



Current Issues & Themes In Offset



Welcome

In these Newsletters we provide our clients and industry partners with an independent assessment of the latest developments in Offset and related issues. Since its inaugural publication in 2009, our Newsletter has received a great deal of positive feedback from companies that are serious about keeping up to date with the latest Defence Industry developments in offset and who want to learn more about best practice in this niche area of defence business. Our aim therefore is to communicate what we have learned through practical experience in our consultancy work together with latest legislation and Industry developments.

With a wide range of synonyms that include; industrial co-operation, industrial collaboration, industrial participation and industrial & regional benefits (to name only a few) offset is now an integral part of defence procurement law in more than 70 countries. Moreover, in today's defence climate, where technical excellence and price competitiveness is taken for granted, offset is now considered a critical success factor in the highly competitive world-wide defence export market.

We have extensive knowledge of current rules and regulations for a wide range of countries. Added to which, we have a growing number of examples where we have 'hands on' experience of managing offset programmes, either through the bidding stage or managing the delivery of contracted offset projects. We hope that these Newsletters and its companion web site (www.offsets2000.com) are therefore of practical assistance to you. If, however, you have a specific question you would like to discuss please feel free to contact us where we shall endeavour to assist you in strictest confidence.

ROGER BULGIN,
CEO

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Market Spotlight

Greece

Following a 2-day SEKPY (Association of Hellenic Defence Manufacturers) conference in January 2010, during which delegates were invited to debate 'Procurement of Defense Systems and Security / Dual Use Material, Export Regulations and Procedures for R & D Programs', the attention of the industry is once again focused on the ongoing furore in the region surrounding offset regulation, management and penalty for failure.

Some blame must of course fall at the feet of policy makers who in December 2006, in an albeit virtuous bid to create valuable and measurable offset regulations, created a highly complex and perhaps unworkable framework that not only induced severe penalties for non-performance (liquidated damages of 10% of the unfulfilled obligation value), but required the use of a 21-coefficient algorithm (amongst several) to calculate offset project value, many components of which fell outside standard accounting/reporting requirements, putting extra burden on Greek industry as well as the obligor.

Although the Greek government have reportedly procured very little under the 3yr old law (preferring to enter into government-to-government bids where offset is not a legislative requirement), some 60 contracts are yet reported to be in default.

The situation reached a head in September/October 2009 when the Hellenic Ministry of Defence (HMoD) reportedly issued more than 70 letters warning obligors that they may be in breach of contract and as a consequence could be required to pay liquidated damages.

Six months on, three contractors are said to have surrendered their performance bonds, whilst others are looking to settle the matter in court.

It must be remembered that the battle is not simply between government and contractors however; Greek industry too has a stake in the outcome of this saga; SEKPY claims that the debacle will cost Greek Industry €5 billion in cancellations, rescinded contracts and delays. The hiatus in offset will no doubt add to Greece's current financial woes. However, to salvage a positive note, defence companies are notoriously innovative in structuring deals which offer value for money in times of economic conflict. Offset can play an important role in providing reciprocal benefits to Greece which can often circumvent traditional financing methods. It is up to the legislators and policy makers to show pragmatism in allowing innovation to be accepted.

UK

As the UK prepares for a general election and possible change in government, the future of the UK offset policy may well be called into question.

Two key studies into the benefits of the UK's Industrial Participation Policy - the first by the United Kingdom Offset Strategy Group (UKOSG), reflecting the views of UK Industry, and the second led by Professor Ron Matthews (Cranfield University and Nanyang Technology University) which use academic and empirical research methods to assess the accrued and inherent benefits - will serve to provide a basis of discussion amongst key UK Government policy makers.

Whilst the industry view is typically in favour of the UK IP Policy which aims to "stimulate work and business opportunities for UK companies and secure access to overseas markets by generating long-term partnerships with offshore companies" (UKTI DSO, Mar 09), it is recognised that as offset requirements may drive up the cost of the defence procurements, they should be avoided where possible so as to allow UK Government to purchase equipment as cheaply as possible.

Whilst the impact of the UK IP policy on the cost of defence procurement for UK Gov is of course a weighty consideration, its impact on the survival of the UK defence industry must also play an important part in decision making.

Defence Industrial Strategy (DIS)

In terms of shaping the UK offset policy for the future, surely now is an opportunity to make changes which allow for a greater coherency between policy instruments such as the Defence Industry Strategy (DIS). For example, one strand of the DIS was to promote the growth and technological capabilities of SMEs in the UK defence sector. Whereas countries such as Norway use multipliers to actively encourage foreign primes to collaborate with its SMEs, the UK does not. Neither does the UK policy allow multipliers to encourage the transfer of 'high-tech' work. It is felt that these simple amendments to the current UK offset policy could have tangible benefits to the UK SME defence industry sector and help to implement key objectives of the DIS.

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CANADA

Canada, who has over C\$20Bn in offset obligations, is this year undergoing a policy review that will result in a number of changes to the offset framework. Industry Canada (the government department responsible for managing Canada's Industrial & Regional Benefits Policy) has attributed the changes to an increase in volume and value of defence procurements as well as a means to provide enhanced support to industry in response to the recent global economic crisis.

