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# Offsets and Defense Procurement in the Czech Republic: A Case Study

Jomana Amara\* and Petr Pargac<sup>1</sup>

## Abstract

This study examines the issues the Czech Republic faces in implementing defense offsets. The paper will briefly outline the history of the Czech Republic's participation in offsets and its current policy towards offset practices. The Czech Republic is a NATO, as well as EU, member and therefore is obliged to follow policies implemented by these institutions. The offsets for the Gripen Program will be used to illustrate the implementation of defense procurement offsets by Czech Republic MoD under its Industrial Participation Program.

**Keywords:** NATO; Czech Republic; Offset; Defense Procurement; Gripen;

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## INTRODUCTION

The term offsets is used in defense sales to mean the compensation given to buyers to offset the economic impact on them from having purchased items made in foreign countries, rather than domestically-produced items. It is designed to reduce the massive expenditure needed for defense procurement, ensure that some of the money paid out by the government (in some cases by the Armed Forces) is offset by an influx of foreign investment, and to justify to a domestic population the purchase of foreign made products.

Offsets have served important foreign policy and national security objectives, such as increasing the industrial capabilities of countries, standardizing military equipment, and modernizing allied forces. Countries require offsets for a variety of reasons with high expectations for benefits resulting from offsets agreements. Nations anticipate that offset agreements will reduce defense acquisition costs; Offsets will initiate positive changes in employment levels, especially in the purchasing country; Offsets will result in a strengthening of the acquiring country's economy by transfers of capital in the form of direct foreign investments, with an emphasis on improving the competitive ability of advanced industrial sectors and services; Offsets result in advanced technologies and know-how transfers. Offsets will help in the development of environmental technologies, human resources, and small and medium-sized businesses.

Offset arrangements may include agreements by the seller to purchase from local suppliers with some connection to the buyer; agreements to invest in production or other facilities in geographical proximity to the buyers; or agreements by the seller to meet certain performance targets (export requirements) or undertake other related activities (countertrade) on behalf of the buyer. One can even point to transactions that might be regarded as "reverse offsets," with the vendor reducing price or providing additional services in exchange for commitments by the buyer that would not normally be part of a "straight" sale. An example would be a commitment by aircraft vendors to reduce prices in exchange for buyer agreements to exclusively purchase their product over some future period.

The US is the biggest offset provider.<sup>2</sup> Some nations, like Germany and the UK are both offset providers and receivers. But most other countries, like the Czech Republic, are the offset receivers.

Countries use different terms to describe their offset programs. In Finland defense offsets are often called *counter purchases* or *industrial participation (IP)*, and in Sweden offsets are referred to as *industrial cooperation (IC)* or *industrial participation (IP)*.<sup>3</sup> The intention is to emphasize the cooperative aspect of offsets and long-term business relations and activities as opposed to short-term transactions. The Czech Republic uses the term “Industrial Cooperation Program”.<sup>4</sup> The Industrial Cooperation Program (ICP) is a tool of economic compensation of expenditures the state incurred in connection with purchase of equipment, material and services, in particular for defense and security purposes, and financed from the state budget of the Czech Republic. The ICP applies to the acquisition of equipment, material, and services from a foreign contractor and whose aggregate value exceeds CZK 500 million, approximately USD 23 million, or where a foreign subcontractor’s contract signed with a domestic prime contractor exceeds the value of CZK 250 million, approximately USD 11.4 million.

The *Value of the Program* is generally understood to be the amount of the contract price, and becomes the so-called *Offset Commitment Value* at the moment the contract has been signed. The Czech Government authorizes an interdepartmental commission to define offset requirements in the course of preparations of tenders for state contracts. The *offset commission* is appointed by the Minister of Industry and Trade (MIT) for the purpose of coordinating activities and steps related to preparations, negotiations, enforcement, evaluation, implementation, and auditing of the program. The commission consists of four representatives of the MIT, two representatives from both the MOD and Ministry of Interior, and one representative each for the Ministry of Foreign Affairs, Ministry of Finance, Ministry of Environment, Ministry of Regional Development, Ministry of Labor and Social Affairs, Ministry of Education, Youth and Sports, Ministry of Agriculture, and Office of the Government of the Czech Republic. However, additional experts from other ministries or institutions, or bidders for public contracts can be invited as well.

The negotiated agreement between the two parties that stipulates that the exporter will complete a certain amount of offset work within a specific time period is called an *offset agreement (OA)*. Such an agreement is the Agreement on Industrial Cooperation Program, through which Gripen International undertook offset programs in the Czech Republic valued at 130 percent of the contract value of CZK 19.650 billion, approximately USD 0.9 billion.<sup>5</sup>

The actual delivery of the offset work by the exporter (e.g., placement of a specific contract) is called an *offset transaction (OT)*. Offset transactions can be classified into four types by functionality: Transfer of technologies and know-how, support of research and development (R&D), direct foreign investment, export promotion, and other projects

The economic benefits to the Czech partner, which result from the implementation of the transaction, are called the *Offset Transaction Value (OTV)*. There are many ways of quantifying the OTV, such as direct foreign investment or revenues generated by the Czech partner as a direct consequence of the OT.

The term *Direct Offset* means offset projects related directly to the subject matter of the public contract, and should account for at least 20 percent of the purchase price in the Czech Republic. For example, exactly 20 percent of the Swedish investment in the Gripen Program was directed immediately into the Czech Defense and Aviation Industry CDAI.<sup>6</sup> All other ICP, those consisting of the involvement of domestic companies in projects related to activities of the bidder, or bidder's subcontractor, are classified as *indirect offsets*.<sup>7</sup>

### **Characteristics of Offsets**

Although offset policies vary among states there are some common characteristics. These characteristics include importing countries usually mandating offset requirements by law as a percentage<sup>8</sup> of the contract value, offset requirements automatically generated for minimum contract value,<sup>9</sup> sometimes as low as USD 5

million, and multipliers <sup>10</sup> frequently attached to offset deals. Practically all defense trade contracts now contain clauses that subject defense exporters to a variety of penalties for non-fulfillment of offset commitments such as exclusion from consideration for future contracts in the Czech Republic. The project must be a new cooperation project with quantifiable and provable economic effects for the purchasing country and the economic results of the implementation of a specific offset transaction may be credited to just one program.

