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The new dark side of international trade — Compensating foreign contracts to encourage national development

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Summary
Countertrade and Offset agreements are a growing phenomenon in international trade. It is a way to develop national industries, to encourage scientific development. It consists to force foreign companies to invest in the national economy to be allowed to sign a public procurement. The investment consists of technology transfer, local content, training, job creation... Unknown but decisive on obtaining large contracts, are they the new dark side in international trade? These contracts are signed between a purchasing country and a foreign supplier. As a condition for the sale of goods or services, the foreign firm is required to provide additional economic benefits to the purchasing government's economy. If the foreign company does not accept these requirements, the government will not award the public procurement. Indeed, public money, even if it is used to buy foreign goods or services, must serve an aim of general interest.

What is the true extent of these offset agreements? How are they related to more general trade treaties and to the WTO rules? Don't they pose some legal challenges? Do they really help meeting development objectives? The presentation will offer some insights on a research in progress and share some open questions.

Content
Introduction
I. A plurality of transactions
II. The position of International Law
III. The Nationals regulations
IV. Focuses and examples
Conclusion

Introduction

Offset agreements are a growing phenomenon in international trade. It is a way to develop national industries, to encourage scientist development. It consists to force foreign companies to invest in the national economy to be allowed to sign a public procurement.
According to Transparency International, National agencies in about 130 countries require offsets when a foreign company wins a contract.

In 2012, $ 214 billion in offset have been promised. By 2016, that number will be around $500 billion. In 2014, the top seven offset markets, notably Saudi Arabia, UAE, and India along with several others are expected to generate over 60% of obligations accured. These statistics concern only aviation and the defence sector. Indeed, offsets are applied to government procurement, mainly in the defence sector but now more widely across the energy, transportation, telecommunications and pharmaceutical/healthcare sectors.

A state imposes offset obligations to compensate a loss of activities and encourage national development. Indeed, a government procurement signed with a foreign company is not signed with a local company. The public money quit definitively the National estate. It would not benefit to nationals, individuals or companies. It will never be a part of the Gross Domestic Product (GDP).

In light of this, the Host Country's Government imposes an offset obligation with one objective, the creation of value added in order to compensate this loss.

Thus, offset obligations correspond to an obligation to create value added. This value added could have several forms: transfer of technology, localization (offset direct because directly related to the main contract), training, various constructions etc (offset indirect because not related to the object of the main contract).

The logic behind these contracts is a form of indirect taxation which benefits the development of the buying country: offsets are imposed by the buying country which validates correct performance of the offset contract as regards the expected benefit for the national economy.

I. *A plurality of transactions*

Offset obligations apply only to international government procurement contracts. The specificities of these contracts are as follows:

- The customer or buyer is a **public institution** (public companies, ministries or national, regional and local agencies). This means that purchases are paid from public funds, which have to be managed correctly and in line with public policy objectives (safeguarding jobs, industrial development, and support for SMEs);

- These contracts cover **infrastructure and high technology products**, particularly in the defence, security, aeronautics, energy and transport sectors;
- These are very substantial contracts, usually worth more than **$10 million**; and
- The purchases made by the buying country are **imports**. These purchases therefore affect its balance of payments and the funds used to pay for them leave the country.

Formally the main contract gives rise to offset obligations. That's why, offset obligations could be interpreted has an indirect taxation. However, in practice, during the negotiations of the main contract, the preliminary acceptance of the offset obligations directly influences the signature of the main contract. When the foreign company wants to win a contract with a government body, it has to discuss about the offset obligations with the National offset authority. This could be complicated for the company because there are negotiations with the National Offset authority on the offset obligations and with the government body on the main contract. To bring the negotiations on the main contract to a successful conclusion, an agreement on the offset obligations have to be accepted by the company. On the ground, there is a plurality of transactions.

The first one is the main contract. This contract is a government procurement awarded by government agencies, ministries or state owned companies. It involves infrastructure or high technology assets, goods or services via an international tendering process to a foreign company. During this international tendering process, negotiation of the offset obligations begins for signature of the offset agreement.

