Offsets in Defense Trade

Fourteenth Study

Conducted Pursuant to Section 309 of the Defense Production Act of 1950, as Amended

U.S. Department of Commerce
Bureau of Industry and Security

December 2009

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Executive Summary

This is the fourteenth annual report to Congress on the impact of offsets in defense trade prepared by the U.S. Department of Commerce's Bureau of Industry and Security (BIS) pursuant to Section 309 of the Defense Production Act (DPA) of 1950, as amended.[1] The report analyzes the impact of offsets on the defense preparedness, industrial competitiveness, employment, and trade of the United States.

Offsets in defense trade encompass a range of industrial compensation arrangements required by foreign governments or foreign firms as a condition of the purchase of defense articles and services. This mandatory compensation can take many forms; it can be directly related to the purchased defense system and related services or it can involve activities or goods unrelated to the defense system.

The official U.S. Government policy on offsets in defense trade states that the Government considers offsets to be "economically inefficient and trade distorting," and prohibits any agency of the U.S. Government from encouraging, entering directly into or committing U.S. firms to any offset arrangement in connection with the sale of defense articles or services to foreign governments.[2] U.S. prime contractors generally see offsets as a reality of the marketplace for companies competing for international defense sales. Several U.S. prime contractors have informed BIS that offsets are usually necessary in order to make defense sales – sales which help support the U.S. industrial base.

In order to assess the impact of offsets in defense trade, BIS collects data from U.S. firms involved in defense exports involving offset agreements. These firms report their offset activities to BIS annually.[3] This report covers offset agreements entered into and the offset transactions carried out to fulfill these offset obligations from 1993 through 2008. This report also includes a progress report on the work of the Interagency Working Group on Offsets, which is chartered to consult with foreign nations on limiting the adverse effects of offsets in defense procurement.

Offset Activities

Offset activities examined in this report involve two distinct business arrangements: offset agreements entered into between U.S. firms and foreign governments or foreign firms in

[1] Codified at 50 U.S.C. app. § 2099 (2000).
[2] Defense Production Act Amendments of 1992 (Pub. L. 102-558, Title I, Part C, §123).
[3] Pursuant to 15 CFR Part 701.

connection with contracts for the sale of U.S.-origin defense items, and offset transactions concluded to satisfy these offset agreements.

Offset Agreements

In 2008, U.S. defense contractors reported entering into 52 new offset agreements with 17 countries valued at $3.48 billion. The value of these agreements equaled 57.1 percent of the $6.10 billion in reported contracts for sales of defense items to foreign entities.

During 1993-2008, U.S. firms reported entering into 677 offset agreements with 45 countries valued at $68.93 billion. The value of these agreements equaled 70.96 percent of the $97.13 billion in foreign sales of defense items reported during the period.[4]

Offset Transactions

In 2008, U.S. firms reported 628 offset transactions with 30 countries with an actual value of $3.23 billion, and an offset credit value of $4.71 billion. Also in 2008, direct offsets accounted for 48.08 percent of the actual value of offset transactions reported. Indirect offsets accounted for 51.90 percent of the actual value of offset transactions.[5]

During 1993-2008, U.S. defense firms reported 9,877 offset transactions with 47 countries with an actual value of $48.96 billion and offset credit value of $58.32 billion. Direct offsets accounted for 40.99 percent of the actual value of the offset transactions during this period, with indirect offsets accounting for 58.46 percent.

Impact of Offsets on the U.S. Industrial Base

The sale of defense items to foreign entities is an important component of U.S. defense contractors' revenues and an important factor of U.S. foreign policy and economic interests. Exports of major defense systems help lower overhead costs for the Department of Defense (DOD) and help maintain production facilities and workforce expertise for current and future U.S. defense requirements. Exports also create business for many U.S. subcontractors and

[4] According to anecdotal information from U.S. defense firms, the value of the actual fulfillment of the offset agreement may be more or less than the offset percentage stated in the contract as a result of applied multipliers and banked credits (credits provided by the foreign government for work previously performed in-country by U.S. defense firms).

[5] The total does not equal 100 percent because a small number of reported offset transactions are not specified as direct or indirect.

lower-tier suppliers, promote interoperability of defense systems between the United States and friends and allies, and contribute positively to U.S. international trade account balances.

However, when an offset agreement requires a high proportion of subcontracting, co-production, licensed production or purchase transactions, it negates some of the economic and industrial base benefits accrued through the defense export sale. U.S. defense subcontractors and supplier businesses, and in some cases portions of the prime contractor's business, can be displaced by the fulfillment of offset transactions.

1 Background

In 1984, the U.S. Congress enacted amendments to the Defense Production Act (DPA) including the addition of Section 309 addressing offsets in defense trade.[6] Section 309 requires the President to submit an annual report on the impact of offsets on the U.S. defense industrial base to the then-Committee on Banking, Finance, and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.[7]

The Office of Management and Budget was the first agency appointed the interagency coordinator for preparing the Section 309 report for Congress. However, Section 309 of the DPA was amended in 1992, and the Secretary of Commerce was directed to function as the President's Executive Agent for carrying out the Section 309 responsibilities.[8] See Annex D for the text of Section 309.

Section 309 authorizes the Secretary of Commerce to develop and administer the regulations necessary to collect offset data from U.S. firms. The Secretary of Commerce has delegated this authority to the Bureau of Industry and Security (BIS). BIS published its offset regulation in 1994.[9] In 2008, BIS initiated a rulemaking to update this regulation (RIN 0694-AE40) and published a proposed rule in the *Federal Register* on April 29, 2009.[10] BIS published the final version of the rule on December 23, 2009.[11] The amendments to the regulation clarify the information BIS is seeking to receive from industry and will require more precise information on the industry sectors in which offset activity occurs.