Unfortunately, the missing component is the auditing, feedback, and offset contract monitoring. Not many countries have ever carried out formal and independent offset contract audits to determine to what degree, if any, the offset contracts fulfill expectations.

There are a number of reasons why governments request offset agreements from vendors:

Job creation and export promotion- In economies where government has a major influence on the behavior of certain industrial sectors because of public ownership or regulation, governments are frequently tempted to impose formal/informal offset requirements on procurement from abroad that are linked to politically popular goals like job creation or export promotion.

Promoting defense base - In all countries, defense purchases are undertaken by the government with a major goal; national security. Transactions involving domestic and foreign defense firms and non-defense goods and services with defense applications are scrutinized and shaped by all governments to reflect their perceived national security interests. In today's international system, national security often has an explicit economic component, such as protecting or stimulating the defense-industrial base. However, in many parts of the world, national security is seen as synonymous over time with industrial strength and national technological capability.

Advocating an industrial policy - Governments often intervene to improve the terms of bargaining between national industry and foreign investors. Clear restrictions and a government-run approval process for foreign investment and access to local

markets can be used to reduce or minimize competition among domestic customers in negotiations with foreign sellers, or otherwise increase the bargaining power of the domestic players. The restrictions are designed to improve the terms on which foreign goods and services are purchased.

Public Funding of Research and Development (R&D) - Governments sometimes fund a major portion of the R&D going into defense. While private firms are probably best equipped to secure the deals that capture the maximum return on private investments in new technology, the same may not hold true when it comes to securing the maximum national return on public investments in new technology.

Trade subsidies - Offsets might be regarded as a form of subsidy to exports. There are restrictions<sup>11</sup> on subsidies and pricing behavior in international trade that discipline the use of such subsidies, and governments therefore are interested in offsets as a trade issue in sectors where they may be used to promote exports by national companies. The defense sector is unique in this regard, in that the national defense exception exempts defense goods and services from some of the effects of these disciplines. Indeed, one might even argue that what might be labeled as "dumping" is routine practice in international sales of defense articles.

### **Legal Framework for International Trade in the Czech Republic**

The Czech Republic as a member of various organizations such as the World Trade Organization, European Union, and Organization for Economic Cooperation and Development abides by the rules and regulations of these organizations. The Czech Republic incorporated into its legislation all relevant provisions of the WTO Agreements, including those dealing with protection of domestic industries against increased imports, subsidized imports or dumping.<sup>12</sup>

Import licensing procedures are regulated under Act No. 62/2000 that is fully consistent with the appropriate provisions of the Agreement on Import Licensing

Procedures. The Government has adopted a decree that defines a list of products that can only be imported or exported against a license.

In the areas of investment and competition, the Czech Republic's support for negotiations is motivated by its specific experience as a country that has completely restructured its system of ownership rights and deregulated its former centrally planned economy. Foreign direct investments have played a key role in the process of economic transformation, and their importance for further development of the economy is continuously growing. As such, the Czech Republic is committed to creating a stable contractual framework that will provide a transparent, predictable and legally certain environment for foreign investors and concurrently will not undermine the regulatory powers of governments to pursue their legitimate economic objectives.

## **THE CZECH ENVIRONMENT**

The Czech Republic is commonly considered to be a political and economic success story among the former communist nations. It has a stable macroeconomic environment with low unemployment, low national debt, a stable currency, and large foreign currency reserves. In 1995, the Czech Republic became the first former Warsaw Pact member to join the OECD. In 1999, the Czech Republic became a NATO member and in 2004, joined the EU as well. The Czech Republic's MoD budget in 1993 was CZK 23.777 billion, representing 2.61% of GDP, or 6.7% share of government expenditures. However, in 2006, the MoD's budget was CZK 55.694 billion, representing 1.8% of GDP, and 5.8% share of the State Budget of the Czech Republic.<sup>13</sup> The decrease in the percentage of GDP allocated for defense is significant.

Similar to defense industries throughout the world, the Czech defense industry found that it must diversify and seek dual-use technologies to expand its market potential. The Czech Republic has a long industrial history of producing high quality aircraft and heavy equipment, as well as sophisticated technologies for radars. The Czech Republic's

massive privatization program included restructuring and consolidating firms. The descendants of the former state owned defense sector include two primary consortia, or holding companies: Aero Holding, and Omnipol. Aero Holding manages several independent companies within the aviation sector; however, 99.96% of Aero is state-owned through the Czech Consolidation Agency.<sup>14</sup> The Czech aviation industry is regulated by MIT. Omnipol deals with the purchase of goods for the purpose of further sale; trading brokerage; economic and management consulting; development, manufacturing, repairs, modification, transport, purchase, sale, lease, storage, degradation and destruction of weapons and ammunition; destruction, degradation, purchase and sale of explosives.<sup>15</sup> Companies trading in the defense industry are required to have licenses.

### **Offset Programs in the Czech Republic**

Offset policy has been a part of the procurement programs in the Czech Republic since 1998 when the government issued its first decree that stated conditions for application of offsets requirements.<sup>16</sup> Experience soon demonstrated that the decree needed revision especially since work on the supersonic aircraft procurement contract required a considerable amount of flexibility in reaching the agreement from both the procurement staff and the contractor.

The MIT used its experience to prepare a new decree governing offsets, which was approved by the government in 2005.<sup>17</sup> Following the decree, the MIT issued an order detailing the governmental decree.<sup>18</sup> In short, the implementation of offsets, or ICPs, is regulated by government decree and is binding on all government organizations and bodies performing procurement with state budget funds. The MIT of the Czech Republic is the keeper of the industrial cooperation policy.