The second transaction is the offset contract. It is an agreement between the foreign company and the national offset authority, which is always part of the government. The offset contract sets the value of the offset obligation to be met by the obligor in line with the proportions set in the applicable offset legislation. This value – a percentage of the main contract – corresponds to the amount of local value added to be created. This percentage can sometimes be reached by combining direct and indirect offsets to reach the total value of the obligation.

In application of the offset contract, two other contracts are signed, the direct offset contract and the indirect offset contract.

The direct offset contract is an agreement signed, in execution of the offset agreement, between the main contractor and the local subcontractor, which will benefit from the offset obligations. The object of this agreement is directly related to the main contract (Technology transfer, localization…). Concerning this transaction there is a very important point, the liability of the fulfilment of the direct offset obligations. Contractually it is possible to separate the liability from the management. This will force the foreign company to make the local subcontractor a new competitor. Most of companies refuse to liable for a work they do not manage.

The indirect offset contract is an agreement signed, also in execution of the offset agreement, between the main contractor and the local subcontractor. The object of this contract is not related at all to the main agreement. For example, helping a local company to sell product.

As an international fact, offsets are regulated at the international level and at the national level.

II. ***The international law***

Public international law governs the relationship between states and international entities. It includes these legal fields: treaty law, law of sea, international criminal law, the laws of war or international humanitarian law and international human rights law.

Our focus is on treaty law, treaties that govern public procurements and offset. There are multilateral agreements and free trade agreements.

A. The government public procurement (GPA)

The GPA is a plurilateral agreement within the framework of the WTO, meaning that not all WTO members are parties to the Agreement. This contrasts with the multilateral agreement, where all members are party to the agreement. Each WTO members can choice to join or not the GPA. The GPA consists of 17 parties covering 45 WTO members, counting the European Union and its 28 member states, all of which are covered by the Agreement, as one part. Indeed, the Article 47 of the Treaty on European Union (TEU) explicitly recognizes the legal personality of the European Union (EU). Another 28 WTO members participate in the GPA Committee as observers. Out of these, 10 members are in the process of acceding to the Agreement.

Within two years of the implementation of GPA 1994, the GPA parties initiated the renegotiation of the Agreement according to a built-in provision of the 1994 Agreement.

The revised GPA entered into force on 6 April 2014.

The Article I of the GPA revised concerns definitions regarding the public procurements. Offsets are defined as “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”.

There are two remarks to be made about this. First, and very important, offset are a condition of awarding a public procurement. Secondly, there are development goals. That explains the nature of the offset obligations. It is an obligation to create value added - transfer of technology, training, and localisation - in the country for development goals.

The offset ban is now included in an article IV *general principle* at the point 6: "with regard to covered procurement, a Party, including its procuring entities, shall not seek, take account of, impose or enforce any offset". However the article V *Developing Countries* still allow the developing countries, based on their development needs to adopt or maintain, during a transition period, "an offset, provided that any requirement for, or consideration of, the imposition of the offset is clearly stated in the notice of intended procurement".

The revised GPA has a new view of offset: temporary measures limited to developing countries.

Like most of international commercial agreements, the GPA concerns civil matters only. Indeed according to the Article III — Security and General Exceptions:

"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."

This article is frequently encountered in free trade agreements, especially those signed by developed countries and those that prohibit offset. It excludes defence sector from the scope of the GPA. But above all, it does not forbid offset in defence sector.

This is related to the interpretation of this provision. First, taking any action or not disclosing any information could cover all types of offset transactions. Secondly the verb considers is very important because it refers to a discretionary choice of the State in his legislation.

B. Free Trade Agreements

Under the impetus of the United States and the European Union, international trade is increasingly regulated by free trade agreements.

A large majority of free trade agreements prohibit offsets, with direct consequences for the national economy concerned. The ban applies exclusively to government procurement contracts in the civil sector since the defence market is always exempt from free trade agreements to avoid any undermining of national security, even if 20 to 25% of the defence market is in fact civil (clothing, food, transport, etc.).

The United States has signed 20 free trade agreements. The United States clearly intends to sign as many free trade agreements prohibiting offsets as possible. It is currently negotiating one with the EU. American companies therefore have the fewest offset obligations.

The European Union (EU) has signed some 30 free trade agreements, many with countries which are not major economic partners. Those countries which have signed an FTA with the EU which includes a chapter on government procurement are only seven.

