

The evolving state of offset arrangements in connection with military and other sales to foreign countries

Since the late 1950s, foreign governments have been requiring that U.S. companies selected to provide U.S.-manufactured military equipment or services offset the financial aspects of the purchase by entering into agreements that effectively return some portion of the value of the transaction to enterprises within the foreign country. These agreements have now become common practice and have become more sophisticated and targeted over time. They take many forms and may be direct or indirect in nature.

While these offset agreements are often necessary in order for U.S. companies to obtain the benefit of the transaction, they obviously reduce the total return that is available to U.S. companies and may have significant long-term business

consequences as well. As a result, careful evaluation and negotiation of the terms of these offsets and their subsequent effects on the company, its subcontractors and its suppliers are critical to determining whether the transaction will be advantageous for the company.

The number, size and sophistication of offset arrangements affecting U.S. companies have increased since 1993, according to annual reports produced by the Department of Commerce. This reporting obligation was shifted to Commerce by Congress when it became clear that the Office of Management and Budget could not perform the role assigned to it for the previous five years of reporting on the impact of offsets on defense preparedness. That reporting

was supposed to be based on interagency studies, but there was neither the data nor the funding to support such studies.

While the economic and other potential consequences of such arrangements continue to be matters of domestic concern, international attention regarding the effects of offsets has been growing in recent years as well. For example, in 2009, the European Defence Agency announced that it had adopted a Code of Conduct on Offsets intended to “bring transparency into the European defense equipment market.” Twenty-six countries participated in this effort and agreed to publish information concerning their national offset policies and practices. A central objective is to help develop a European defense technological and industrial base that is “capability-driven, competent and [globally] competitive.” The participating countries also agreed not to request or accept offsets that exceed 100% of the value of the associated contract.

Thus, it appears that offset arrangements will continue to evolve and be matters of concern to governments around the world. Their potential impact on individual companies and the business climate in general makes it important that companies be more aware of their scope and nature and the cost-benefit issues that they raise.



What is an offset?

Offset agreements may include arrangements for such things as co-production, local content requirements, licensing, subcontracting, in-country purchases, marketing and credit assistance, export sale subsidies, technology sharing, training, commodity trading, investment, and joint ventures with manufacturing or other entities in the foreign country. These arrangements are often complementary, and an agreement to purchase a high-value system may be accompanied by an offset arrangement that includes a combination of types. For example, a co-production agreement may be coupled with licensing, investment and technology-sharing obligations that will result in a more capable indigenous manufacturing capacity.

These arrangements are negotiated directly between the U.S. company that is making the sale and the host government. While the U.S. government may be a party to the sale and exercise approval authority over certain types of offsets — e.g., defense articles and technology transfer — it plays no role in the negotiation of the offset agreement itself and assumes no liability or responsibility for the performance of the offset requirements.

A good example of an indirect offset is an agreement to purchase some amount of material or goods on the local market.



Host countries view these offset arrangements as significant means to deal with internal political and public issues that may arise regarding the transaction; reduce unemployment; increase workforce and industrial capabilities; and acquire useful technology. These arrangements are most often sought in the context of purchases of high-cost military systems such as military aircraft, but they may also be features of sales to foreign governments of commercial systems such as passenger aircraft, telecommunications equipment, and power generation and transmission equipment. In some cases, countries have begun to demand offset proposals prior to contract award.

Offsets may be either direct or indirect in nature. Direct offsets are commitments to take actions that are specifically related to the particular items being purchased. The best example of a direct offset would be a requirement that a firm in the host country be involved to one extent or another in the actual production of the item or provision of the services.

Indirect offsets require activities that relate to something other than the purchase to which the offset has been attached. A good example of an indirect offset is an agreement to purchase some amount of material or goods on the local market.

Whether other forms of offset are direct or indirect depends on the specific facts involved. For example, a foreign firm might be licensed to produce a part or a subsystem of the specific defense system that is being purchased, which would be a direct offset, or to produce an unrelated product of the U.S. company that is selling the system, which would be an indirect offset. The same direct or indirect character can be true of credit assistance, technology sharing, training and investment agreements.

Offset obligations may be set at any level of value, up to and even exceeding 100% of the value of the military goods and services that are involved in the associated purchase. The host country will monitor and maintain records concerning the extent to which the U.S. company has satisfied the offset agreement in order to ensure full compliance and to give the company credit for its performance in fulfilling the offset obligations.