To understand the reasons behind adopting the industrial cooperation policy, it is necessary to look at the recent history of the Czech Republic. Not even two decades ago the former Czechoslovakia, of which the Czech Republic was an integral part, belonged to industrially developed countries. During the last fifteen years the Czech Republic

sustained complete political and economical changes. Large heavy industrial companies disappeared and mostly small and medium-sized enterprises took their place. Transformation of the economy also caused a turn away from the traditional markets. That meant also the loss of traditional customers. This situation was particularly significant in the defense industry. The drastic changes in the economy also resulted in a radical change in the wealth of citizens. Different regions were developing unevenly. There are traditionally industrial regions of the Czech Republic where the unemployment rate increased dramatically to 20 percent. Therefore, all Government purchases from foreign suppliers are politically a very sensitive issue.

In the offset decree, the government formulated objectives of the ICP that complement the overall governmental policy of employment, regional development and industrial development. Compensation for the loss of manufacturing opportunities and jobs incurred by the Czech economy, due to the fact that a contract for purchasing of equipment, materials and services for defense and security purposes was awarded by an open public tender to a foreign subject, is therefore considered one of the key objectives of industrial cooperation. All other objectives support other governmental policies, like increase in the competitiveness of the domestic industry together with the export capabilities, transfer of know-how and progressive technologies, stimulation of foreign investments and support of the establishment of joint ventures and long-term relationships.

There are four main principles for offset transactions in the Czech Republic:<sup>19</sup>

- Compensation transactions to direct deliveries exceeding CZK 500 million (+/- EUR 16.6 million), or sub deliveries exceeding CZK 250 million (+/- EUR 8.3 million) of equipment, materials and services for defense and security purposes from abroad
- The compensation to constitute at least 100% of contract value with at least 20% of direct offsets
- Maximum length of the program to be 10 years
- Condition for participation in a public tender

Specific preference for direct offsets is one of the main features of the ICPs. The direct offsets are those transactions, directly related to the subject of the public contract, to which the offset obligation is related. Direct Offset Transactions account for at least 20 percent of the purchase price of the subject matter of the public contract in question, which is charged by the foreign contractor or subcontractor. The requirement for the implementation of an offset program in the framework of a public contract is generally formulated as an indispensable condition for taking part in a public tender or, if just one contractor is addressed, an indispensable condition of the performance of the public contract.

Officially, the Czech Republic does not use offsets as a selection criteria for selecting a winner in the public tender. That means that no specific companies have advantage. Nor are coefficients used to show a preference to the specific type of transactions. Therefore it is safe to say that the Czech Republic does not use offsets to give advantage to some companies over the remaining ones. Methods of measuring the value of transactions will be shown later.

The relationship of the Governmental bodies and the supplier in the process of ICP is introduced in Figure 1. There are several key players in the ICP. At the stage of contract negotiation, the key players are the MoD on one side and the winner of the competition on the other. These two players therefore maintain the legal relationship as long as the offset agreement is in effect; this means they sign the agreement on the ICP. The MoD represents the Czech Republic and has the final word on approval of the final value of particular offset transactions.

Another key relationship is between the contractor and the Czech industry. Professional associations, such as the Defense Industry Association (DIA), can represent the industry. The government neither declares where the offsets should be directed nor selects the Czech partner of the offset transaction. It is a responsibility of the contractor to research capabilities of the Czech industry and to find the suitable partner. Once the contractor and the selected Czech partner come to an agreement, they together develop the offset transaction proposal and the contractor submits the proposal to the MIT. The MIT presents the proposal to the Offset Commission.

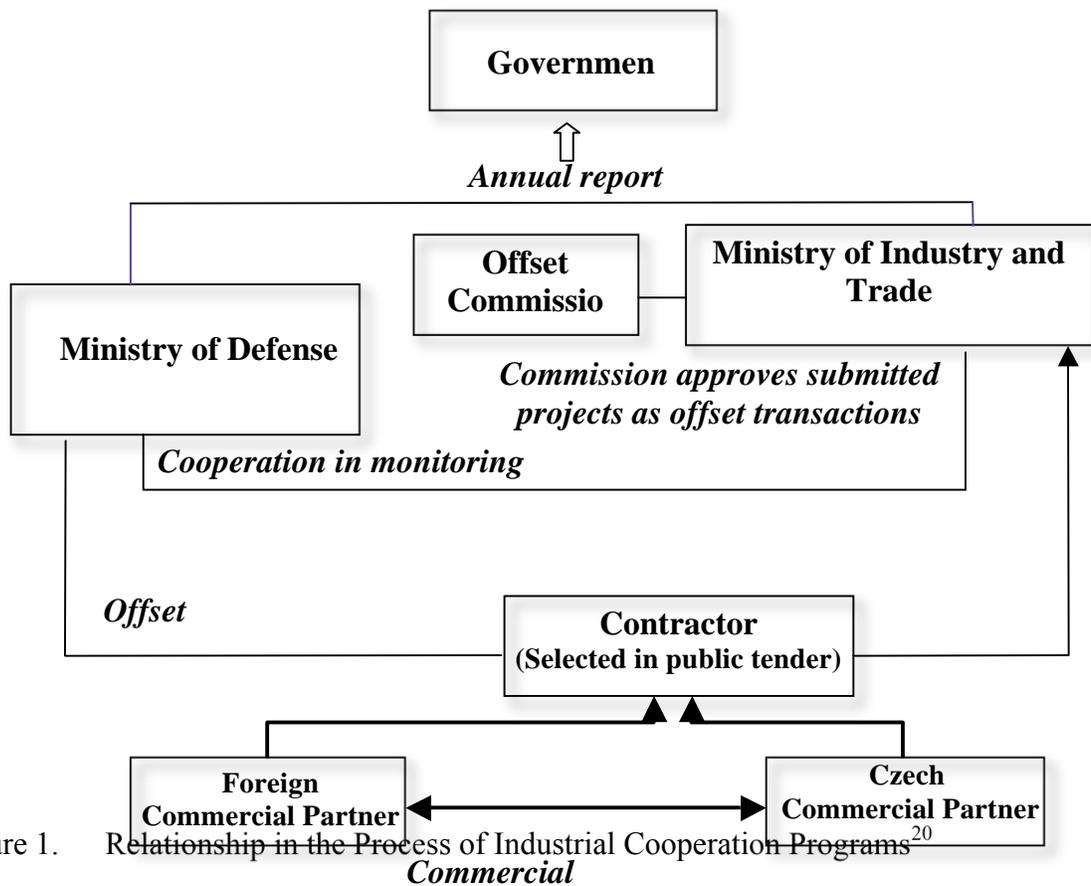


Figure 1. Relationship in the Process of Industrial Cooperation Programs<sup>20</sup>

