

National Offsets in the Defence Sector

Next Steps for Improving Integrity & Effectiveness in Defence Offset Contracts

Sandeep Verma¹

Presented to the **Public Procurement: Global Revolution VI** Conference
Nottingham, United Kingdom :: June 24-25, 2013

INTRODUCTION

While imposition of offsets and counter-obligations in defence procurement has become fairly widespread², academic research into effectiveness and integrity dimensions of defence offset contracts continues to emphasise a number of important areas for reform³. Most importing countries⁴ imposing offset obligations generally do so with stated objectives of leveraging large procurement volumes for energising their nascent domestic industrial bases; however, offsets can also serve as useful political tools for mollifying domestic constituencies that may be apprehensive about the outflow of public funds that ends up boosting manufacturing and employment in foreign countries from where these acquisitions are made⁵. Simultaneously, offsets may have adverse implications for maintaining integrity and probity in public procurement⁶, and are sometimes seen as convenient mechanisms for both the host government, as well as for foreign suppliers, to circumvent anti-bribery laws and potentially serve as useful channels facilitating cross-border corruption⁷.

¹ © 2013, Sandeep Verma. The author holds an LLM with highest honours, having specialised in Government Procurement Law from the George Washington University Law School, Washington DC. In 2009, he established www.BuyLawsIndia.com, a website dedicated to the advancement of public procurement law research in India. This paper has been prepared for the *Public Procurement: Global Revolution VI* Conference organised by the Public Procurement Research Group (PPRG), University of Nottingham in June 2013. Views contained herein are personal and academic; and do not reflect the official position or policy of the Government of India or any of her departments or agencies.

² *The Defence Industry: Guns and Sugar*, The Economist, May 25, 2013, available online <http://www.economist.com/news/business/21578400-more-governments-are-insisting-weapons-sellers-invest-side-deals-help-them-develop>. See, also, Pyman, M. (2012), *Shy Ethics: Transparency and the Defence Industry*, IHS Janes, June 27, 2012, available online <http://www.ti-defence.org/publications/1313-shy-ethics--transparency-and-the-defence-industry>.

³ See, e.g., Behera, L.K. (2012), *A Critique of India's Defence Offset Guidelines 2012*, IDSA, September 03, 2012, available online http://www.idsa.in/system/files/PB_DefenceOffset2012.pdf; Verma, S. (2012), *A Conceptual Framework for Efficient Design of Counter-Obligations in Government Contracts and Licenses*, 5th IPPC 2012, available online http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2151084, p.1003.

⁴ The term “importing government”, as used in this paper, refers to a procuring government that sources equipment from a foreign supplier, and imposes a counter-obligation on such suppliers in the form of an offset contract. This phrase should not therefore be confused with a country that imports, or a country whose business entities import, an item or a service from the procuring country that imposes an offset obligation on foreign suppliers in the first instance.

⁵ Marshall, S. (2010), *The Modernisation of Bribery: The Arms Trade in the Arab Gulf*, available online http://www.jadaliyya.com/pages/index/413/the-modernization-of-bribery_the-arms-trade-in-the. See, also, Verma, *supra* n.3, p.1003.

⁶ Transparency International-UK (2013), *Building Integrity and Countering Corruption in Defence and Security*, p.62, available online <http://www.ti-defence.org/publications/88-building-integrity-and-reducing-corruption-in-defence-and-security--20-practical-reforms>.

⁷ Marshall, *supra* n.5. See, also, The Economist, *supra* n.2; TI-UK, *ibid*.

The first analytical reports on the subject, and perhaps the most comprehensive ones, were published by Transparency International-UK (“TI-UK”) in 2010⁸ and in 2012⁹; highlighting the following important integrity concerns: (i) lack of adequate scrutiny and monitoring of contracts; (ii) few transparency and public accountability requirements, including lack of audit and limited publication of offset benefits; (iii) possibility of using the offset package as a vehicle to offer benefits to individuals in return for undue influence or access to offset contracts; and (iv) agents, progress or intermediaries offering benefits to officials to secure undue advantages to prime contractors¹⁰. The reports accordingly proposed a number of guidelines on integrity good practices for importing governments, along similar lines to an earlier paper¹¹ published by a TI-UK team in regard to preventing abuse of offset mechanisms by unscrupulous entities, potentially consisting of defence suppliers as well as defence officials¹². Some of the important proposals for reform advanced in these documents are as follows¹³:

- (i) National governments should ensure that defence purchases do not deviate from the basis of strategic security requirements on account of the offset arrangements;
- (ii) Exporting governments¹⁴ should publish annually all offset obligations into which national defence companies have entered;
- (iii) National governments should make companies liable for the actions of partners and third parties in offsets agreements, including local companies, agents, representatives, and consultants involved in the process; and exporting governments should increase enforcement of anti-corruption laws;
- (iv) Importing governments requiring offsets should ensure that performance delivery and transparency are the cornerstones of the offsets policy;
- (v) Procurement directors should ensure that the offsets team is properly constituted with competent and experienced personnel bound by a robust code of conduct, as offsets are a specialised area not suitable for Defence Ministry officials or military officers without experience in the field;
- (vi) Procurement officials should be subject to regulations requiring the disclosure of any potential conflicts of interest, particularly in respect of possible beneficiaries from the offset packages or contracts;
- (vii) Governments and procurement agencies need to establish clear responsibility and accountability for oversight and management of offsets programmes, and should ensure that there is an agreed cycle of performance and value-for-money audits;

⁸ da Cunha, F.V., Pyman, M. and Magahy, B. (2010), *Defence Offsets: Addressing the Risks of Corruption and Raising Transparency*, TI-UK, available online <http://www.ti-defence.org/publications/153-defence-offsets-report/>.

⁹ Fluker, L., Muravska, J. and Pyman, M. (2012), *Due Diligence and Corruption Risk in Defence Industry Offset Programmes*, TI-UK, available online <http://www.ti-defence.org/publications/1019-due-diligence-and-corruption-risk-in-defence-industry-offsets-programmes>.

¹⁰ See, generally, da Cunha *et al*, *supra* n.8, pp.14-19; Fluker *et al*, *ibid*, pp.14-20.

¹¹ Muravska, J., Pyman, M. and da Cunha, F.V. (2010), *Corruption Risks in Defence Offset Contracts*, TI-UK, available online <http://www.ti-defence.org/publications/155-corruption-risks-in-defence-offset-contracts>.

¹² More often than not, it appears that the very structure of offset contracts creates adequate scope for mutually beneficial relationships between unscrupulous actors on both sides of the main procurement contract; see, generally, Marshall, S. (2012), *The New Politics of Patronage: The Arms Trade and Clientelism in the Arab World*, Crown Center for Middle East Studies Working Paper 4, available online <http://www.brandeis.edu/crown/publications/wp/WP4.pdf>.

¹³ Muravska *et al*, *supra* n.11, pp.13-14; Fluker *et al*, *supra* n.9, pp.21-22; da Cunha *et al*, *supra* n.8, pp.31-42.

¹⁴ The phrase “exporting government” refers to the country whose suppliers are awarded a government contract by an “importing government” (defined earlier: *supra* n.4), and therefore, whose suppliers are obligated by an importing government to discharge an offset contract or a counter-obligation.

- (viii) National governments should require due diligence to be carried out to ensure that no member of the Government or official will benefit improperly from any offset contract, and to ensure that all potential conflicts of interest by officials, military officers and Parliamentarians are disclosed;
- (ix) National governments should require that every offset obligation contract is specific about how offset performance will be monitored, with public information about their valuation mechanisms, and should establish incentives and penalties for performance;
- (x) National governments should commit to publishing the offset obligations and publish annually the achievement of progress against those obligations;
- (xi) National authorities dealing with defence procurement should actively consider a dual pricing requirement to facilitate an enhanced monitoring process, involving all bids being submitted with two prices for the defence capability being procured—one with the offsets package and one without—allowing for a real cost-benefit analysis to be made an offsets and increasing visibility over the economics of offsets; and
- (xii) National governments should develop mechanisms to recognise each other’s blacklisting processes, increasing the toll on improper conduct from suppliers.

Despite a number of detailed suggestions for reform, the particular features of offset mechanisms that could lead to integrity violations in the first place have not discussed in sufficient detail in the available academic literature on the subject¹⁵, although some documents, such as the 2010 TI-UK paper, do contain examples on how certain on-going commercial transactions, with no bearing on foreign suppliers’ efforts, could be masked as offset transactions and could used as a vehicle for impropriety¹⁶. With a view to bridging some of these gaps, this short paper picks up cues from previous academic work by various authors, and attempts to highlight various mechanisms through which effectiveness and integrity in defence offset contracts could be significantly impaired. It then makes certain broad policy suggestions for embedding a number of conceptual and contractual requirements in offset rules and regulations of importing countries, so that the possible impairments to integrity and effectiveness in defence offset contracts could be substantially controlled and mitigated, and perhaps avoided completely.