This is the fourteenth report to Congress on offsets in defense trade that BIS has prepared. This report reviews offset data for the 16-year period from 1993-2008.[12] BIS has structured this report similarly to the report published in December 2008; the chapters correspond with the sequence of events for defense sales involving offsets. In preparing this report, BIS has incorporated data from other U.S. Government sources, including the Department of Defense (DOD), the Census Bureau (Census) and the Bureau of Economic Analysis (BEA).

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[6] See Pub. L. 98-265, April 17, 1984, 98 Stat. 149.

[7] Section 309 of the DPA was amended in 2001 to reflect the change in the name of the House committee to the "Committee on Financial Services of the House of Representatives." See 50 U.S.C. app. § 2099(a)(1).

[8] See Pub. L. 102-558, Oct. 28, 1992, 106 Stat. 4198; see also Part IV of Exec. Order No. 12919, 59 Fed. Reg. 29525 (June 3, 1994).

[9] See 59 Fed. Reg. 61796, Dec. 2, 1994, codified at 15 C.F.R. § 701.

[10] See 74 Fed. Reg. 19466, April 29, 2009.

[11] See 74 Fed. Reg. 68136, December 23, 2009.

[12] The initial offsets report, issued in 1996, covered the time period from 1993 to 1994; each subsequent offset report added an additional year to the reporting period, with the exception of the eighth report, which added two years.

In preparation for this report, BIS published a notice in the *Federal Register* on February 25, 2009 reminding the public that U.S. firms are required to report annually on:

- contracts for the sale of defense articles or defense services to foreign governments or foreign firms that are subject to offset agreements exceeding $5,000,000 in value; and
- offset transactions completed in performance of existing offset commitments for which offset credit of $250,000 or more has been claimed from the foreign representative.[13]

The data elements collected each year from industry are listed in Section 701.4 of the BIS's offset regulation and were referenced in the February 25 notice.

In response to the February 25 notice, twenty-two firms reported offset agreement and transaction data to BIS for calendar year 2008. BIS analyzes the data submitted by the reporting firms, as well as data collected from industry on offset activity from 1993 – 2007 (which BIS maintains in a database) in preparing this report.

BIS prepared this report in consultation with and clearance from the Departments of Defense, State and Labor, and the Office of the United States Trade Representative. Collectively these agencies are members of the interagency working group chartered to consult with foreign nations on limiting the adverse effects of offsets in defense procurement.[14] As such, the agencies developed and cleared their annual progress report found in Annex F, which is specific to their interagency activities. This is the sixth annual progress report submitted to date; the third report is considered to be a comprehensive report, while the others were annual progress reports.

[13] See 74 Fed. Reg. 8502, February 25, 2009.
[14] See Pub. L. 108-195, Dec. 19, 2003, 117 Stat. 2892.

2 Defense Export Sales with Offset Agreements

In 2008, 14 U.S. defense contractors reported entering into 52 contracts for the sale of defense items and services valued at $6.10 billion with 17 countries that had related offset agreements.[15] In 2007, ten U.S. firms reported entering into 43 contracts for the sale of defense items valued at $6.74 billion with 18 countries that had related offset agreements.

During 1993-2008, 48 U.S. firms reported entering into 677 defense export sales contracts worth $97.13 billion with 45 countries. See Table 2-1.

Table 2-1: Summary of Defense Export Sale Contract Values with Related Offset Agreements, 1993-2008

Year	Contract Value ($ millions)	Companies (Number)	Agreements (Number)	Countries (Number)
1993	$13,935.00	17	28	16
1994	$4,792.42	18	49	20
1995	$7,529.92	20	47	18
1996	$3,119.67	16	53	19
1997	$5,925.47	15	60	20
1998	$3,029.20	12	41	17
1999	$5,656.62	10	45	11
2000	$6,576.21	10	43	16
2001	$7,017.30	11	34	13
2002	$7,406.23	12	41	17
2003	$7,293.05	11	32	13
2004	$4,927.51	14	40	18
2005	$2,259.87	8	25	18
2006	$4,832.45	12	44	20
2007	$6,735.74	10	43	18
2008	$6,096.15	14	52	17
Total	**$97,132.82**	**48**	**677**	**45**
Average	**$6,070.80**	**13.1**	**42.3**	**16.9**

Source: BIS Offset Database
Note: Due to rounding, totals may not add up exactly.

[15] Pursuant to 15 CFR 701.3(a) and 701.4(b), U.S. firms are required to report annually to BIS on contracts for the sale of defense-related items or defense-related services to foreign governments or foreign firms that are subject to offset agreements exceeding $5,000,000 in value.

3 Offset Agreements

In 2008, 14 U.S. defense contractors reported entering into a total of 52 new offset agreements with 17 countries valued at $3.48 billion. The value of these agreements equaled 57.10 percent of the $6.10 billion in related contracts for the sale of defense items to foreign entities. In 2007, ten U.S. defense contractors had reported entering into 43 new offset agreements with 18 countries valued at $5.44 billion (accounting for 80.73 percent of the value of the related defense sales contracts).

During 1993-2008, a total of 48 U.S. firms reported entering into 677 offset agreements with 45 different countries related to defense export sales totaling $97.13 billion. These offset agreements were valued at $68.93 billion and averaged 70.96 percent of the related defense contracts value (see Table 3-1). U.S. firms entered into an average of 42 agreements annually during the 16-year period, with a high of 60 reported agreements in 1997 and a low of 25 in 2005. Both the number of countries demanding offsets and the number of companies entering into offset agreements have increased during the time period. In addition, the value of offset agreements as a percentage of contract values has increased during the 16-year period. However, in 2008 the value of the offset agreements as a percentage of the related defense contracts represented a sharp decline from the percentage in 2007 and was the lowest percentage since 1994. BIS views this as a positive development as the value of new offsets demanded in 2008 fell, but notes that it is too early to determine if this is the start of a new trend or a one-year anomaly in the data.

