

Source: US Department of Commerce Bureau of Industry and Security, 12th Report to Congress (December 2007).

Over half of the defence purchases (54 per cent) and offset agreements (52.4 per cent) involving US firms from 1993 to 2005 were attributed to five countries – the United Kingdom, Taiwan, South Korea, Greece and Canada. At the regional level however, European countries have been in the recent past the predominant

beneficiary of US offsets, accounting for 65.9 per cent of offset agreement value, while only 48 per cent of defence contract value

IFBEC Offset Working Group

Semi-structured Questionnaire

Responses to this survey should only be sent to the Basel Institute on Governance (please send by e-mail to gemma.aiolfi@baselgovernance.org). The names of companies responding to this survey and all responses will be treated as confidential by the Basel Institute on Governance. None of the information contained in the responses will be disseminated in any form that could lead to any company or individual being identified.

Name of company:

Name of contact person:

1. Introduction

In the following questions the term 'offset' should be broadly interpreted and include 'industrial participation' and 'industrial cooperation'.

If your answer pertains specifically to a direct, indirect or mixed offset activity please state this in the response.

In the context of this questionnaire, 'semi-structured' means that follow up interviews may be requested of respondents.

2. Objectives

This questionnaire seeks to identify:

- The drivers of offsets
- The bribery and corruption risks ("risk") in relation to offset activities
- How those risks are addressed by obligors (and others)
- Areas where companies would be prepared to address issues of common interest that will mitigate the identified risks.

3. The drivers for offset activity

- a) Are offsets limited to customer requests or voluntarily proposed by your company?
- b) Are offsets part of your company's business model?
- c) Does your company have a dedicated offset organization that supports your company's marketing efforts?
- d) What sources (e.g persons, entities, government) do you use or rely on to identify offset opportunities?
- e) Does your company see a greater demand for offsets from certain regions or countries? If yes, please identify them.
- f) Does your company have any policy (howsoever called) defining the criteria for accepting or excluding particular types of offsets?

4. The bribery and corruption risk in relation to offset activity

- a) Does your company use offset service providers, brokers, agents, consultants, intermediaries or any other third parties that provide services towards fulfilling the offset obligation? Please give some examples of the types of services provided.
- b) Does your company use consultants /advisors (third party howsoever called) that are visible towards government offset authorities and/ or act on your company's behalf?
Does your company use such third parties during the entire offset project?
- c) At what stage in the lifecycle of offsets (including, where applicable, the pre-offsets phase) are the potential corruption risks assessed?
- d) Do the risks differ according to the offset model (i.e. direct, indirect or a mixed model)? If yes, in what ways?
- e) Does your company have any specific policy regarding the remuneration scheme applicable to service providers, brokers, agents, consultants, intermediaries or any other third parties?
- f) What processes are in place for the review and approval of proposed offset arrangements from an anti-bribery and anti-corruption perspective?
 - 1. Who undertakes these reviews?
 - 2. Who approves proposed arrangements?
- g) Does the size of the offset obligation affect the level of risk?
- h) In the negotiations to win a government contract in a country that requires offsets, at what point are the corruption risks most likely to arise?
- i) Has your company experienced any form of corruption from an offset customer (government or private) who is responsible for or administers offset programs?
- j) Does your company have a definition of "conflict-of-interest"?
- k) How does your company minimize the risks associated with potential conflicts-of-interests involving the offset customer?

5. How do obligors address corruption risks

- a) Does your company have specific policies that address offset activity? If yes, identify the risk areas that are covered in these policies.
- b) How does your company assess risk in offset activities?
- c) How do the due diligence requirements and the review and approval processes differ according to the assessment of risk in offset activities?

- d) If your company retains responsibility for performance-risks related to the prime contract where the offset obligation has been transferred to a sub-contractor, does your company remain responsible for managing the bribery and corruption related risks that could arise with the third parties executing the offset?
- e) How do you monitor the ongoing compliance of an offset activity after it has been approved? Do you have any procedures in place for the ongoing monitoring of offset activity?
- f) Who, within your company, is responsible for conducting due diligence related to third party offset activity?
- g) Are brokers, intermediaries, consultants, agents and other such third parties required to adhere to your company's code of conduct or other policies in fulfilment of an offset contract? If yes, how does your company monitor adherence to your standards?
- h) How is due diligence information on third parties (brokers, agents etc.) verified? Are the same standards (of due diligence verification) applied to companies involved in fulfilling offset obligations?
- i) Has your company stopped negotiations relating to a main contract due to corruption risks identified in the offset requirement? If yes, what were the circumstances?
- j) How does your company evaluate and propose multipliers?
- k) Who within your company (title/function, division) is responsible for approving the following offset activities?
 1. Offset Program Contract (e.g. Obligation/Commitment)
 2. Third Party Offset Service Provider Agreement
 3. Third Party Offset Partner/Participant Agreement
 4. Other Third Party Offset Arrangements

6. Focus areas for action

- a) Is there a level playing field between Aerospace & Defense companies when competing for business that also involves offering offsets? If not, what needs to change?
- b) Can offsets be made more transparent? How might that be achieved?
- c) In your experience with the national authorities, have you identified any particular specificities and weaknesses (e.g. legislation; authorities capacities, organization and/or procedures) in the way such authorities address and/or monitor offset projects and arrangements? Does your company have a policy defining any particular actions that should be implemented to address those specificities and weaknesses?

- d) What areas relating to offsets would you like to see addressed when discussing with other Aerospace & Defense companies?