IMPAIRMENT OF INTEGRITY AND EFFECTIVENESS IN OFFSETS

In what may well be the first publicly available audit report on defence offsets¹⁷ undertaken by a supreme audit institution in any country, typical issues that were noticed in audit, *inter alia*, included the following¹⁸:

¹⁵ A dated GAO report, published in 1998, lists a number of ways in which offset obligations are implemented by US contractors worldwide, but for obvious reasons, it does not analyse these transactions either from an effectiveness or an integrity perspective; *see, generally*, GAO (1998), *Defence Trade: US Contractors Employ Diverse Activities to Meet Offset Obligations*, GAO/NSIAD-99-35, *available online* <http://www.fas.org/asmp/resources/govern/NSIAD-99-35.pdf>.

¹⁶ Muravska *et al*, *supra* n.11, pp.6-10; *see, also*, The Economist, *supra* n.2.

¹⁷ Comptroller and Auditor General of India (2012), *Performance Audit Report No. 17 of 2012-13 for the Period ended March 2011: Union Government (Defence Services) Air Force and Navy (Chapter II: Ministry of Defence)*, CAG, *available online*

http://saiindia.gov.in/english/home/Our_Products/Audit_Report/Government_Wise/union_audit/recent_reports/union_compliance/2012_13/Defence/Report_17/Chap_2.pdf. The current situation at the time of writing this paper is therefore different from the one that existed at the time of the 2012 TI-UK Report, when there were no publicly available audits of offset contracts performance or integrity; *see* Fluker *et al*, *supra* n.9, p.10.

¹⁸ CAG, *ibid*, pp.18-25.

- (i) Assigning offset credits without ascertaining value-addition;
- (ii) Inclusion of inadmissible items and transactions towards grant of offset credits;
- (iii) Claiming equipment imports towards discharge of offset obligations;
- (iv) Selection and approval of ineligible offset partners;
- (v) Unauthorised deviations from offset rules; and
- (vi) Non-recovery of contractual penalties and lack of adequate monitoring.

These issues could become important in view of the fact that imposing offset obligations with respect to a main procurement contract typically raises the estimated cost to the public exchequer in the importing country anywhere in the range of 8% to 33%¹⁹. Given that defence contracts are also typically non-competitive²⁰, these additional costs can be easily in-built in a non-transparent manner by defence suppliers on account of the cost of discharging additional offset obligations caused by (potential) disruptions of their existing supply chains²¹. Under these circumstances, it can safely be presumed that if a defence supplier could somehow improperly manage offset credits from the equipment importing country²², without making any extra efforts for fostering the defence industrial base, then these extra sums get placed with a foreign supplier as an *undue* benefit, with significant potential for affecting integrity and efficiency of the contracting process on a continuing basis.

Here, it may be important to keep in mind that while a main procurement contract is generally designed within a rigorous, commonly understood procurement framework, and is generally be awarded following transparent and competitive procedures, the situation with defence offset contracts can be quite the exact opposite²³. Typically, the choice of selecting a domestic offset partner (DOP) could be left entirely to the discretion of a foreign supplier²⁴, and together with the kinds of offset violations stated above, it could become relatively easy for unscrupulous stakeholders to steer high-value offset contract to domestic entities, without any transparency in the selection process²⁵ for the domestic partner. Since, in theory, the choice of a DOP could be made at the sole discretion of a foreign vendor, unscrupulous stakeholders can easily maintain the façade of not having any role in the award decisions of these private contracts²⁶. In this context, the offset mechanism becomes an easy, anti-corruption law-compliant tool²⁷ for steering business opportunities to favoured domestic companies, while adversely affecting integrity and efficiency of the procurement process²⁸.

¹⁹ Fluker *et al*, *supra* n.9, p.9.

²⁰ TI-UK, *supra* n.6, pp.53-57.