The Offset Commission is an intergovernmental body, whose members have the authority to approve the submitted transaction. The Commission itself consists of representatives of the MIT, Ministry of Finance, Ministry for Regional Development, Ministry of Foreign Affairs, and Ministries of Defense and Interior as representatives of the state in the offset agreement. The MIT provides the Chairman of the Commission and an administrative support. The administrative support functions include preparing the decision on the presented transaction and keeping a record of each of the ICP. The MIT therefore is the only body that has a total overview on all programs and all transactions. By preparing the Commission's decision, it prevents the contractors from registering the same offset transaction to more than one ICP. The Commission should meet regularly, at least four times a year. During the meeting, The MIT, after the decision is taken, registers the approved transaction to the specific program.

Once the Offset Commission approves the transaction and MIT registers it against the particular program, the contractor, foreign commercial partner and the Czech partner work together on meeting the offset transaction objectives. To be able to prove the actual value of the transaction, the Czech partner has to establish a separate branch in its accounting records. The contractor, once a year, submits the annual report to the MoD. The MoD forwards the report to the MIT and to the Offset Commission for comments. Final decision on the actual value of the offset transaction and the whole ICP, however, is issued by the MoD. The decision is based on the comments of the Offset Committee and on the audit results on the transactions. MoD representatives and/or the private subject with the delegated authority from the MoD reviews the book keeping records of the Czech partner, related to the offset transaction. The contractor therefore is required to forward a list of invoices, and relevant parts of the records of the Czech partner that are related to the transaction, as an attachment of the annual report to the MoD. When the ICP obligations are met, the MoD and the MIT inform the government.

The Czech side does not set up any specific requirement (industrial, branch or regional) for the individual offset programs or transactions. The MoD and the contractor set the legal relationship. The contractor looks for the business opportunities either for himself or for another foreign partner. The foreign partner and the Czech partner establish the commercial relationship. The MIT provides the keeping of the ICP record. The Offset Commission approves the transactions and provides the statement to the Annual report. The MOD approves the actual value of transactions performed over the monitored year, and through that the overall performance of the Industrial Cooperation Program Agreement.

The ICP is a relationship agreed on for a maximum of 10 years. Conditions of the relationship are listed in the Industrial Cooperation Agreement. The MIT directive set out the important issues that should be covered specifically by the agreement. Those are the subject matter of the deal, scope and structure of the program, rules to be used to measure the program value, timetable of the program, method of monitoring the program and rules governing any changes of and amendments to the program, sanctions for non-performance, and provisions concerning proprietary and confidential information.

Specific areas for negotiation are especially those dealing with the performance timetable, connected with the milestones and related penalizations. Also, procedures and required documents for approval of the final value of the transaction and the whole program are agreed upon.

Besides the obvious categories of the offset transactions, which are the direct and indirect offsets, the offset transactions are recognized by their type, as follows:

- Transfer of Technologies and Know-how, Support of R&D
- Direct Foreign Investment
- Export Promotion
- Others

The transfer of technologies are represented by Offset Transactions intensifying the transfer of technologies and know-how for the benefit of the Czech Republic, promoting participation of Czech entities in the international research and development programs, strengthening Czech scientific and research capabilities and last, but not least, improving skills and knowledge of human resources.

Direct investments are represented by direct investment activities of a foreign partner in the Czech Republic.

Export promotion is represented by arranging and mediating new export contracts for domestic entities. It may be, for example, introducing a Czech product, which has not yet been exported, to foreign markets, acquiring new foreign customers for products that have already been exported, or a significant increase in existing export levels.

Others are represented by Offset Transactions that have been discussed and accepted by the Offset Commission and in respect whereof an agreement has been achieved between the party submitting the proposal and the Offset Commission.

## **OVERVIEW OF THE GRIPEN PROGRAM IN THE CZECH REPUBLIC**

The Gripen Program is the largest ICP program for the Czech Republic MoD.

The program underwent the following development steps:

- 1993 - MiG-29 supersonic fighters were decommissioned from the inventory of the Czech Armed Forces.
- 1995 - The Chamber of Deputies of the Czech Republic Parliament resolved that plans to modernize the MiG-21 aircraft were ineffective.
- 1997 - The Government decided in favor of supersonic aircraft acquisition and endorsed the procurement of 72 L-159 subsonic aircraft.
- 1999 - Concept on the Development of the MoD Department, including procurement of supersonic aircraft, was approved by the Government. In the same year, MiG-23 and Su-25 aircraft were decommissioned from the inventory of the Czech Armed Forces.
- 2000 - Public bidding process began in order to select a supersonic aircraft supplier.
- 2001 - Report on bids evaluation was submitted. The Government decided to initiate contractual negotiation with BAE/SAAB. Furthermore, the L-159 aircraft were introduced.
- 2002 - Draft agreement on the procurement of 24 Gripen tactical supersonic aircraft was submitted, and approved by the Government. With that, the Chamber of Deputies of the Parliament of the Czech Republic rejected the draft bill on the aircraft's procurement financing.
- July 9, 2003 - The Government of the Czech Republic Decree No. 686 endorsed the draft provision for completing the Concept on the Development of the Czech Air Force and the Czech Armed Forces in the area of airspace protection by means of a supersonic aircraft. MoD was commissioned to: 1. Send a request for submitting a Feasibility Study to the Governments of the Kingdom of Belgium, French Republic, Canada, the Kingdom of Netherlands, Republic of Turkey, United States of America, Federal Republic of Germany and the Kingdom of Sweden; 2. Assess the Feasibility Studies received, including that of the Government of the United Kingdom of Great

Britain and Northern Ireland, develop a proposal on further procedures and submit these to the government for decision.

