Offset in the European Union

Trends, developments and outlook

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Offset in the EU: Background

Offset proliferated in Europe during 2000s:

• 11 EU countries introduced formal offset policies between 2000 and 2011
  \(^1\)
• Threshold levels were typically low and quota demands high – circa 200% in some cases \(^2\)
• Tendency in CEE to leverage growth through non-direct demands – projects ranged from hotels and healthcare to electrical goods plants and passenger car production.

Offset historically opposed by EU:

• Viewed as “[a violation of] basic rules and principles of primary EU law” \(^3\)
• Initially curbed through non-binding code of conduct in 2009 – returns capped at 100% contract value

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\(^1\): Estonia, Greece, Portugal (2006); Czech Republic, Romania (2005), Hungary, Bulgaria, Croatia (2004), Lithuania (2003), Italy (2002) and Slovenia (2000)

\(^2\): Eg, Austria

Offset in the EU: Directive 2009/81/EC

Offset in EU severely restricted by defence procurement directive 2009/81/EC of 2011 – but limited exemptions offered under Article 346 TFEU in particular

Directive makes no mention of offset, counter-trade, or industrial participation:
“Since [offsets] violate basic rules and principles of primary EU law, the Directive cannot allow, tolerate or regulate them.”

<table>
<thead>
<tr>
<th>2009/81/EC Article</th>
<th>Verbatim text</th>
<th>Implications for offset</th>
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<tbody>
<tr>
<td>Article 4</td>
<td>“Contracting authorities/entities shall treat economic operators equally and in a non-discriminatory manner”</td>
<td>Imposing offset on foreign entrants but not domestic companies would be discriminatory</td>
</tr>
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<td>Article 38</td>
<td>“Minimum levels of ability required for a specific contract must be related and proportionate to the subject-matter of the contract.”</td>
<td>Capacity to meet offset obligations – or financial reserves to guarantee penalties – could be viewed as unrelated</td>
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<tr>
<td>Article 47</td>
<td>Awards must be on basis of “… delivery date, security of supply, interoperability and operational characteristics; [or] the lowest price”</td>
<td>Offset can no longer be a determining factor</td>
</tr>
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Offset in the EU: Directive 2009/81/EC

Specific developments:

• Offset policies across Europe put under review – some limited clarity emerged as updated policies returned over following 48 months.

• European Commission provided limited public guidance beyond 2012 communiqués – but acted in background to guide amended policies

Implications for offset:

• Offset demands permitted on security grounds (eg, preservation of supply and essential capabilities) under Article 346 of TFEU – economic justifications no longer permitted.

• Blanket offset demands (eg, based on programme value) are no longer acceptable.
Offset in the EU: Status today

- Directive 2009/81/EC approaching 9th anniversary of entry into force, and 7th anniversary of mandated transposition.

- Vast majority (almost 80%) of EU states apply offset on a formal or case-by-case basis under Article 346.

- Those without an offset programme either insist on juste retour rights (France, Germany) or have negligible defence requirements / industrial assets.

- Mandated sub-contracting prerogative (30% maximum - article 21 of 2009/81/ec) broadly ignored.

- Broad application of Article 346 (TFEU) remains a source of tension between EC / member states.

- EC now pushing back, but lack of jurisprudence remains.

- Common member states approaches to offset emerging.

- Spending decline in years after 9/81 transposition, but renewed growth bringing offset back to the fore.
Offset in the EU

The vast majority EU member states (79%) continue to apply offset on a formal or case-by-case basis under Article 346 procurements.

Offset policies by EU member state

- Codified approach to procurements – A346 or otherwise
- Case-by-case approach – right to apply offset (A346 TFEU) reserved
- No programme, but juste retour rights expressed (9/81 A-13C)
- Alternative approach (eg, UK voluntary programme)
- No offset programme / requirement
- Not covered by study

Source: Jane’s Offset Advisory Module
Offset in Europe: Modus Operandi

Beyond juste retour, two principal game-plans have emerged in years since transposition:

<table>
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<tr>
<th>Codified national security requirements:</th>
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<tr>
<td>• Typically a defence industrial / strategic document is published setting out security objectives in context of national defence industries – attempt to meet EC’s requirement for clear definitions.</td>
</tr>
<tr>
<td>• Document is used to justify offset on national security grounds in the context of Article 346.</td>
</tr>
<tr>
<td>• Examples:</td>
</tr>
<tr>
<td><strong>Denmark:</strong></td>
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<td>National defence industrial strategy and revised national offset guidelines published simultaneously on 1 July 2014.</td>
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<td><strong>Netherlands:</strong></td>
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<td>Priority technology domains outlined in 2013 defence industry strategy.</td>
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<td><strong>Belgium:</strong></td>
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<tr>
<td>Applies offset to meet &quot;Essential Security Interests&quot; outlined in &quot;Belgian Essential Security Interests within the Framework of the Security and Defence Policy&quot;.</td>
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<th>Framed procurements</th>
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<td>• Procurement specifications set to make domestic industrial participation virtually unavoidable:</td>
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<td>• Example:</td>
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<td><strong>Czech Republic:</strong></td>
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<tr>
<td>Mine Resistant Ambush Protected Vehicle requirement of 2015 - Tatra chassis specified for &quot;commonality&quot;</td>
</tr>
</tbody>
</table>
European Commission: Push back against ‘transgressions’

• **Source of friction:**
  
  • EC accepts offset may be applied in context of Article 346 in “exceptional and clearly defined cases”.
  
  • It is the broad application of Article 346 that has proved controversial.