²¹ *See, generally*, Marshall, *supra* n.5. US Government (USG) regulations, for instance, advise contracting officers to treat all offset costs as *allowable* contract costs, without full disclosure to foreign governments entering into *Foreign Military Sales* (FMS) arrangements, thereby essentially transferring the burden of offset costs in a non-transparent manner to procuring governments under USG's FMS programmes; *see* Office of Under Secretary of Defence (1999), *Memorandum on Pricing Issues in FMS Contracts*, July 13, 1999, *available online* http://www.acq.osd.mil/dpap/paic/attachments/offsets/OUUSD_A-T_DP_memo_on_Competition7-13-1999.pdf; DPAP, *Offsets of Foreign Military Sales: FMS Offsets and Other Issues Affecting FMS Procurements-Frequently Asked Questions*, *available online* http://www.acq.osd.mil/dpap/cpic/ic/offsets_of_foreign_military_sales.html. *See, also*, DFARS 225.7303-2(a)(3).

²² da Cunha, *supra* n.8, p.13.

²³ Fluker *et al*, *supra* n.9, p.10. *See, also*, Marshall, *supra* n.5.

²⁴ *See, e.g.*, Behera, *supra* n.3.

²⁵ Marshall, *supra* n.5.

²⁶ Marshall, *supra* n.12, p.5.

²⁷ *Ibid.*

²⁸ Muravska *et al*, *supra* n.11, p.7.

A. OFFSET CREDIT SANS ADDITIONALITY AND CAUSALITY

The first set of potential integrity violations in offset contracts relates to impairment of the core principles of *additionality* and *causality*²⁹. The “additionality” principle requires that offset transactions undertaken by a foreign supplier must be *other than* his *normal* transactions that are taking place, or would have taken place, *anyway*³⁰. The “causality” principle, which closely relates to the additionality principle, requires that the offset transactions undertaken by a foreign supplier are *caused by his participation*, or his potential participation, against a main procurement contract awarded by the host country. However, against these core objectives, foreign suppliers can improperly claim offset credit in a variety of ways, without taking any extra steps for indigenisation efforts in the host country. At a conceptual level, such irregular claims allow a foreign supplier to retain the extra costs padded by him for offset performance, while the actual cost of performance would have remained low in comparison, thus allowing *retention* and *distribution* of these undue benefits. Typically, this could happen through one or more of the following mechanisms, although any such list can only be indicative and not exhaustive:

- (i) Obtaining offset credits for indigenisation activities that form part of the scope of the main procurement contract itself, thereby making no additional efforts for indigenisation, while getting a certificate for discharge of offset obligations imposed under the main procurement contract;
- (ii) Obtaining offset credits for activities and transactions that are fully paid for by DOPs, for instance, obtaining offset credits for capital equipment imported into the importing country whose costs have been borne by DOPs either directly under business contracts, or indirectly through mechanisms such as royalties or technical fees;
- (iii) Obtaining offset credits for activities and transactions that are otherwise ineligible for discharge of offsets³¹ or against highly inflated or for purely fictitious transactions, thereby reducing the effective cost of offset implementation while padding higher costs into the main procurement contract;
- (iv) Claiming offset credits for transactions that occurred well before the grant of a main procurement contract, essentially for activities unrelated to and uninfluenced by the award of a main procurement contract that contains the padded costs;
- (v) Obtaining offset credits for transactions between third parties and DOPs that are unrelated to the award and performance of a main procurement contract, thereby allowing existing commercial transactions to be disguised as offset activities undertaken in pursuance of a main procurement contract³²;

²⁹ Balakrishnan, K. (2007), *Evaluating the Effectiveness of Offsets as a Mechanism for Promoting Malaysian Defence Industrial and Technological Development*, University of Canfield PhD Thesis, pp.182-183, available online <https://dspace.lib.cranfield.ac.uk/bitstream/1826/2504/1/final%20thesis07ver7.pdf>; Botha, D. (2003), *Offsetting the Costs of South Africa's Strategic Defence Package*, ISS Paper 75, p.2, available online <http://www.issafrica.org/uploads/paper75.pdf>.

³⁰ For a general discussion on *Additionality* and *Causality* in a counter-obligations framework, see, Balakrishnan, *supra* n.26, pp.182-193; Verma, *supra* n.3, pp.2-3; and Singhal, A. (2011), *Policy Design for Offset Programmes in Public Procurement: A Comparative Analysis of Canada's Industrial and Regional Benefits Policy*, LBSNAA Policy Paper (available on file with author), pp.2-3.

³¹ CAG, *supra* n.17, pp.18-22.

³² Muravska *et al*, *supra* n.11, p.8. See, also, Fluker *et al*, *supra* n.9, p.11; and Verma, S. (2011), *Constructing an Effective Offsets Programme: Drawing Lessons from the South Korean Experience*, LBSNAA Policy Paper published in *The Administrator*, Vol. 52 No. 1, 2012, pp.147-148.