Table 3-1 : Summary of Offset Agreements, 1993-2008						
Year	**Contract Value ($ millions)**	**Offset Agreement Value ($ millions)**	**% Offset**	**Companies (Number)**	**Agreements (Number)**	**Countries (Number)**
1993	$13,935.00	$4,784.43	34.33%	17	28	16
1994	$4,792.42	$2,048.72	42.75%	18	49	20
1995	$7,529.92	$6,102.58	81.04%	20	47	18
1996	$3,119.67	$2,431.62	77.94%	16	53	19
1997	$5,925.47	$3,825.53	64.56%	15	60	20
1998	$3,029.20	$1,768.15	58.37%	12	41	17
1999	$5,656.62	$3,456.89	61.11%	10	45	11
2000	$6,576.21	$5,704.81	86.75%	10	43	16
2001	$7,017.30	$5,460.85	77.82%	11	34	13
2002	$7,406.23	$6,094.81	82.29%	12	41	17
2003	$7,293.05	$9,110.44	124.92%	11	32	13
2004	$4,927.51	$4,329.69	87.87%	14	40	18
2005	$2,259.87	$1,464.13	64.79%	8	25	18
2006	$4,832.45	$3,425.35	70.88%	12	44	20
2007	$6,735.74	$5,437.57	80.73%	10	43	18
2008	$6,096.15	$3,480.63	57.10%	14	52	17
Total	**$97,132.82**	**$68,926.22**		**48**	**677**	**45**
Average	**$6,070.80**	**$4,307.89**	**70.96%**	**13.1**	**42.3**	**16.9**

Source: BIS Offset Database

Note: Due to rounding, totals may not add up exactly.

4 Offset Transactions

In 2008, 21 U.S. firms reported concluding 628 offset transactions with 30 countries.[16] The offset transactions reported by U.S. firms had an actual value of $3.23 billion in 2008. In 2007, 18 U.S. firms reported 589 offset transactions with 28 countries with an actual value of $3.76 billion. During 1993-2008, a total of 55 U.S. firms reported 9,877 offset transactions with 47 countries. On average, a total of 617 offset transactions per year were completed during the 16 year period. The actual value of the offset transactions from 1993-2008 was $48.96 billion (see Table 4-1).

Table 4-1: Summary of Offset Transactions, 1993-2008

Year	Actual Offset Transaction Value ($ millions)	Companies (Number)	Transactions (Number)	Countries (Number)
1993	$1,897.88	22	444	27
1994	$1,934.86	21	566	26
1995	$2,890.49	21	711	26
1996	$2,875.82	22	634	26
1997	$2,720.58	19	578	26
1998	$2,312.17	20	582	29
1999	$2,059.73	13	513	25
2000	$2,208.18	16	627	24
2001	$2,555.80	15	617	25
2002	$2,616.04	17	729	26
2003	$3,565.50	16	689	31
2004	$4,933.07	15	706	33
2005	$4,709.56	12	611	30
2006	$4,687.96	15	653	28
2007	$3,764.81	18	589	28
2008	$3,228.59	21	628	30
Total	**$48,961.05**	**55**	**9,877**	**47**

Source: BIS Offset Database
Note: Due to rounding, totals may not add up exactly.

[16] Pursuant to 15 CFR Part 701.3(b) and Part 701.4(b), U.S. firms are required to report annually on offset transactions completed in performance of existing offset agreements for which offset credit of $250,000 or more has been claimed from the foreign representative. Pursuant to 15 CFR Part 701.4(a), to avoid double counting, prime contractors report offset transactions to BIS for which they are directly responsible for reporting to the foreign customer (i.e., prime contractors report for their subcontractors).

In 2008, U.S. industry reported that 74 offset transactions (11.78 percent of all transactions completed during the 12 month period) had a multiplier applied, compared to 88 transactions (14.94 percent) in 2007. The offset credit value of reported offset transactions was $4.71 billion in 2008. In 2007, industry reported offset transactions with a credit value of $4.70 billion. The total credit value of reported offset transactions for 1993-2008 was $58.32 billion. Overall, the actual and credit values of reported direct offset transactions and indirect offset transactions have increased at similar rates during the time period.

In 2008, direct offsets accounted for 48.08 percent of the actual value of reported offset transactions. Indirect offsets accounted for 51.90 percent of the actual value of reported offset transactions.[17] In 2007, direct offsets had accounted for 49.93 percent of the actual value of reported offset transactions, with indirect offsets accounting for 49.84 percent. During 1993-2008, direct offsets accounted for 40.99 percent of the actual value of the reported offset transactions, with indirect offsets accounting for 58.46 percent.

In 2007 and 2008, the distribution of transactions between direct and indirect offsets shows the potential of a new trend toward a higher level of value placed on direct offsets. In each of the past two years, the value of direct and indirect offsets have accounted for roughly half of the value of all offset transactions. However, during the16-year period, the value of direct offsets has equaled, on average, 40 percent of the value of offset transactions and the value of indirect offsets has accounted for 60 percent of the total value of offset transactions.

The data does not point to any specific reason for this new trend, but the consideration of credit values is one possible explanation. In both 2007 and 2008, the credit value of direct offsets was higher than that for indirect offsets, even though the actual value was approximately equal. The higher credit value for direct offsets implies that a greater number of positive multipliers, or a higher multiplier, is being applied to direct offset transactions than indirect offset transactions. By applying a great number of multipliers or a higher multiplier to direct offset transactions, the offset demanding countries are providing incentives to U.S. defense firms to provide more of these types of offsets, thereby increasing the occurrence of direct offsets.