- July 25, 2003 - Multilateral working session was held where the tender specifications and further requirements by the MoD were conveyed to the bidders.
- September 11, 2003 - Expert workshop attended by representatives of addressed countries was held at AFB Caslav to specify the terms of the procurement process. The workshop was not attended by UK representatives. The British party, having analyzed the requirements that were submitted to all addressed countries on July 25, 2003, decided not to continue in the process of searching for an interim solution to securing the Czech Republic's airspace. The aim of this meeting was to specify technical, financial and time aspects concerning the bids processing. The workshop participants were apprised of the operational conditions and parameters of the airbase where the aircraft are planned to be operated in future.
- October 20, 2003 - The Government of the Czech Republic Decree No. 1051 determined that the aircraft procurement is a strategic order.
- October 31, 2003 - The three-month period for development of feasibility studies was terminated and the bidders' proposals were submitted. Seven countries presented their bids - Belgium, Canada, France, Germany, The Netherlands, Sweden and the USA. Turkey withdrew on October 15, 2003. Bids Review and Evaluation Commission was appointed based on the Decree No. 1050, dated October 20, 2003. This nine -member joint commission included representatives of the MoD, MFA, MIT, and MF.
- November 30, 2003 - The interdepartmental commission completed the Feasibility Studies assessment, and based on the set criteria established a bids order that was then presented to all government members by the Minister of Defense. The Commission recommended that the bid submitted by the Kingdom of Sweden on the JAS-39 Gripen complex system be accepted as the most favorable. The bid on F-16 MLU aircraft by the Kingdom of Belgium placed second, while bids submitted by Canada, the Netherlands and the USA followed.

- December 17, 2003 - The Government of the Czech Republic decided the Swedish bid was the best one for the Armed Forces of the Czech Republic, and commissioned MoD, MF, MIT, and MFA to negotiate procurement of fourteen aircraft exclusively with the Kingdom of Sweden. The negotiations were initiated.
- May 28, 2004 – The documentation on the prepared supersonic aircraft lease was presented to the Government.
- June 2, 2004 - The Government held deliberations on a draft Memorandum of Understanding, Lease Agreement and Industrial Co-operation Agreement.
- June 9, 2004 - The Government of the Czech Republic based on successful negotiation between the Czech and Swedish parties, decided by the Government Decree No. 596 on the lease of Gripen aircraft, and entrusted the Ministry of Defense with finalizing negotiations with the Swedish party and signing contractual obligations.
- June 14, 2004 – Agreements between the Czech Republic and the Kingdom of Sweden concerning the lease of JAS-39 Gripen aircraft for the needs of the Czech Armed Forces were signed at the Ministry of Defense.
- 2005 - Service life of the MiG-21 supersonic aircraft was over.<sup>21</sup>

### **Primary Facts about the Gripen Program**

The Agreement on the ICP is from June 14, 2004 through December 31, 2014.<sup>22</sup> The offset obligation represents 130% of the Gripen aircraft lease, of which 20% represents the direct offsets. Speaking in absolute figures, the offset obligation is CZK 25.5 billion.<sup>23</sup> The ICP was approved, as was the main delivery contract, by the Czech government.<sup>24</sup> The projected performance over the years in terms of value and percentage of the Industrial Cooperation is introduced in Figure 2.

BAE Systems actually started fulfillment of the program in the year 2002, when the public bidding started for the first time. However, it was stopped and started

again in 2003. After selection of a bidder, it took almost 4 months to develop an industrial cooperation agreement.

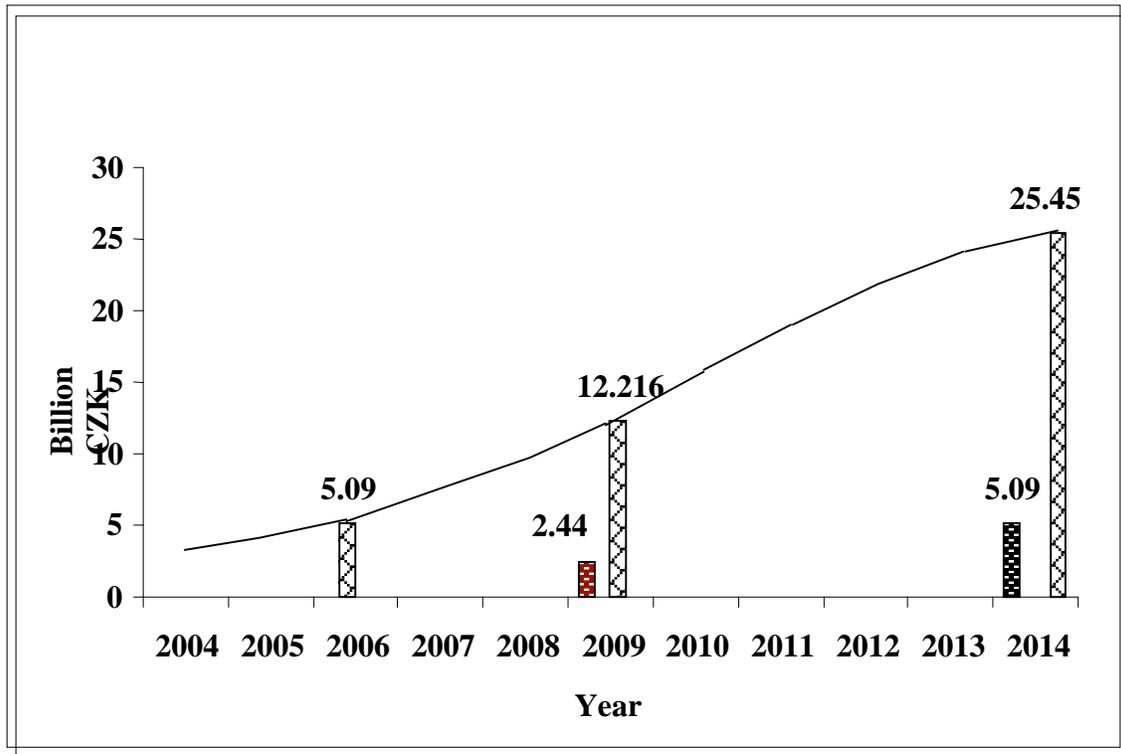


Figure 2. Gripen Program Projected Performance Agreement<sup>25</sup>

BAE Systems agreed to implement the ICP with a total cumulative value CZK 25.5 billion. The performance is carefully estimated with milestones at the years of 2006 and 2009, with the final “milestone” at the end of the program. At the milestones, the performance must reach for the forecast volume.