The EU companies have to accept offset obligations, despite these FTAs.

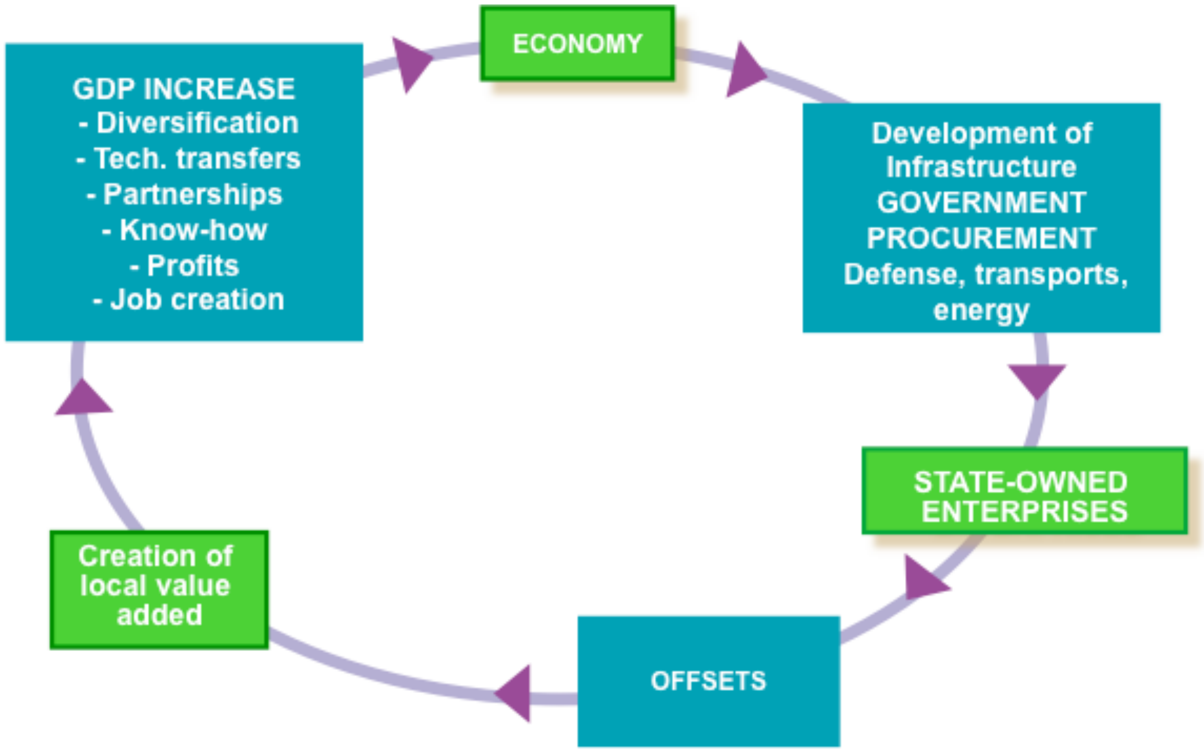
The revised GPA and existing FTAs tend to prohibit offsets. But in a globalized world, this ban is rarely applied as developing countries increasingly seek to use offset to further their economic and industrial development. The impact of free trade agreements on a country's economy can be determined by examining its Gross Domestic Product (GDP). GDP is the principal indicator used to measure economic production within a given country in a given year and quantifies the total value of the wealth produced by resident institutional units in that country (households, companies and public administrations). GDP is particularly helpful for policymakers and can guide them in their work to improve their country's economic development. It is even more useful where government procurement contracts are concerned since public expenditure is a government prerogative.

III. National regulations: the examples of the Kingdom of Saudi Arabia and the United Arab Emirates

Not all countries apply industrial compensation measures and in those that do, the corresponding legislation varies from one country to another. The way to impose offset is very different from one country to another. Indeed government can use all types of regulations (national law, guidelines or requirements) or no regulation at all like in China. In China, offset obligations are imposed on a case-by-case basis.

Economic analysis of law is very useful to understand the ratio legis of offset legislation

Schema: Economic analysis of law & Offset cycle



National offset regulations have the following characteristics in common: the threshold, the value of the offset obligations, the offset eligibility criteria and the penalties.

Theses characteristics will be explained with examples from Saudi Arabia and the United Arab Emirates.