Based on anecdotal evidence and discussions with U.S. defense firms, one possible explanation for this recent trend is that the offset demanding countries increasingly view direct offsets as a more efficient means to bolster their domestic defense industrial base capabilities. Direct offsets allow foreign firms to produce parts, components and sub-systems for the U.S. defense articles

[17] The total does not equal 100 percent because a small number of reported offset transactions are not specified as direct or indirect.

being sold by U.S. defense firms. These types of offsets are more likely to provide the kind of goods, technology and expertise that they can use in the future to enhance the productive capabilities of their own defense industrial base. BIS will continue to monitor this trend in future reports.

Table 4-2 presents reported offset transaction data by value and type (direct, indirect, or unspecified) for each year from 1993 to 2008. Table 4-2 also shows the total actual and credit values of the reported offset transactions for each year.

Table 4-2 Offset Transactions by Type, 1993-2008							
Year	**Total**	**Direct**	**Indirect**	**Unspecified**	**Direct**	**Indirect**	**Unspecified**
	Actual Value ($ millions)				**% Distribution**		
1993	$1,897.88	$636.65	$1,197.37	$63.85	33.55%	63.09%	3.36%
1994	$1,934.86	$628.17	$1,202.38	$104.32	32.47%	62.14%	5.39%
1995	$2,890.49	$1,108.76	$1,756.84	$24.89	38.36%	60.78%	0.86%
1996	$2,875.82	$1,248.79	$1,625.64	$1.40	43.42%	56.53%	0.05%
1997	$2,720.58	$1,041.70	$1,657.52	$21.37	38.29%	60.93%	0.79%
1998	$2,312.17	$1,469.68	$842.37	$0.13	63.56%	36.43%	0.01%
1999	$2,059.73	$699.79	$1,348.52	$11.43	33.97%	65.47%	0.55%
2000	$2,208.18	$785.63	$1,411.91	$10.63	35.58%	63.94%	0.48%
2001	$2,555.80	$940.88	$1,614.93	-	36.81%	63.19%	-
2002	$2,616.04	$941.76	$1,672.95	$1.33	36.00%	63.95%	0.05%
2003	$3,565.50	$1,112.98	$2,446.96	$5.56	31.22%	68.63%	0.16%
2004	$4,933.07	$2,534.25	$2,398.33	$0.50	51.37%	48.62%	0.01%
2005	$4,709.56	$1,797.48	$2,912.09	-	38.17%	61.83%	-
2006	$4,687.96	$1,688.92	$2,980.74	$18.30	36.03%	63.58%	0.39%
2007	$3,764.81	$1,879.62	$1,876.32	$8.87	49.93%	49.84%	0.24%
2008	$3,228.59	$1,552.27	$1,675.70	$0.62	48.08%	51.90%	0.02%
Total	**$48,961.05**	**$20,067.31**	**$28,620.55**	**$273.19**	**40.99%**	**58.46%**	**0.56%**
	Credit Value ($ millions)				**% Distribution**		
1993	$2,213.62	$737.40	$1,407.54	$68.68	33.31%	63.59%	3.10%
1994	$2,206.09	$802.47	$1,294.81	$108.82	36.38%	58.69%	4.93%
1995	$3,592.59	$1,302.57	$2,250.70	$39.31	36.26%	62.65%	1.09%
1996	$3,098.02	$1,182.01	$1,880.01	$36.00	38.15%	60.68%	1.16%
1997	$3,272.31	$1,183.49	$2,039.12	$49.71	36.17%	62.31%	1.52%
1998	$2,623.21	$1,629.41	$991.27	$2.54	62.12%	37.79%	0.10%
1999	$2,808.33	$1,133.99	$1,604.02	$70.32	40.38%	57.12%	2.50%
2000	$2,846.44	$1,146.35	$1,689.46	$10.63	40.27%	59.35%	0.37%
2001	$3,274.43	$1,292.33	$1,982.10	-	39.47%	60.53%	-
2002	$3,284.51	$1,111.24	$2,171.94	$1.33	33.83%	66.13%	0.04%
2003	$4,010.65	$1,215.46	$2,783.23	$11.96	30.31%	69.40%	0.30%
2004	$5,364.28	$2,663.35	$2,700.43	$0.50	49.65%	50.34%	0.01%
2005	$5,426.61	$1,870.89	$3,555.72	-	34.48%	65.52%	-
2006	$4,888.54	$1,634.95	$3,239.78	$13.80	33.44%	66.27%	0.28%
2007	$4,701.98	$2,488.33	$2,196.99	$16.67	52.92%	46.72%	0.35%
2008	$4,706.09	$2,736.98	$1,965.78	$3.34	58.16%	41.77%	0.07%
Total	**$58,317.72**	**$24,131.21**	**$33,752.90**	**$433.61**	**41.38%**	**57.88%**	**0.74%**

Source: BIS Offset Database
Note: Due to rounding, totals may not add up exactly.

Table 4-3 presents offset transaction data by quantity and type (direct, indirect, or unspecified), as well as the quantity and percentage of transactions including multipliers greater than one for each year from 1993-2008. In general, during the time period the total number of offset

transactions reported each year has increased, with direct offset transactions increasing at a greater rate than indirect transactions. However, indirect offset transactions have consistently accounted for over half of the offset transactions reported each year, except for 2004 when direct offset transactions represented 52.55 percent of the number of transactions reported.