By the end of the year 2006, the volume of the ICP should reach CZK 5.09 billion. This represents 20% of the total value of the program. By the end of 2009, the overall value of performed transactions shall reach slightly more than CZK 12 billion, with CZK 2.44 billion of that amount in the direct offset area. Those amounts represent 48% and 9.6% respectively. Should the BAE System perform below these agreed values, the penalty will be applied by the MOD. Generally, the penalty will represent a percentage of the difference between the actual performance and the planned value. The penalty bears a feature of the performance bond; it means that once the BAE System reaches the planned performance, the projected curve again, the money would be released back by the MoD. Should BAE Systems fail to reach the specified program performance, the penalty will be used as a part of the final penalization. In the time between the milestones, the performance may drop below the projected curve without problems. The drop will be noted and the performance will be closely observed in the upcoming years.

Actual performance is depicted in Figure 3. As shown, BAE System had an excellent start in the program and instead of the value of CZK 2.79 billion actually generated CZK 4.21 billion. Some of these values were generated by the pre-offset transactions during the two year approval process. In percentage terms, the required generated value was 11 percent. The approved value generated by the end of 2004 was 16.5 percent. Unfortunately, the actual publicly releasable data is for the first year of the Gripen Program only.

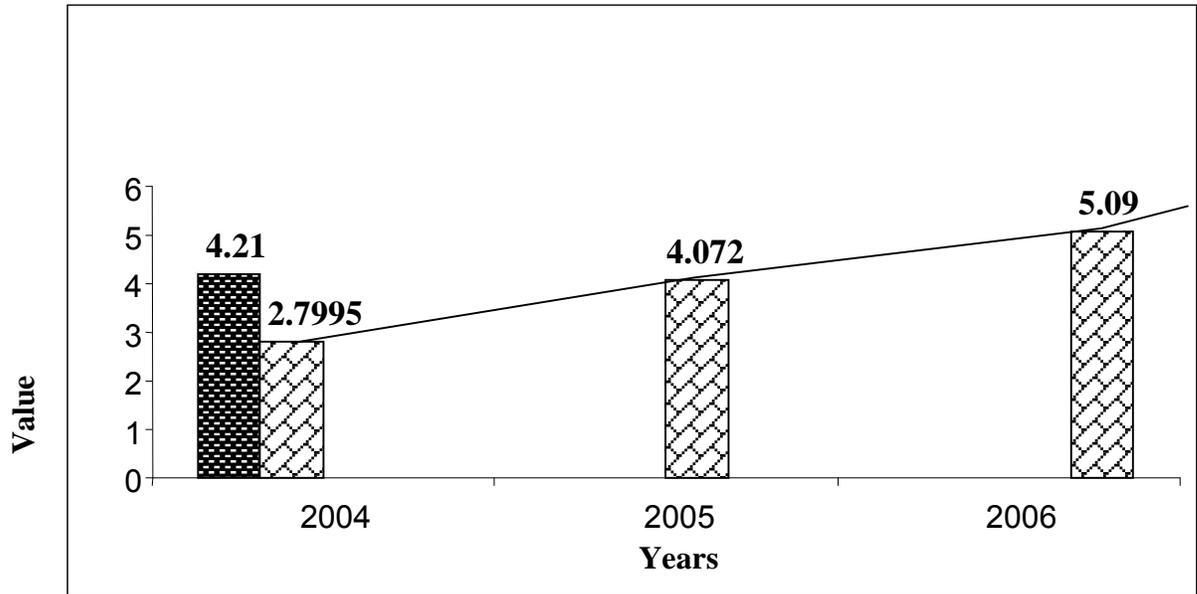


Figure 3. Actual Gripen Program Performance<sup>26</sup>

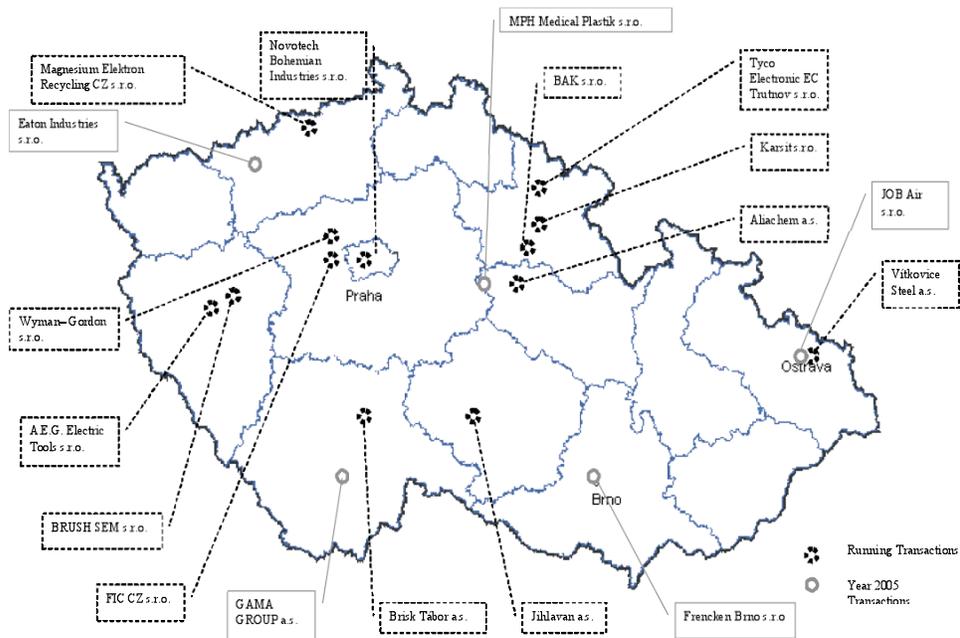


Figure 4. Distribution of Offset Transactions

Figure 4 describes the geographical spread of transactions. The offset delivery team attempted to spread all transactions evenly, so they would not face any future complaints.