- (vi) Obtaining offset credits based on *gross value* of international transactions, rather than *value-addition* in the importing country³³, thereby defeating the very objective of levying offset obligations in the first place; and
- (vii) Entering into *unbalanced* offset contracts, where offset obligations kick-in much later after supplies and payments to foreign vendors under the corresponding main procurement contracts, leaving little incentive for foreign suppliers to faithfully discharge the contracted offset obligations, and leaving small residual bargaining power with importing governments to leverage any meaningful offset projects at such late stages;
- (viii) Obtaining offset transactions for incomplete transactions, such as obtaining offset credit for capital equipment imports in the absence of exports of any resultant manufactured product, or obtaining offset credit against deliveries when final payments have not been made, where the deliveries could be eventually rejected and returned to the importing country, thus causing no benefits to the domestic industrial base in importing countries.

B. PRIVATE/ MILITARY PROJECTS AS OFFSET TRANSACTIONS

A second set of problems arises when projects that should be independently procured by private entities (or by military wings in importing governments) are disguised, either by oversight or connivance, as eligible offset projects. For instance, infrastructure projects and knowledge assets, whether for military wings, or for private DOPs, can be claimed as offset transactions³⁴, even without linking such asset placements with firm export transactions. Since such assets-based offset projects are selected through non-competitive procedures, they essentially result in private placement of benefits with private entities, while being actually paid for by the public exchequer through the padded costs of offset discharge that are built into the main procurement contract.³⁵

An added problem, especially in the context of using offsets for asset-creation for military wings of the importing government, can arise from insufficient capabilities for valuation of such assets by administrative agencies in such countries³⁶, thus leading for higher claims of offset discharge against actual low-worth transactions. Another peculiar problem with such cases is that since military wings of importing governments are generally not involved in manufacturing and exports, the placement of such infrastructure or knowledge assets with such wings of the government is unlikely lead to any benefits for the domestic industrial base, in terms of the domestic industry getting embedded within global supply chains for defence manufacturing.

C. POTENTIAL FOR THIRD-PARTY ROLE IN OFFSET CONTRACTS

A third set of problems listed in published research relates to the role of middlemen and third parties in negotiating, facilitating and implementing offset transactions³⁷. Upon closer scrutiny, it is easy to see that the reported problem of third-parties/ middlemen in offset transactions could potentially exist under the following situations:

³³ CAG, *supra* n.17, pp.18-19. *See, also*, Behera, *supra* n.3.

³⁴ CAG, *supra* n.17, pp.18-22.

³⁵ *See, generally*, Marshall, *supra* n.12.

³⁶ da Cunha, *supra* n.8, p.16.

³⁷ *Ibid*, p.13.

- (i) Where the offset rules are unclear on important operational matters such as valuation, effective dates of discharge etc., and where genuine queries raised by foreign suppliers at pre- or post-contract stages are not responded to in a timely fashion;
- (ii) Where offset rules are not applied in a uniform manner, and where offset contracts are also shielded from public scrutiny;
- (iii) Where the acquiring ministries and departments are willing to dilute the application of offset rules on a case-to-case basis;
- (iv) Where offset contracts are not strictly monitored and enforced, including non-enforcement of contractual penalties for non-discharge of offset obligations³⁸; and
- (v) Where integrity obligations and penalties for violations that are imposed on contractors and sub-contractors under the main procurement contract are not levied on the various actors involved in offset transactions and/ or claiming offset credits.

Essentially, most of these problems arise when there is a difference between rules as publicly notified and the actual practices followed in practice. Particularly for countries where exemptions are commonly granted, and where these exemptions are not placed in the public domain, wide discrepancies can actually exist between the *officially notified* offset rules that are formally known to genuine foreign suppliers/ DOPs and the *actually approved offset projects* that are known only to a select handful of largely internal stakeholders and to unscrupulous foreign suppliers, including middlemen acting on their behalf.

ANALYSIS AND RECOMMENDATIONS

As stated earlier³⁹, *additionality* and *causality* are the core elements of an effective offsets framework. It stands to reason that no useful purpose is served by imposing counter-obligations if the offset mechanism is used by vendors to only capture existing commercial transactions that would have happened even in the absence of the award of a procurement contract by a public authority⁴⁰. Further, poor offset design may only serve to create potential for integrity abuses in the procurement process if foreign suppliers are able to successfully pad additional costs, without any commensurate additional efforts for indigenisation efforts in the importing country.