Table 4-3: Number of Offset Transactions by Type and with Multipliers, 1993-2008

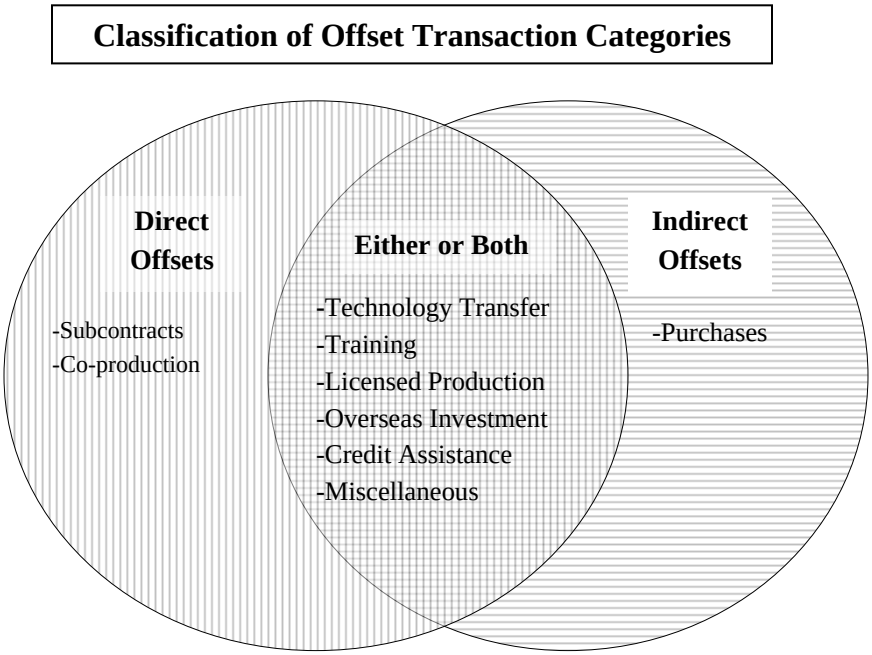
Year	Number of Transactions				Transactions with Multipliers Greater than 1	
	Total	Direct	Indirect	Unspecified	Number of Transactions	Percent of Total Transactions
1993	444	160	280	4	63	14.2%
1994	566	178	383	5	80	14.1%
1995	711	204	505	2	110	15.5%
1996	634	228	404	2	64	10.1%
1997	578	202	372	4	61	10.6%
1998	582	241	340	1	87	14.9%
1999	513	212	296	5	87	17.0%
2000	627	216	409	2	83	13.2%
2001	617	224	393	-	115	18.6%
2002	729	194	534	1	84	11.5%
2003	689	179	506	4	64	9.3%
2004	706	371	334	1	74	10.5%
2005	611	206	405	-	52	8.5%
2006	653	287	364	2	33	5.1%
2007	589	289	298	2	88	14.9%
2008	628	220	406	2	74	11.8%
Total	**9,877**	**3,611**	**6,229**	**37**	**1,219**	**12.3%**

Source: BIS Offset Database
Note: Because of rounding, totals may not add up exactly.

In addition to classifying offset transactions by type (direct or indirect), BIS identifies offset transactions by categories specifically describing the nature of the transaction. For the purposes of this report, BIS has categorized offset transactions as one of the following: purchases, subcontracts, technology transfers, credit assistance, training, overseas investment, co-production, licensed production, and miscellaneous.[18] The diagram below illustrates how each

[18] With respect to any export of product or technology from the United States, U.S. export control laws apply. Whether or not an export is associated with an offset agreement, U.S. exporters must comply with U.S. export control requirements, which include licensing requirements. License applications are carefully reviewed by the appropriate U.S. Government agencies to ensure that the proposed export of an item (commodity, software or technology) or a service is consistent with U.S. laws, regulations, and foreign policy and national security considerations. Where no license is required, U.S. exporters must comply with end-use and end-user restrictions.

category may be classified as direct and/or indirect. See Annex E for definitions of each offset transaction category.



Source: BIS Offset Database

The top three offset transaction categories reported by industry for 2008 were purchases, subcontracts, and technology transfers. These three categories represented 78.18 percent of all transactions reported for 2008 based on quantity, 77.95 percent of transactions based on actual value, and 68.42 percent of the transactions based on credit value. The top three offset transaction categories for transactions involving multipliers were purchases, technology transfer, and miscellaneous transactions. Based on the total number of transactions including a multiplier, miscellaneous transactions accounted for 24.32 percent, technology transfers accounted for 18.92 percent and purchases accounted for 17.57 percent.

The top three offset transaction categories reported by industry for the 16-year reporting period (1993-2008) were also purchases, subcontracts, and technology transfer (on the basis of quantity, actual value and credit value). Based on the number of total offset transactions, purchases, subcontracts, and technology transfers accounted for 46.47 percent, 22.77 percent, and 11.52 percent respectively, of all transactions. Based on actual value, the same offset transaction categories accounted for 36.39 percent (purchases), 22.18 percent (subcontracts), and 17.54 percent (technology transfer), respectively. Finally, based on credit value, they comprised 33.73 percent (purchases), 20.58 percent (subcontracts), and 17.83 percent (technology transfer), respectively.

The top three offset transaction categories that included multipliers were purchases, technology transfers, and subcontracts. Based on the number of transactions, purchases accounted for 32.08 percent of all transactions that included a multiplier, technology transfers accounted for 22.45 percent, and subcontracts accounted for 13.14 percent. See Annex C for complete information on offset transactions by category.

Table 4-4 presents a summary of reported offset transactions by category, type, and value for the 16-year reporting period (1993-2008).