- There is a **threshold** beyond which offsets are obligatory: offsets only apply to large contracts. For instance, in the **UAE**, the threshold is $10m. In **Saudi Arabia**, SR 400m ($107m);

- The **value of the offset obligation** is set: this value is expressed as a percentage of the value of the main contract. For example if the value of the offset obligations is 40 % of a main contract which cost is $100m, the foreign companies will have to create an amount of $40 m of national added value in the host country. In the **UAE**, the value is about 60 percent of purchase contract value;

- Offset **project eligibility criteria** are laid down: these criteria concern the industrial sectors and types of project accepted by the country and set multipliers where appropriate. In the **UAE**, there is a strong focus on Aerospace systems, Munitions Land systems, Naval systems, Autonomous systems, metals and advanced materials Radars, communication, command and control Electronics. There is also a strong preference to Technology transfer in the areas of designing, engineering, system integration, manufacturing, testing and qualifications, programme management, MRO;

- **Penalties** are set: penalties are applied when obligations are not met. In practice, these penalties are expressed as a percentage of the value of the main contract or the part of the obligation which has not been performed. These penalties may or may not discharge the party of all its obligations. An obligor's commitment to honour its obligation is usually represented physically by a **bank guarantee**.

To sum up this point, there are three majors points to build an offset regulation: the threshold, the value the offset obligations and the penalties. Thus, in Saudi Arabia, as soon as a public procurement is awarded for a price above $107 m, the foreign contractor must create a national wealth for an amount of 40% of the price paid for the public procurement.

To be more concrete and to understand how offsets work in a country, after the legislation, there are two main points: the offset authority and the political preference for national development.

IV. Focuses and examples

A. The Kingdom of Saudi Arabia

In Saudi Arabia, Offset obligations may apply to government contracts in the defence or non-defence sectors.

Saudi Arabia has two offset authorities:

The Economic Offset Committee (EOC), established in 1984, facilitates joint ventures. A member of the royal family chairs the committee and its members also consist of representatives of the ministries of Finance, Industry, Planning and Commerce, individuals representing the private sector, and the Managing Director of the Saudi Basic Industries Corporation (SABIC). This committee facilitates joint ventures with foreign partners and signs the offset agreements.

The Economic Offset Secretariat (EOS), established in 1985, carries out the day-today business of the Economic Offset Committee. The EOS's duty is to liaise with Saudi government agencies to streamline license procedures, and to support existing offset obligors in the areas of marketing, manpower and training.

The objectives in Saudi Arabia [1] by utilizing offset are technology transfer, scholarships and training, developing in-country capabilities, creation of high value job opportunities for Saudi Nationals, self-sufficiency and reduction of dependence on foreign sources, expanding existing Saudi joint ventures, R&D and diversifying the economy.

Theses objectives are used to encourage precise sectors:

- Aircraft and Aerospace;
- Communications and Electronics;
- Downstream Petrochemicals;
- Pharmaceuticals;
- Environment;
- Information Technology;
- Engineering/Mechanical;
- Renewable Energy; and
- Spare Parts Manufacturing.

Priority sectors for indirects offset projects – sectors non related to the main contract – include healthcare, training, higher education, engineering skills, capabilities for the pharmaceuticals sector, IT, electronics, communications, spare parts manufacture, desalinisation, renewable energy.

Indeed, multipliers will be applied when offset projects cover these sectors. It is a way used by government to give priority to projects politically important. These projects will be cheaper to fulfil for the foreign company. 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.

Example: A government interested in a specific technology may offer a multiplier of "six" for offset transactions providing access to that technology. A defense company with a 120 percent 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 company could offer only $200,000 (actual value) in technology transfer and earn $1.2 million in credit value, fulfilling its entire offset obligation under the agreement.

In Saudi Arabia, multipliers are in the range of 1 to 4.

[1] NB: The Saudian guidelines are currently being amended.

Projects	Multipliers
Employment of Saudi nationals beyond the Ministry of Labour set requirements	1 to 3
SME's, depending upon the project type and number of Saudis it employs	1 to 3
Training of Saudi manpower	3
In-kind donations	1-2
Cash donations (provided there are no strings attached). Tying R&D to joint use, for example, would be a standard offset and not eligible for a multiplier	4
Research & Development	1-4

The best current example in Saudi Arabia is the Haramain high-speed project.