It is perhaps a result of such concerns that some countries explicitly recognise that offset offers are to be tested for additionality and causality before a certificate for discharge of offset obligations is issued⁴¹. Hence, to the extent that a procuring country has strong capacities amongst its public procurement officials, a subjective and case-by-case examination of offset projects for additionality and causality can be one policy option for such countries. However, for obvious reasons, adopting a case-by-case approach and exposing offset contracts to what could essentially be *inherently subjective* analysis, could lead to integrity problems in countries with poor professional capacities and/ or poor oversight mechanisms. It may therefore become necessary, particularly in emerging countries, to instead use *alternate proxies* for testing additionality and causality, so that a large part of the problem gets weeded out through the use of such objective proxy markers.

³⁸ Marshall, *supra* n.5. See, also, CAG, *supra* n.17, pp.24-25.

³⁹ See n.29.

⁴⁰ Verma, *supra* n.3, pp.1003-1004.

⁴¹ See, e.g., Industry Canada, *Industrial and Regional Benefits Eligibility Criteria*, available online http://www.ic.gc.ca/eic/site/042.nsf/eng/h_00043.html for application of the “causality test” for weeding out ineligible offset transactions. See, also, Singhal, *supra* n.30, pp.2-3.

As one element of such objective testing, countries could insist for awarding credits against only those offset contracts that are signed between a foreign suppliers and DOPs *pursuant to* the signing of the main procurement contract between the procuring country and the foreign supplier. However, while this can be a *necessary* test by itself, it may not be *sufficient* for the purpose, as depending on business alignments between a foreign supplier and DOPs, they may choose to extinguish their on-going contracts and enter into fresh agreements after the signing of the main procurement contract, only to create the false impression that such new business transactions has been caused by the signing of the main procurement contract.

In view of the potential limitations with the above condition, it may therefore become necessary for countries to require additional testing through other proxy elements to determine whether offset transactions are actually a result of a main procurement contract awarded by a particular country. Some amount of testing could be undertaken by examining the *direct* elements of an offset offer⁴², as more often than not, transactions relating to products or components being integrated in a main procurement contract would generally be *caused* by the award of the main procurement contract⁴³. Again, imposing direct offset obligations may not be a practical possibility for all importing countries, as the imposition of a purely direct offset policy is a complex function not only of a country's will and capacity to leverage their procurement actions to obtain reciprocal benefits, but also its state of industrial advancement in the defence sector⁴⁴.

Another proxy element that can be used for additionality and causality testing is to restrict offset discharge to transactions between foreign suppliers *directly* with DOPs. Treating Tier-I, sub-tier and third-party transactions as eligible for offset discharge carries with it significantly enhanced risks of capturing ongoing and unrelated commercial transactions as offset activities, with obvious implications for the efficiency of the offset policy itself, as well as potential for integrity abuse in offsets⁴⁵. Therefore, Tier-I or third-party transactions, if being considered as eligible for offset discharge by a prime contractor, should necessarily form part of the particular equipment being procured by the importing country. In addition, in such a scenario, the integrity obligations and associated penalties imposed on a prime contractor against the main procurement contract would need to be extended to such Tier-I and third-party actors as well.

Another related policy issue in this context relates to requirements for banking of offset contracts, although such banking mechanisms can have both positive as well as negative implications in terms of offset contract efficiency and integrity. Promoting banking of offset credits, in one sense, can encourage more and more foreign suppliers to undertake commercial transactions with DOPs in the importing country, in the *anticipation* of a procurement contract, thereby potentially galvanising the particular industrial sector of interest⁴⁶. At the same time, allowing offset banking carries with it the risk of formally allowing ongoing commercial transactions to be captured as "officially-approved" offset credits, which are then discharged against the procurement contract subsequently concluded,

⁴² da Cunha, *supra* n.8, p.25. *See, also*, Balakrishnan, K. (2010), *Evaluating the Role of Offsets in Creating a Sustainable Defence Industrial Base: The Case of Malaysia*, The Journal of Defence and Security Vol. 1 No. 1, p.22, *available online*

http://midas.mod.gov.my/index.php?option=com_phocadownload&view=file&id=11&Itemid=171.

⁴³ da Cunha, *supra* n.8, p.33.

⁴⁴ Verma, *supra* n.3, pp.1005-1006.