In some cases, the host country may grant the company performance credits that exceed the value of the offset activity itself in order to encourage companies to engage in types of offset activities that are of particular importance to the

host country. This may be done on an ad hoc basis or more formally through a multiplier that is applied so that there is more than a one-to-one correlation between the value due in offsets under the arrangement and the actual value of the company's efforts to satisfy the obligation. For example, one dollar's worth of one type of offset may result in one dollar of credit against the offset account, while one dollar's worth of another type may count for two, three or more dollars of credit to the account as a result of the multiplier effect.

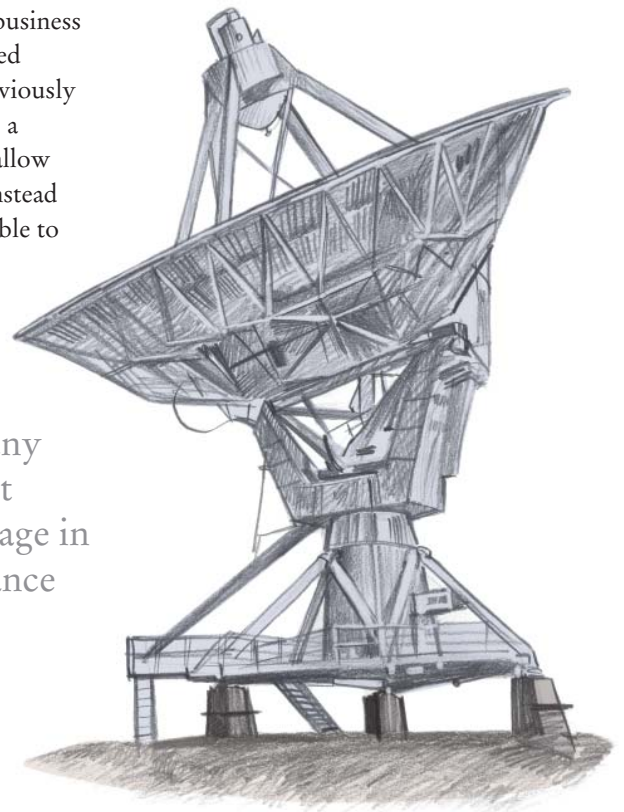
Finally, some U.S. companies have been able to bank excess offset credits that have been earned in the course of satisfying offset obligations. These credits may then be used to satisfy offset requirements in a future sale in that country. In addition, a rudimentary trading market may develop, with a company that has been awarded business in a country purchasing the banked credits that another company previously earned in that country. However, a particular host country may not allow this type of trading and require instead that all offset activity be attributable to new business in the country.

What are the volume and value of offsets?

Most offsets involve developed countries, many of which now have formal offset policies that include specific requirements for offsets, such as:

- the amount of the offset that will be required as a percentage of the sale with which the offset is associated,
- which projects within the host country are eligible for offset credits,
- the value of the offset,
- any multipliers that will be applied,
- periods of performance for completing the offset requirements, and
- penalties for nonperformance.

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In Turkey, for example, a 2007 *Industrial Participation/Offset Directive* explains that direct offsets are preferred; an offset value of 50% of the purchase will be required on any transaction of \$5 million or more; multipliers between 1 and 6 will be available; and the offset performance period will be two years.

Rough comparisons and orders of magnitude are available to illustrate the volume of defense articles and services that have been subject to offset agreements, as drawn from the December 2009 annual report of the Commerce Department's Bureau of Industry and Security. That report is based on a requirement in the Defense Production Act of 1950, as amended, that U.S. companies report annually to the Commerce Department regarding offset agreements in excess of \$5 million associated with sales of defense articles or services, along with offset credits of \$250,000 or more claimed from foreign governments.

In 2008, total U.S. merchandise exports were \$1.29 trillion, of which about \$17 billion (1.3%) pertained to defense articles. That same year, U.S. industry entered into contracts, as opposed to producing exports, for \$6 billion in defense articles and \$3.5 billion in offset agreements, in addition to completing \$3.2 billion in offset transactions. Between 2003 and 2008, 37% of overall defense article sales included offset agreements.

Between 1993 and 2008, 48 U.S. companies reported entering into almost 700 agreements with 45 foreign countries for offsets in connection with sales of U.S. military articles or services. These offset agreements were valued at almost \$68 billion, or 71% of the \$97 billion in foreign sales with which they were associated.