Whilst the bulk of the framework has been retained, policy enhancements allow for a more flexible business development environment, an increased number of beneficiary business sectors & stakeholders, potential for more strategic and sustainable projects, and increased flexibility to discharge offset obligations. To the relief of many, banking of credits will now be permitted in advance of contract award (with restrictions), and multipliers (the use of which has previously been limited) will now be granted for investment in multiparty consortia. Other changes include the introduction of a demand-driven priority list, increased focus on innovation focused activities with Canadian start-up companies, and a widening of scope for those with direct offset requirements.

More information on the changes to Canada's Industrial & Regional Benefits Policy is available on the Industry Canada website at www.ic.gc.ca/irb alternatively please do not hesitate to contact us at Offsets 2000 Ltd for advice.

A|D|S & UKTI DSO Seminar - "Doing Defence & Security Business with Brazil"

On the 4th March, Offsets 2000 Ltd participated in an informative and well attended seminar jointly organised by UKTI DSO and A|D|S.

The purpose of the seminar was to raise UK Defence and Security companies' awareness of the opportunities afforded by the Brazilian market and provide practical advice on how to approach it. With presentations by such distinguished dignitaries as the Brazilian Ambassador, His Excellency Carlos Augusto R. Santo-Neves, the Logistics Department Director of the Brazilian MoD, Air Marshal Odil, and the Advisor to the President of BNDES (Brazilian Development Bank) on defence and aeronautics industrial policy, Sergio Leite Schmitt Correa Filho, the event demonstrated the ever growing prominence of the Brazilian defence market in the aerospace, defence and securities industry.

Offsets 2000 Ltd was pleased to participate; being on hand during the seminar to provide advice, key offset intelligence, trends and changes in legislation, and welcomed the invitation to participate in future events.

Presentation to A|D|S British Aviation Group Committee

Offsets 2000 Ltd was pleased to present at the quarterly meeting of the Airport Consultants Group, a sub-committee of the A|D|S British Aviation Group. Representing companies involved in the design, planning, construction, equipping, management and operation of airports and aviation projects, the group had expressed an interest in learning more about airport development opportunities that may be linked to offset requirements around the world.

Providing first a general introduction to offset and indirect offset in particular, also covered past projects that have seen airport and civil aviation companies leveraging offset and economic compensation programmes to further develop their export markets and attract inward investment. Examples were also discussed of two- and three-way countertrade deals included that have allowed airport and civil aviation companies to engage in commodity finance and barter deals as part of a wider offset programme.

It is also of interest to note that approximately 50% of all defence offset results in business of a civil nature. Most countries allow some element of the offset obligation to be discharged in civil projects which opens the door to opportunities for civil companies to look at offset as a source of new business and investment during the current financial climate. Airport programmes and related products and services are one example of where defence offset has engaged the civil sector.

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Best Practice

As in previous newsletters, we continue in this section to provide insight on offset management and delivery gathered from our consulting experience.

There is much discussion amongst industry professionals around what measures governments should be prepared to take in the event of offset non-performance, and what or where the limits to those measures should be.

As Greece threatens to cash the non-performance bonds of defaulting obligors (See 'Market Spotlight – Greece', p2), many offset practitioners will be looking nervously towards Poland where failure to deliver an obligation can incur penalties of up to 100%.

It is true however that Poland is very much an exception; penalties for non-performance tend to be between 5% and 9% and as they are typically imposed as a bank guarantee, some industry professionals question the penalties as a real deterrent in the belief that the penalty itself amounts to far less than the costs involved in delivering the obligation.

Whether this is true or not, it is our experience that the real deterrent is in the risk of jeopardising long-term business relationships with the customer country. Offset is subject to detailed legislation in over 70 countries and failure to deliver offset in those countries is a breach of contract.

Defence contractors and potential obligors should also remember that some countries (India, Romania, Denmark for instance) will 'blacklist' companies that default on their offset obligations, preventing those companies from doing business in the country for a set period of time. Moreover, all those listed above publish their 'blacklists' online, potentially causing global reputational damage. The Government of Romania cites several contractors that are 'excluded from any other procedure for awarding a procurement contract which also implies the fulfilment of an offset obligation'.

As in previous editions of this newsletter, we conclude that where the financial risk is not a sufficient deterrent, companies should remember that the damage to their reputation may be much more severe.

Offset Training Workshop - 2nd July, Farnborough

The next in a series of Offset Training Workshops is to be held on 2nd July in Farnborough. This Offset Training Workshop is to be held in conjunction with A|D|S and will be of benefit to all companies engaged in defence business. The workshop provides 'Best Practice' on offset, yet is of value to both novices and experienced practitioners.

For more information please contact Christine Gomm at A|D|S on: Christine.gomm@adsgroup.org.uk

Farnborough International Airshow (19th– 23rd July)

Offsets 2000 will be manning the ADS 'Offset Information' stand at this year's Farnborough Airshow. We would be delighted to offer advice and guidance on any offset related matter – so please feel free to drop in for a chat!

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