Table 4-4: Offset Transactions by Category, Type, and Value, 1993-2008

Transaction Category	Actual Values ($ millions)				Percent by Column Total			
	Total	**Dir.**	**Ind.**	**Unsp.**	**Total**	**Dir.**	**Ind.**	**Unsp.**
Co-production	$3,457.18	$3,457.18	-	-	7.06%	17.23%	-	-
Credit Assistance	$2,050.39	$219.83	$1,830.56	-	4.19%	1.10%	6.40%	-
Licensed Production	$364.47	$165.85	$174.58	$24.03	0.74%	0.83%	0.61%	8.80%
Miscellaneous	$3,415.70	$590.35	$2,807.00	$18.35	6.98%	2.94%	9.81%	6.72%
Overseas Investment	$1,383.64	$326.38	$979.81	$77.46	2.83%	1.63%	3.42%	28.35%
Purchase	$17,818.91	-	$17,818.91	-	36.39%	-	62.26%	-
Subcontract	$10,857.64	$10,857.64	-	-	22.18%	54.11%	-	-
Technology Transfer	$8,588.83	$3,927.02	$4,510.31	$151.49	17.54%	19.57%	15.76%	55.45%
Training	$1,024.29	$523.05	$499.37	$1.86	2.09%	2.61%	1.74%	0.68%
Total	**$48,961.05**	**$20,067.31**	**$28,620.55**	**$273.19**	**100.00%**	**100.00%**	**100.00%**	**100.00%**
Transaction Category	**Credit Values ($ millions)**				**Percent by Column Total**			
	Total	**Dir.**	**Ind.**	**Unsp.**	**Total**	**Dir.**	**Ind.**	**Unsp.**
Co-production	$3,843.87	$3,843.87	-	-	6.59%	15.93%	-	-
Credit Assistance	$2,283.73	$289.08	$1,994.65	-	3.92%	1.20%	5.91%	-
Licensed Production	$557.66	$182.81	$343.61	$31.23	.96%	0.76%	1.02%	7.20%
Miscellaneous	$5,296.04	$1,621.02	$3,594.03	$80.98	9.08%	6.72%	10.65%	18.68%
Overseas Investment	$2,557.03	$645.48	$1,783.39	$128.16	4.38%	2.67%	5.28%	29.56%
Purchase	$19,670.05	-	$19,670.05	-	33.73%	-	58.28%	-
Subcontract	$12,004.24	$12,004.24	-	-	20.58%	49.75%	-	-
Technology Transfer	$10,399.52	$4,644.17	$5,575.50	$179.86	17.83%	19.25%	16.52%	41.48%
Training	$1,705.58	$900.55	$791.66	$13.37	2.92%	3.73%	2.35%	3.08%
Total	**$58,317.72**	**$24,131.21**	**$33,752.90**	**$433.61**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: BIS Offset Database
Note: Due to rounding, totals may not add up precisely.

Table 4-5 presents the number of reported offset transactions by category and type and with multipliers for the 16-year reporting period (1993-2008).

Table 4-5: Number of Offset Transactions by Category and Type and with Multipliers, 1993-2008					
	# of Transactions				Number of Transactions with Multipliers Greater than 1
Transaction Category	Total	Direct	Indirect	Unspecified	
Co-production	542	542	-	-	25
Credit Assistance	160	13	147	-	25
Licensed Production	45	30	13	2	9
Miscellaneous	659	128	524	7	157
Overseas Investment	192	31	156	5	63
Purchase	4,590		4,590	-	393
Subcontract	2,249	2,249		-	161
Technology Transfer	1,138	477	643	18	275
Training	302	141	156	5	117
Total	**9,877**	**3,611**	**6,229**	**37**	**1,225**
Source: BIS Offset Database					

Annex C presents a summary of reported offset transactions by category, value, and quantity on an annual basis during the 16-year reporting period (1993-2008). Based on the reported data summarized in the Annex, the number of overseas investment offset transactions has increased steadily, as has the number of transactions involving technology transfer. In contrast, the number of licensed production offset transactions has decreased over the reporting period, as has the number of offset transactions involving purchases and training (although the overall number of purchase offsets remains high as compared to the other offset transaction categories). Only the number of subcontract offset transactions has remained steady during the time period. The yearly fluctuations in the number of reported transactions for each of these different categories do not show any clear pattern that would demonstrate a trend for an increased or decreased preference for a certain transaction category. The only clear trend is that the three most popular offset transaction categories discussed above – purchases, subcontracts and technology transfer – have consistently been the most reported categories and that trend shows no signs of changing.

5 Impact of Offsets on the U.S. Industrial Base

The revenues generated by the sales of defense items to foreign entities are important to U.S. defense contractors and to U.S. foreign policy and economic interests. Exports of major defense systems help lower the Department of Defense's overhead costs through economies of scale on defense programs and help maintain production facilities and workforce expertise for U.S. defense requirements. Defense exports also provide additional business to many U.S. subcontractors and lower-tier suppliers, promote the interoperability of weapon systems between the United States and friends and allies,[19] and contribute positively to U.S. international trade account balances.

However, offset agreements negate some of the economic and industrial base benefits accrued through the sale of defense items to foreign entities. For example, offset transactions that require a high proportion of subcontracting, co-production, license production or purchases transactions can displace U.S. defense subcontractors and suppliers, and in some cases, portions of the prime contractor's business.

Studies and discussions between industry and U.S. Government officials indicate that, at times, U.S. prime contractors develop long-term supplier relationships with overseas subcontractors based on short-term offset requirements.[20] These new relationships, combined with the mandatory offset requirements related to offset agreements, can limit future business opportunities for U.S. subcontractors and suppliers, with negative consequences for the domestic industrial base. Other kinds of offsets, such as technology transfers, may increase research and development spending and capital investment in foreign countries for defense or non-defense industries, thereby helping to create or enhance current and future competitors for U.S. industry. Although the impact of increased R&D spending and capital investment overseas may result in increased defense industrial base capabilities for U.S. allies and partners, the foreign purchasing country pays an additional price for offsets.

[19] It is the policy of the United States to standardize the equipment, including weapons systems, ammunition, and fuel, procured for the use of U.S. armed forces stationed in Europe under the North Atlantic Treaty or to make that equipment interoperable with the equipment used by other members of the North Atlantic Treaty Organization. (10 U.S.C. § 2457: US Code - Section 2457: Standardization of equipment with North Atlantic Treaty Organization members)

[20] For example, see GAO report on offset activities, "Defense Trade: U.S. Contractors Employ Diverse Activities to Meet Offset Obligations," December 1998 (GAO/NSIAD-99-35), pp. 4-5.