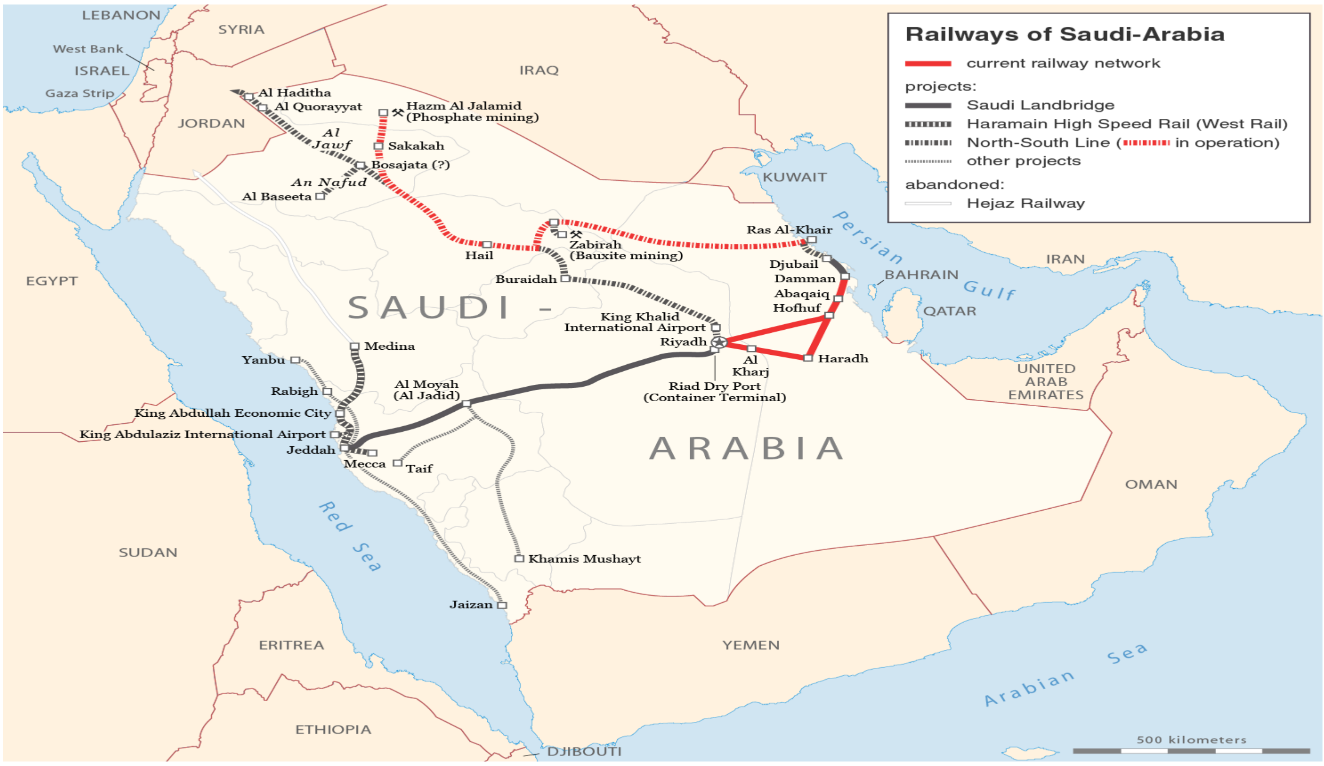
In October 2011, a Spanish consortium wins the Haramain High-Speed Rail contract, a 453.0 kilometres high-speed inter-city rail transport system in Saudi Arabia.

It will link the cities of Medina and Mecca via King Abdullah Economic City, Rabigh, Jeddah, and King Abdulaziz International Airport with latest signaling and communications system.

It is one of the world's most advanced high-speed rail projects with the California high-speed rail, the High-Speed 2 (HS2), the Hefei-Fuzhou high-speed rail line, the Argentine high-speed railway, Florida high-speed railway and the Follo high-speed rail line.

There will be shops, restaurants, mosques, car parking, a helipad and VIP lounges. Stations were designed by Buro Happold and Foster + Partners.