• **Indications that the European Commission (EC) is now starting to take action:**
  
  • Denmark and Netherlands - "Imposed unjustified offset requirements demanding compensation from non-national suppliers when purchasing defence equipment from them"
  
  • Letters of formal notice sent by European Commission 25 January 2018.
  
  • Request to comply likely to follow, and potentially referral to European Court of Justice.
  
  • Outlook uncertain.
  
  • As it stands, there is no jurisprudence relating to directive 2009/81/EC
  
  • Previous round of infringement proceedings between 2012 and 2013 related to transposition - Poland, Luxembourg, Slovenia, Netherlands, Austria, UK.
European Union: Defence spending and offset

- Directive entered into force during the financial crisis, and defence spending was deeply subdued when transposition took place.

- Offset was less of a consideration as addressable spending declined -10% fall 2009 to 2014.

- Spending growth post 2014 reflects changed security environment and renewed economic rigour.

- Addressable spending growth outstripping wider growth as procurement programmes came back on stream.

Source: Jane’s Defence Budgets

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European Union: Defence spending and offset

**EU: Addressable defence spending (procurement / RDT&E)**

- **10% real decline**
- **12% real growth**
- **14% forecast growth**

**European Union defence spending**

- **Elasticity of addressable spending meant disproportionate cuts during decline...**

Source: Jane's Defence Budgets © 2018 IHS Markit
### PESCO and the European Defence Fund

#### European Defence Fund

- Approved 2017.
- Aims for 20% / 80% funding between EU and national governments for defence capability prototyping and acquisition projects.
- Two components – research and capability acquisition.
- Projects within PESCO structure could attract additional EU 'bonus' taking common fund to 40%.
- EUR500m central launch budget 2019/2020 (EUR1+ bn PA post 2020 including research funding of EUR500m)
- First project awarded February 2018 - Generic Open Soldier Systems Reference Architecture (GOSSRA) project won by Rheinmetall.

#### Permanent Structured Co-operation

- Approved 2017
- Permanent Structured Co-operation (PESCO) clause of Lisbon Treaty was long-dormant. Jean-Claude Junker: "Sleeping beauty clause".
- Permits rapid and deeper co-operation in specific areas - an EU integration fast-track.
- 25 EU states (all minus Malta, UK, Denmark) have subscribed to defence PESCO.
- Aimed to identify areas for co-operation - 17 capability projects approved March 2018.
- Projects include medical command, military mobility, maritime surveillance, and cyber security.
PESCO projects

Programmes approved March 2018

1. European Medical Command;
2. European Secure Software defined Radio (ESSOR);
3. Network of Logistic Hubs in Europe and Support to Operations
4. Military Mobility;
5. European Union Training Mission Competence Centre (EU TMCC);
6. European Training Certification Centre for European Armies;
7. Energy Operational Function (EOF);
8. Deployable Military Disaster Relief Capability Package;
9. Maritime (semi-) Autonomous Systems for Mine Countermeasures (MAS MCM);
10. Harbour & Maritime Surveillance and Protection (HARMSPRO);
11. Upgrade of Maritime Surveillance;
12. Cyber Threats and Incident Response Information Sharing Platform;
14. Strategic Command and Control (C2) System for CSDP Missions and Operations;
15. Armoured Infantry Fighting Vehicle / Amphibious Assault Vehicle / Light Armoured Vehicle;
16. Indirect Fire Support (EuroArtillery);
17. EUFOR Crisis Response Operation Core (EUFOR CROC).

Observations

- Emphasis on new military sub-systems - effectively enablers rather than larger capabilities.
- Limited emphasis on hard-kit beyond IFV / indirect fire support.
- Limited ambition at this stage?
PESCO / EDF: Offset implications

• Measures will edge EU in collaborative direction rather than bringing about revolutionary change:

• Funding insufficient.

• Entirely new EU solutions will not always be practicable / cost-effective - external reliance will continue.

• Current ambitions do not point to step-change technological co-operation, although greater ambition beyond 2020 is plausible.

• Collaborative projects fall into juste-retour category and therefore offset in conventional form not applicable.

• Risk of back-door protectionism and therefore (marginally) reduced external reliance - wording of European Defence Fund "Capability Window" proposal specifically excludes non-EU owned / based operators from participation in European Defence Fund backed projects.
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PESCO / EDF: Insufficient funding?

- EUR1.5 billion value (EUR1 billion for development and acquisition and EUR500 million for R&D from 2020).

- Capability window (D&A) element on a basic 20%/80% EU / pMS basis.

- Potential to leverage EUR5.5 billion into collaborative activity.

- This is equal to 12% of 2017 addressable EU expenditure (procurement + RDT&E) of EUR45.8 billion or 11% of forecast 2020 addressable EU expenditure.

- Collaborative European R&T expenditure in 2014 (EDA): 8.6% of the total.
Offset in Europe: Outlook

- **Primary legislation**: Article 346 rights remain the sticking point, and treaty change would be necessary to overcome this.

- **Directive 9/81**: Objectives not achieved - failed to overcome procurement borders or to curtail offset application.

- **New measures?**: Suggestions of 're-visiting' directive or adding auxiliary measures, but this would not overcome the primary legislation challenge – Article 346 to remain a trump card.

- **Growth**: Offset activity in Europe will grow in tandem with procurement spending with absence of a clear brake at present.

- **EDF / PESCO**: Scale and ambition suggest measures will not be transformational in isolation, and reliance on external suppliers with commensurate compensation packages will persist.
Thank you

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