⁴⁵ *Ibid*, pp.1009. *See, also*, Verma, *supra* n.32, pp.147-148.

⁴⁶ Behera, *supra* n.3, p.5.

thereby potentially having little *additionality*- or *causality*-based relationship with the main procurement contract. Particularly in countries with poor contracting capabilities or poor oversight mechanisms, banking certificates could mask improper, *quid pro quo* transactions sought as advance payments⁴⁷ for facilitating/ favouring vendors as procurement cases progress from issue of RFPs to technical shortlisting to contract award, and sometimes even at later stages such as contract modifications that are usually valued on a *cost-plus basis* and lack the rigorous oversight exercised at the time of contract award.

Certain other policy issues for examination by importing countries can be treatment of transactions covered within the scope of the main procurement contract. For instance, as a rule, countries do not generally allow offset credit for indigenisation activities that are specifically covered under the scope of a main procurement contract⁴⁸, and therefore offset credit is only provided for activities that foreign vendor, at his own *discretion*, decides to get indigenised in the importing country. Additional testing is also possible by such governments to exclude transactions that are either *paid for* by the importing government or by DOPs located within the importing country, and also for transactions that are covered within scope of other arrangements such as *Government-to-Government* agreements.

For mitigating the problem of disguising private or military acquisitions as offset projects, importing governments may consider requiring offset proposals for asset creation or knowledge transfers to military wings to be processed mandatorily as *regular procurement cases*, rather than as offset projects. For capital equipment or technology transfers to private entities, instructions could also be issued along the lines of the certain countries where equipment/ technology imports are permitted subject to the fulfillment of the following general conditions⁴⁹:

- (i) That the equipment is capital equipment and/ or the technology is absolutely necessary for the manufacture of defence products;
- (ii) That the government maintains ownership rights over such equipment/ technology, even if such equipment/ technology is placed in possession of an indigenous manufacturer;
- (iii) That such equipment/technology is made available to the indigenous manufacturer without costs such as lease/ rent/ upfront payment/ royalties/ technical fees etc.; and
- (iv) That such equipment/ technology costs cannot exceed a specified percentage of the total offset offer.

Steps that could be considered by importing governments for limiting/ eliminating the role of middlemen and other third parties in offset contracts could perhaps be along the following lines:

- (i) The offset rules and regulation should be carefully designed, so as to provide meaningful guidance to foreign suppliers and DOPs on all important operational aspects such as rules for determination of value-addition, eligibility of DOPs to participate in defence offset programmes, etc.⁵⁰;

⁴⁷ Marshall, *supra* n.5.

⁴⁸ Verma, *supra* n.3, pp.1006-1007. See, also, DAPA (2012), *Defence Offset Program Guidelines*, ¶14(b)(8), p.11, available online http://www.dapa.go.kr/common/eng/download/2012_Defense_Offset_Program_Guidelines_VI_Cho.pdf.

⁴⁹ DAPA, *supra* n.48, ¶10(e)(4)-(5), pp.8-9.

⁵⁰ Fluker *et al*, *supra* 8, p.21; Muravska *et al*, *supra* n.11, p.13; da Cunha *et al*, *supra* n.8, pp.34-35.

- (ii) In cases such as single source procurements based on strategic considerations, importing governments should consider lowering the effective rate of offset obligations, rather than diluting the essence of principles and rules on eligibility of offset projects and offset transactions;
- (iii) Importing governments should endeavour to place as much of offset contracts in the public domain as possible, after suitable redaction, so as to invite public accountability to the maximum extent possible while preserving their national security requirements⁵¹;
- (iv) All queries from foreign suppliers/ DOPs should be responded to in a timely fashion, and all such responses should be published in the same manner as that provided/ mandated for the publication of offset rules and regulations;
- (v) Proper due diligence should be undertaken while approving offset projects as the time of signing of offset contracts⁵²; and
- (vi) Rules on post-contract monitoring and implementation of penalties for non-performance should be strictly enforced⁵³.

The following table captures in brief the sense of a comprehensive reforms agenda for defence offsets, based on the foregoing analysis.