***"Rail transport map of Saudi Arabia"* by Maximilian Dörrbecker**



Thus, Saudi Railway Organization (SRO) Chairman Mohammed Khaled Al-Suwaiket confirmed to Arab News, the acceptance of offset obligations:

- "The Spanish company with the support of *King Abdullah University of Science and Technology* will establish specialized training center in order to train Saudi graduates and help in the development of this promising railway industry in the Kingdom";
- "Haramain High Speed Rail project require some 3,098 employees where over 70 % will be Saudi nationals"; and
- "The Kingdom will soon start the work on its part of this GCC rail link; Saudi Arabia will build 663 km rail link for the GCC."

The GCC rail link will have an estimated total length of 2,177 km.

B. The United Arab Emirates

In the UAE, offset programme focuses on the defence sectors.

The contract award process includes the written acceptance of an offset agreement. Defence contractors must develop an offset fulfilment plan while negotiating the procurement contract with the UAE Armed Forces. It is not possible, in the UAE, for a foreign company to sign defence contract without accepting, before, to develop local industries, by fulfilling offset obligations.

The UAE Offsets Group was established in 1992 and became the Offset Programme Bureau (OPB) in May 2007.

The OPB became the Tawazun Economic Council (TEC) in June 2012 and the official offset Authority.

The Tawazun Economic Program has created several multi-million dollar JVs in various economic and industrial sectors (Source: Tawazun).

The objective is about enabling domestic industries with knowhow, technology transfer, training of Emirati nationals, and investment. Exports of Emirati products are particularly important.

The focus will be about 80 percent on defence and defence-related projects, and 20 percent on high-tech dual use technologies suited to the UAE's requirements.

Civil offset programs are rare and linked to specific needs, such as investment in cancer clinics or an education program for schools.

Tawazun's focus is on:

- Aerospace systems;
- Munitions and Weapon System;
- Land Systems;
- Naval Systems;
- Autonomous system;
- Metals & Advanced Materials;
- Radars, Communication, Command & Control; and
- Electronics.

Always involved in the defense sector, Tawazun created Tawazun dynamics.

On the Tawazun's website, Tawazun dynamics is presented as *" the Middle East region's first facility for the development, manufacture, assembly and integration of precision-guided systems for conventional air munitions." "The Tawazun Dynamics facility is located in the Tawazun Industrial Park where it builds and employs national capacities in its technical operations."*

The best example of Tawazun activities is the missile Al-Tariq, a family of strap-on bomb kit systems, used on MK81, MK82 and MK83 bombs. Al-Tariq provides the user with all-weather, day or night operational capabilities, utilizing GPS/INS guidance.

It is one example of the weapons Tawazun dynamics will offer. Tawazun Dynamics has announced that its Al Tariq system has been successfully integrated into Dassault's Mirage 2000 fighter aircraft.

It is now direct competitor to *Sagem's AASM*, *Boeing's JDAM-ER*, and *Raytheon's AGM-154 JSOW*.

Furthermore, the entire region are concerned by offset. For instance, Qatar has no formal offset policy. An informal policy was developed and is implemented by the Foundation for Education, Sciences and Community Development, at Education City.

However, it applies offset on a case-by-case basis. In 2015, the Emirate bought 24 French-built Rafale fighters. The seller is a French company, Dassault. Dassault did not accept any offset but make the French state, through the President Hollande, accept additional traffic rights to fly three times a week to Nice-Cote d'Azur and Lyon-Saint Exupéry. The beneficiary will be the national company Qatar Airways.

Besides, Kingdom of Saudi Arabia and the United Arab Emirates are part of the Gulf Cooperation Council. It is an economic and political organisation. Above all, it is a subject of International law, which can conclude treaties, free trade agreements.

Thus, the Gulf Cooperation Council Free trade agreement with the **European free trade association** (Iceland, Liechtenstein, Norway and Switzerland). It is one of the First free trade agreements between two political and economic organizations. Offset is prohibited for one party (EFTA) and allowed for the other (GCC).

Conclusion

It is not possible at all, for a foreign company to win large government procurement without accepting offset obligations, in particular in emerging markets. In the same time, offsets are more and more a total part of the fair competitiveness, which is able to replace corruption on the award of international public procurement.

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