### **Transactions Distribution**

The approximate distribution of running transactions for the Gripen Program by the type of industry is as follow:

- Direct Offsets
  - Aerospace CZK 10.3 million
  - Ammunition Components CZK 68.5 million
  - Naval Material CZK 108.5 million
- Indirect Offsets
  - Heavy Industry CZK 1847.5 million
  - Automotive Industry CZK 674.8 million
  - Electronics/Electrical CZK 1504.2 million

The Government agreed to extend the understanding of direct offsets to the transactions placed with the whole defense industry of the Czech Republic for purposes of the Gripen program. The offsets were placed with the traditionally strong areas of the Czech economy, except for the transactions directed to the area of electronics. The government has obviously preferred regions of the Czech Republic, or areas of the industry. The preferred regions are those with higher unemployment rates. The areas of industry are those where the technological progress can be the highest and where the Czech Republic feels her industrial capabilities are lagging.

The Czech Republic understands offsets as generating new economic benefit for the Czech Republic by means of income produced by foreign investments, by means of new export, and contracts of transfer of technology. The government does not use offsets as a means to provide advantage to the selected regions, nor areas of industry. The MoD, as a contractual partner, has final authority to endorse the actually produced value of each offset transaction and the overall performance of the program.

The key to the successful and for both sides beneficial, relationship is the comprehensive agreement on the ICP. The Gripen program is a good proof of the quality of the new government policy and a positive example of the industrial cooperation execution. Although most of these offset transactions will generate a value in the future, the Czech MoD approved the second annual Offset Performance Report, which claims that about two years into the ten year program, the total offset reached CZK 6.6 billion, 26% of the total obligation.<sup>27</sup> Nevertheless, approximately 75 percent of the overall value of the program has yet to be generated and the total value of offset transactions will not be clear until the end of the Gripen offset program in 2015.

## **CONCLUSION**

Offsets represent reciprocal economic advantages that result from economic agreements. Due to increasing competition among suppliers, the reduced global defense market, declining military budgets, and other aspects, buyers are able to influence the conditions under which major defense programs are obtained. Therefore, offsets are used predominantly in a sense of variety of industrial, commercial and political arrangements under which foreign suppliers implement specific actions aimed at partially or fully compensating the buyer's procurement cost. The Czech Republic seeks these compensations for the direct cost of procuring major defense programs. These offset practices, however, do not fit the free trade principles and create barriers to free trade.

Offsets differ with the type of trade. Better economic infrastructure, health service, and social aspects of a particular country are usually seen behind implementation of different offsets. Fulfillment of offset agreement is usually achieved through various

projects realized in the buying country, and very often together with third parties, and often in the form of technological transfer, license, and mutual interest. These projects also offer the possibility of global expansion for small businesses.

The Czech Republic strongly supports offsets implementation as indispensable to conducting business. Offset policy has been implemented into the procurement programs of the Czech Republic since the year 1998, when the Czech Government issued its first decree (Decree No. 421/1998) that stated conditions for application of offset requirements. Gaining experience, especially from work on the supersonic aircraft procurement contract, required a considerable amount of flexibility in reaching the agreement from both the procurement staff and the contractor. The implementation of offsets, or industrial cooperation programs, has never been regulated by a special law in the Czech Republic. It is regulated by government decree and is binding on all government organizations and bodies performing procurement through state budget. The MIT of the Czech Republic is the keeper of the industrial cooperation policy.

There are four main principles for offset transactions in the Czech Republic: a) to apply compensation transactions to direct deliveries exceeding CZK 500 million (+/- EUR 16.6 million), or sub deliveries exceeding CZK 250 million (+/- EUR 8.3 million) of equipment, materials and services for defense and security purposes from abroad; b) the compensation to constitute at least 100% of contract value with at least 20% of the direct offsets; c) maximum length of the program to be 10 years, and; d) condition for participation in a public tender.

Direct Offset Transactions shall account for at least 20 percent of the purchase price of the subject matter of the public contract in question, which is charged by the foreign contractor or subcontractor.

The requirement for the implementation of an offset program in the framework of a public contract is generally formulated as an indispensable condition for taking part in a public tender or, if just one contractor is addressed, an indispensable condition of the performance of the public contract.

There are several key players in the ICP. At the stage of contract negotiation, the key players are the MoD on one side and the winner of the competition on the other. These two players therefore maintain the legal relationship as long as the offset agreement is in effect. The MoD represents the Czech Republic and has the final word in approval of the final value of particular offset transactions.

Another key relationship is between the contractor and the Czech industry. Professional associations, such as the Defense Industry Association (DIA) represent the industry. The government does not declare where the offsets should be directed, nor does it select the Czech partner of the offset transaction. It is a responsibility of the contractor to research capabilities of the Czech industry and to find the suitable partner. Once the contractor with the selected Czech partner comes to the agreement, they together develop the offset transaction proposal and the contractor submits the proposal to the MIT. The MIT presents the proposal to the Offset Commission.

Even though the total value of offset transactions will not be clear until the end of the Gripen offset program in 2015, the Czech MoD has already approved the second annual Offset Performance Report, which claims that after about two years into the ten year program, the total offset reached CZK 6.6 billion, 26% of the total obligation. Nevertheless, about 3/4 of the overall value of the program has yet to be generated. It is relatively easy to monitor formal fulfillment of offset program in terms of contracts signed; however, it is difficult to establish whether these offset transactions are the result of the offset arrangements. It is also difficult to evaluate the contribution of offsets to the achievement of long-term goals within defense and economic development policy due to the multitude of other determinants that can affect these goals.

The duration of the ICP must be also considered when assessing the long-term impact of an offset program. Direct offsets are usually established for the time period of the contract and so are considered to have a relatively short-term economic effect. When the offset program is completed, there is a need to find another work for labor, and other use for machinery, equipment, and capital. Therefore, it is even more difficult to estimate the value of a particular contract. The more an offset activity is fitted to an existing strategy, the better results in the future.