Table 1

Aspect for Offset Reform	Possible Strategies for Adoption by Importing Governments
Ensuring Effectiveness of Offset Contracts	Mandatory testing for Additionality and Causality elements in claims for offset discharge, either thorough a case-by-case testing, or where such testing may be infeasible or undesirable, through the use of proxy indicators.
	Using a direct-offset approach to the extent possible and warranted by host country leveraging capabilities, requirements and state-of-play of domestic industries.
	Setting cut-off dates mirroring the signing of the main procurement contract as the earlier possible date for eligible offset transactions.
	Excluding Tier-I and third-party exports from DOPs, at least to the extent they do not form part of the main equipment being supplied by the prime contractor.
	Restricting banking of offset transactions to the extent feasible and desirable, given the need for balancing with providing incentives for advance mobilisation of domestic industries.
	Excluding indigenisation efforts that already form part of the scope of activities under the RFP for the main procurement contract.
	Restricting eligibility of military infrastructure or private infrastructure as offset projects.
	Mandatory testing of offset offer elements for restricting offset credits to value-addition in the procuring country.
	Conducting due diligence in order to ensure balanced offset contracts, where the yearly volume of offset obligations generally follows a pattern similar to the value of supplies and payments under the main procurement contract.
Enhancing Transparency and Accountability	Public availability of comprehensive offset rules and regulations, with clear guidance on detailed operational matters.
	Publishing offset contracts, both approved cases and as well as those under implementation, in a publicly available format after suitable redacting as necessary.
	Publishing responses to queries on offset rules and regulations in a timely and public fashion.
	Ensuring due diligence at all stages of offset approval, starting from preliminary approvals to offset offers, as well as grant of interim or final offset credits at the stage of offset implementation.

⁵¹ Fluker *et al, ibid*, p.21; Muravska *et al, ibid*, p.13; da Cunha *et al, ibid*, p.33.

⁵² Fluker *et al, ibid*, p.21; Muravska *et al, ibid*, p.13; da Cunha *et al, ibid*, p.32.

⁵³ Fluker *et al, ibid*, p.21; Muravska *et al, ibid*, p.14; da Cunha *et al, ibid*, p.34.

Aspect for Offset Reform	Possible Strategies for Adoption by Importing Governments
	Ensuring regular audit of offset contracts through entities that do not have any conflict-of-interests, preferably as concurrent audit, and regular publication of such audit reports and timely policy corrections in response.
Limiting/ Eliminating Role of Third-parties and Middlemen in Offsets	Avoiding any case-by-case exemptions from the operation of offset rules and regulations. Consider exempting specific procurement cases from offset obligations or reducing the quantum of offset obligations on a case-to-case basis, rather than diluting fundamental or core requirements that impact additionality and/ or causality.
	Extending integrity obligations and penal provisions for integrity violations imposed on prime/ sub-contractors under the main procurement contract to all actors permitted to claim discharge of offset obligations, either directly or indirectly.
	Ensuring that procurement and offset officials at all stages are fully sensitised to the need for flagging any deviations from settled offset policies, and of the need for obtaining prior policy directions wherever regulatory gaps may exist.
	Ensuring strict monitoring of offset implementation, including timely levy of penalties for non-discharge of offset obligations.
Enhancing Professionalism, Integrity and Effectiveness amongst Procurement and Offset Officials	Adequate training of public officials handling contracting aspects, both for the main procurement contract as well as for the offsets part.
	Designing appropriate retention policies for such officials and imbining in them a sense of offset programme ownership.
	Encouraging proper contracting discipline in terms of conducting due diligence, raising red flags wherever warranted, and obtaining prior policy guidance where necessary.
	Developing appropriate policies and restrictions for government officials entrusted with offset management for taking up post-retirement employment, either directly or indirectly in a contractual/ consulting capacity.

CONCLUSIONS

Designing offset rules and regulations for maximising their effectiveness, without compromising integrity and transparency in the procurement process, is an especially challenging task for importing governments intending to impose such counter-obligations. Before embarking on such a policy option, they may need to examine all important areas of concern, such as contracting capabilities of their own public procurement professionals, as well as their procurement volumes and resultant leveraging capacities, as also the state-of-play in their domestic industries. Having identified the broad contours of their offset policies, they may then need to take a number of precautions while designing or reforming their offset rules and regulations, perhaps along the framework suggested in this paper, so as to ensure that offset contracts are not prone to abuse by unscrupulous stakeholders. As demonstrated by available research on the subject, the possibility of offsets being easily reduced to mere vehicles of cross-border corruption remains rather grave. Adequate regulatory care and oversight would therefore be vital for countries genuinely aspiring to embed their domestic suppliers within global supply chains in defence manufacturing through the use of such offset obligations.