Export and Offset Activity Trends

According to Census, the value of U.S. merchandise exports totaled $1.29 trillion in 2008. Based on end-use export data published by Census, in 2008, defense-related merchandise exports totaled $16.59 billion, or approximately 1.29 percent of total U.S. merchandise exports.[21]

For purposes of context, in 2008 U.S. industry reported entering into contracts with a total value of $6.1 billion for the sale of defense items to foreign entities and accompanying offset agreements valued at $3.48 billion, and completing offset transactions with an actual value of $3.23 billion. The value of U.S. merchandise exports cannot be directly compared with the value of defense contracts and offset agreements because while export data reflect actual shipments during the calendar year, there is usually several years between the conclusion of a contract for a defense sale or an offset agreement and the shipment if the item(s) related to the contract or agreement. See Table 5-1 for defense-related merchandise exports and offset activity trends from 2003–2008.

Table 5-1: U.S. Merchandise Exports and Reported Offset Activity Trends, 2003-2008

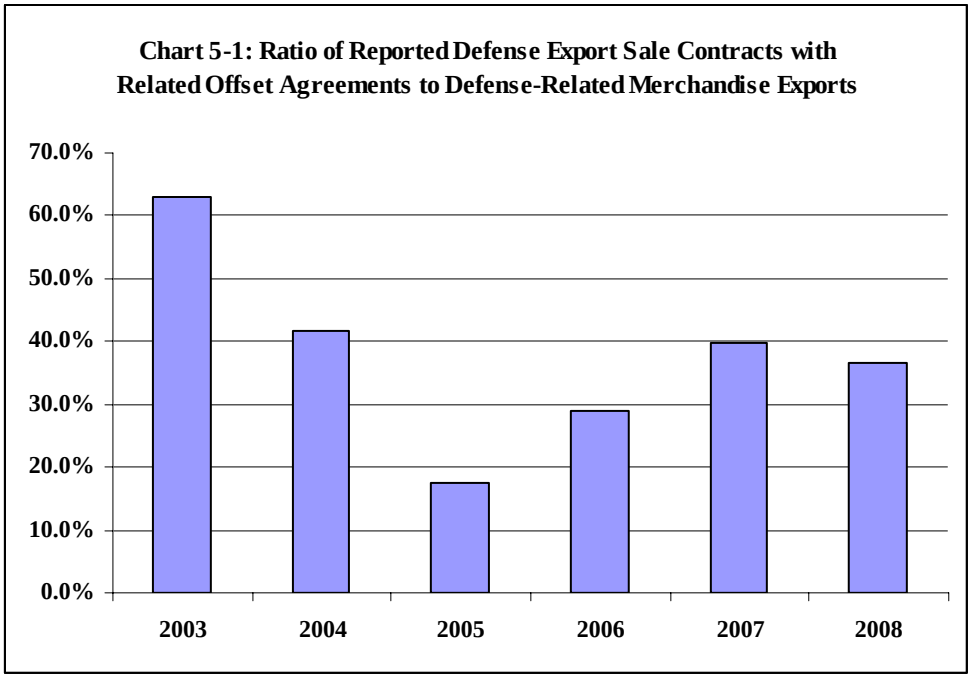
Year	Total Merchandise Exports ($ millions)	Defense-Related Merchandise Exports ($ millions)	Defense-Related Exports as a Percentage of Total Merchandise Exports	Value of Reported Defense Export Sale Contracts with Related Offset Agreements ($ millions)	Value of Reported Offset Agreements ($ millions)
2003	$724,770.98	$11,564.51	1.60%	$7,293.05	$9,110.44
2004	$814,874.65	$11,844.30	1.45%	$4,927.51	$4,329.69
2005	$901,081.81	$12,834.77	1.42%	$2,259.87	$1,464.13
2006	$1,025,967.50	$16,628.72	1.60%	$4,832.45	$3,425.35
2007	$1,148,198.72	$16,893.87	1.47%	$6,735.74	$5,437.57
2008	$1,287,442.00	$16,594.06	1.29%	$6,096.15	$3,480.63

Sources: BIS Offset Database and the U.S. Census Bureau, End-Use Export Data

Table 5-1 illustrates the ratio of U.S. defense-related merchandise exports to total U.S. merchandise exports. Although the relationship fluctuated over the six-year period, it dropped to 1.29 percent in 2008, reflecting an increase in total merchandise exports and a decline in defense-related exports.

[21] The value of defense exports includes the exports categorized under the following export end-use codes: (50000) Military aircraft, complete; (50010) Aircraft launching gear, parachutes, etc; (50020) Engines and turbines for military aircraft; (50030) Military trucks, armored vehicles, etc.; (50040) Military ships and boats; (50050) Tanks, artillery, missiles, rockets, guns, and ammunition; (50060) Military apparel and footwear; and (50070) Parts for military-type goods. The end-use data series does not include exports of defense services. See www.census.gov/foreign-trade/statistics.

Merchandise exports related to a defense sales contract are typically spread out over several years in accordance with the delivery schedule specified in the contract. Although there is not a direct correlation between the value of annual defense-related merchandise exports and the annual value of signed defense-related export sales contracts, over time the fulfillment of the contracts is reflected in the annual export levels. Chart 5-1 examines the value relationship between reported defense export sale contracts with related offset agreements to defense-related merchandise exports during 2003-2008. The ratio of the value of defense export sale contracts with related offset agreements to the value of defense-related merchandise exports averaged 37.2 percent during 2003-2008, with a peak of 63.1 percent in 2003, and low of 17.6 percent in 2005. As mentioned above, these figures are included to provide context on the extent of the use of offsets in defense trade. The figures do not indicate any clear trend to date, however, BIS will continue to monitor these figures in future reports.