During this time period, U.S. companies entered into an average of 42 offset agreements annually, with a high of 60 in 1997 and a low of 25 in 2005. The number of countries and U.S. companies entering into offset agreements generally increased between 1993 and 2008, as did the value of offsets as a percentage of the associated contract value.

U.S. companies also reported in excess of 9,800 actual transactions with 47 countries in fulfillment of offset agreements between 1993 and 2008. The value of these transactions was almost \$49 billion, earning credits of \$58.3 billion for the U.S. companies as a result of multipliers. Direct offsets represented 41% of the actual value, while 59% of the value resulted from indirect offset transactions.

The average annual number of offset transactions during this period was 617. Both the actual and the credit value of direct and indirect offset transactions increased between 1993 and 2008, and the emphasis appeared to be shifting toward direct offsets — e.g., co-production and technology transfer — as foreign countries sought to strengthen their domestic defense industries.

Purchasing local goods and services, entering into subcontracts with local producers, and sharing technology were the three most frequent forms of offset between 1993 and 2008, in terms of numbers (47%, 23% and 12%, respectively) as well as actual and credit value (37% and 33%; 22% and 21%; and 18% and 18%, respectively). These three categories were also the most often to be subject to the application of multipliers.



What is the impact of offsets on U.S. companies?

Offset agreements obviously reduce the bottom line for U.S. companies in the specific sales with which they are associated. On the other hand, those sales might not have occurred in the first place or on the same terms but for the agreement on offsets. While these “on the one hand, on the other hand” considerations make it difficult to make a clear determination of the long-term impact of offsets on both the U.S. domestic economy and individual companies, the costs and benefits of offset arrangements can be evaluated in a general way.

To begin with, the United States is the world's largest exporter of military equipment and services, and foreign sales lower the Defense Department's unit costs for the equipment. These sales support the maintenance of the U.S. defense industrial base and the health of its many subcontractors and suppliers. These sales also provide employment for the U.S. workforce, contribute favorably to the balance of trade, and result in interoperable military systems between the U.S. and its allies.

Nonetheless, offsets do reduce overall profitability and the employment and other benefits that would otherwise result from these foreign sales. Offsets also increase the amount of foreign content in U.S. weapons systems and create competitors for U.S. companies that are sharing their know-how with foreign firms. In addition, they affect U.S. subcontractors that are not represented in the offset negotiations and may be replaced by foreign co-producers or subcontractors as part of an offset agreement.

These foreign firms not only benefit from the immediate financial and employment benefits of the offset, but are thereafter in a much better position to compete with U.S. companies and subcontractors as a result of the strengthened relationships these firms have established and the enhanced capabilities they have developed. In fact, one provision of federal law bars a U.S. contractor from making incentive payments to induce another U.S. company to purchase goods or services from a foreign country that has an offset agreement with that contractor. This provision is traceable to the domestic impact of an indirect offset: Sen. Russell Feingold of Wisconsin reportedly sponsored the amendment after discovering that a Wisconsin subcontractor had lost a \$50 million award for machinery to a Finnish company as part of an offset arrangement with the Finnish government.

Negotiating and evaluating offset agreements

As a result of the complexity and potential for long-term adverse consequences that may follow from offset obligations, U.S. companies must make an effort to anticipate and plan for the demands that a foreign government may make in connection with a sale of U.S. military equipment or services. Before negotiations begin, a strategy should be developed that will protect the U.S. company's most important resources. Thorough evaluation of proposals and counterproposals should be conducted throughout the course of the negotiations to ensure that the strategy is being carried out and amended appropriately to reflect changes in circumstances. Grant Thornton LLP possesses significant experience and know-how in strategy and planning, business intelligence, and analysis that would be invaluable for such an effort.



Authors

Lou Crenshaw
Defense and Intelligence Principal
Global Public Sector
T 703.837.4430
E Lou.Crenshaw@gt.com

Rick Cinquegrana
Senior Manager
Global Public Sector
T 703.837.4523
E Rick.Cinquegrana@gt.com

Contact information

For additional information on Grant Thornton LLP's Aerospace & Defense practice, contact:

Chip Schweiger
Aerospace & Defense Practice Leader
T 303.813.4077
E Chip.Schweiger@gt.com

Camila P. Wingrove
Aerospace & Defense Marketing Manager
T 312.602.8548
E Camila.Wingrove@gt.com

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