Offsets themselves add complexity to an already complex international trade. The more complex the program, the more space it has for a hidden agenda. Maximum effort has to be made to ensure transparency throughout the whole process of Industrial Cooperation Programs.

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<sup>2</sup> According to the US Bureau Industry and Security – Offsets in Defense Trade [www.bis.doc.gov](http://www.bis.doc.gov) (accessed July 15, 2006).

<sup>3</sup> Elisabeth Sköns, “Evaluating Defense Offsets: The Experience in Finland and Sweden,” chapter 10 in J. Brauer and J.P. Dunne (eds.) Arms Trade and Economic Development: Theory, Policy, and Cases in Arms Trade Offsets (London and New York: Routledge, 2004), 149.

<sup>4</sup> See “Annex 1 of Action Document No. 3/2005” of the Ministry of Trade and Industry.

<sup>5</sup> Ministry of Defense, “Agreements on the Gripen Lease for the Czech Armed Forces,” <http://www.army.cz/scripts/detail.php?id=3567> (accessed July 2, 2006).

<sup>6</sup> Examples of real implementation of Gripen program’s direct offsets:  
Aerospace (Hydraulic cylinder for JAS-39 Gripen, Jihlavan Co., value of CZK 10.3 million)

- Ammunition components (Cellulose Nitrate for BAE Systems, Aliachem Co., value of CZK 68.5 million)
- Naval material (Steel for the Royal Navy ships, Vitkovice Steel Co., value of CZK 108.5 million)

For more information see [www.army.cz](http://www.army.cz) accessed June 24, 2006.

<sup>7</sup> Examples of real implementation of Gripen program’s indirect offsets:

- Heavy industry in total of CZK 1847.5 million (Smithy equipment for Saudi Arabia, PSJ Novotech Co., value of CZK 189.5 million)

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- Automotive industry in total of CZK 674.8 million (Brake discs for export, BAK Co., value of 534,1 million)
  - Electronics/electrical industry in total of CZK 1504.2 million (Electric tools for export, AEG Electric Tools Co., value of 423.1 million)

For more information see [www.army.cz](http://www.army.cz) accessed June 24, 2006.

<sup>8</sup> In the Czech Republic the compensation to constitute at least 100 percent of the contract value (Decree of the Government of the CR No. 9 of January 5, 2005 on Principles on Implementation of ICP).

<sup>9</sup> The Czech Republic sets the limit at CZK 500 million (approximately USD 23 million) for direct deliveries, or CZK 250 million (approximately USD 11.4 million) for sub-deliveries.

<sup>10</sup> “Multipliers are incentives used by purchasing countries to stimulate particular types of offset transactions. Prime contractors receive added credit toward their obligation above the actual value of the transaction when multipliers are used. In a small number of cases, a negative multiplier is used to discourage certain types of offsets. In Europe, 83 percent of transactions (by number) have no multiplier involved for the prime contractor when fulfilling the offset commitment.” This is taken from DISAM Journal June 22, 2005, p. 34.

<sup>11</sup> World Trade Organization, “SCM: Overview of Prohibited Subsidies,” [http://www.wto.org/english/thewto\\_e/whatis\\_e/eol/e/wto04/wto4\\_28.htm](http://www.wto.org/english/thewto_e/whatis_e/eol/e/wto04/wto4_28.htm) (accessed June 18, 2006).

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<sup>12</sup> Act No. 152/1997 Coll., On Protection against the Import of a Dumping Product; Act No. 62/2000 Coll., On Some Measures in the Export or Import of Products and the Licensing Procedures; and Act No. 63/2000 Coll., On Protection against Subsidized Imports.

<sup>13</sup> Ministry of Defense, “Basic Data of the State Budget in Chapter of the Ministry of Defense in 1993-2005,” <http://www.army.cz/scripts/detail.php?id=5760> (accessed July 16, 2006).

<sup>14</sup> Aero Vodochody, “Company Structure,” <http://www.aero.cz/main.php?pageid=21> (accessed August 20, 2006).

<sup>15</sup> Omnipol, “Company Profile,” <http://www.omnipol.cz/index.html> (accessed August 20, 2006).

<sup>16</sup> The Government of the Czech Republic Decree No. 421, June 17, 1998, on Realization of Offset programs.

<sup>17</sup> The Government of the Czech Republic Decree No. 9, January 5, 2005, on Industry Cooperation Programs Realization.

<sup>18</sup> Ministry of Industry and Trade of the Czech Republic Order No. 3, February 2, 2005, on Industry Cooperation Programs Realization.

<sup>19</sup> Ministry of Industry and Trade of the Czech Republic Order No. 3, February 2, 2005, on Industry Cooperation Programs Realization.

<sup>20</sup> LTC Petr Hakl, e-mail message to the author, May 11, 2006.

<sup>21</sup> Peter Fuzak, e-mail message to the author, June 2, 2006.

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<sup>22</sup> On Monday, June 14, 2004, a set of agreements were entered into and signed at the Czech Ministry of Defense by the Czech Republic and the Kingdom of Sweden on the lease of JAS-39 Gripen supersonic fighter aircraft to be operated by the Armed Forces of the Czech Republic, <http://www.army.cz/scripts/detail.php?id=3567> (accessed June 24, 2006).

<sup>23</sup> Petr Hakl, telephone interview with the author, July 31, 2006.

<sup>24</sup> The Government of the Czech Republic Decree No. 596/2004  
[http://wtd.vlada.cz/vyhledavani/vyhledavani\\_usnes.htm](http://wtd.vlada.cz/vyhledavani/vyhledavani_usnes.htm) (accessed July 16, 2006)

<sup>25</sup> LTC Petr Hakl, e-mail message to the author, May 11, 2006.

<sup>26</sup> LTC Petr Hakl, e-mail message to the author, May 19, 2006

<sup>27</sup> Gripen International, “Second Gripen Offset Claim Approved in Czech Republic,”  
<http://www.gripen.hu/pressreleases/060524/secondgripenoffsetclaimapprovedinczechrepublic.4.10948cf10b64c88e22800022.html> (accessed July 20, 2006).