Economic Impact of Offsets on U.S. Industrial Activity and Employment

Given the variety of defense systems exported and the number of reported offset transactions, it is not possible to determine precisely the impact of defense sales contracts, offset agreements, and offset transactions on industrial activity and employment. However, BIS has developed an estimate by utilizing reported aerospace-related defense export sale and offset transaction data,

BEA's *Benchmark Input-Output Accounts of the United States* (I/O accounts)[22], and Census' *Annual Survey of Manufactures*.[23]

During 2005-2008, industry reported the value of aerospace-related defense export sales contracts as $16.9 billion. All of the reported contracts had associated offset contracts. BIS has categorized these sales into three subsectors of the aerospace industry: aircraft manufacturing, aircraft engine and engine parts manufacturing, and other aircraft parts and auxiliary equipment manufacturing. According to the Bureau of the Census' (Census) Annual Survey of Manufacturers data, the $16.9 billion in aerospace defense export sales created or sustained employment opportunities equivalent to approximately 91,000 U.S. aerospace sector jobs.[24] As shown in Table 5-2, the I/O accounts demonstrate how these defense export sales have a positive multiplier effect not only on the U.S. aerospace industrial sector but on hundreds of other U.S. economic sectors that supply inputs to the aerospace sector.

Conversely, for the purpose of this analysis, BIS considers offset transactions to have a negative impact on U.S. inputs because these transactions represent activity that is not provided by sectors of the U.S. economy (see Table 5-3).[25] According to Census' Annual Survey of Manufacturers data, the $5.9 billion in reported offset transactions would have created or sustained employment opportunities equivalent to approximately 59,000 U.S. aerospace sector jobs if the work associated with those transactions were performed in the United States.[23] As shown in Table 5-3, the I/O accounts provide an approximation of the multiplier effect across all U.S. economic sectors had these transaction been performed in the United States. Note that only reported offset transactions related to subcontracting, co-production, licensed production, and purchases were considered in BIS' analysis because these four categories of offset transactions provide for the most direct and measurable displacement of U.S. input opportunities.

Table 5-4 shows the net impact in terms of inputs across all sectors of the U.S. economy resulting from defense export sales with related offset agreements. BIS derived this information by subtracting the reported offset transaction-related data (Table 5-3) from the reported defense

[22] The I/O accounts show the dollar value of inputs from all industries required to produce a dollar worth of an industry's output. The I/O accounts provide an extensive accounting of the production of goods and services by each industry, which includes the goods and services purchased by each industry, the income earned in each industry, and the distribution of sales for all goods and services to industries and final uses.

[23] BIS limited the measurement of impact of offsets to this industrial sector since sales of aerospace-related weapon systems accounted for more than 80 percent of the value of defense sales contracts with related offset agreements and offset transactions reported by industry during 2005-2008. A four-year data set was used to evaluate impact in order to account for annual fluctuations in reported defense sales contracts, offset agreements, and offset transactions.

[24] 2006 Annual Survey of Manufacturers, U.S. Census Bureau, November 18, 2008.

[25] There is however, no certainty that this work would be conducted in any particular case in the United States.

export sales contracts-related data presented in Table 5-2. In all three sectors of aerospace industry, the results indicate a highly favorable net gain on U.S. manufacturing opportunities, resulting in a positive $12.5 billion in added "input" opportunity for the U.S. industrial base.

Table 5-2: Inputs from Selected Industry Sectors Related to Reported Defense Export Sales Contracts, 2005-2008

	Aircraft manufacturing	Aircraft engine and engine parts manufacturing	Other aircraft parts and auxiliary equipment manufacturing
	Outputs		
Total Value of Reported Aerospace-Related Defense Export Sale Contracts (In $)	10,479,041,602	485,361,955	5,920,214,726
Number of Reported Aerospace-Related Defense Export Sale Contracts	34	6	57
Inputs from Selected Industries	Inputs ($)		
Air transportation	82,324,399	657,425,389	53,482,036
Aircraft engine and engine parts manufacturing	38,488,472	1,564,273	192,941,574
Aircraft manufacturing	10,702,141,446	95,181,130	780,042,756
Couriers and messengers	22,573,951	251,806	4,519,492
General Federal defense government services[26]	326,254,481	4,467,271	52,898,895
General Federal nondefense government services[23]	7,697,904	397,997	3,115,217
Guided missile and space vehicle manufacturing	24,272,604	1,344,598	4,080,212
Other aircraft parts and auxiliary equipment manufacturing	50,191,466	6,682,075	6,136,503,851
Propulsion units and parts for space vehicles and guided missiles	13,236,077	1,363,139	2,932,282
Transportation and support activities for transportation	9,747,604	515,260	34,368,031
Secondary smelting and alloying of aluminum	2,855,539	238,895	7,135,043
All Other Industries	261,010,920	26,624,627	393,086,273
Total Inputs[27]	11,540,794,864	796,056,461	7,665,105,661

Sources: BIS Offset Database and BEA's *Benchmark Input-Output Accounts of the United States*.

Table 5-3: Inputs from Selected Industry Sectors Related to Reported Offset Transactions in Aerospace Industrial Sectors, 2005-2008			
	Aircraft manufacturing	**Aircraft engine and engine parts manufacturing**	**Other aircraft parts and auxiliary equipment manufacturing**
	Outputs		
Total Value of Reported Aerospace-Related Offset Transactions (In $)	1,235,331,615	419,901,987	4,246,918,125
Number of Reported Aerospace-Related Offset Transactions	184	47	939
Inputs from Selected Industries	**Inputs ($)**		
Air transportation	9,704,889	568,759,509	38,365,809
Aircraft engine and engine parts manufacturing	4,537,249	1,353,302	138,408,336
Aircraft manufacturing	1,261,631,949	82,344,207	559,570,535
Couriers and messengers	2,661,151	217,845	3,242,097
General Federal defense government services	38,460,815	3,864,778	37,947,488
General Federal nondefense government services	907,475	344,320	2,234,728
Guided missile and space vehicle manufacturing	2,861,399	1,163,254	2,926,976
Other aircraft parts and auxiliary equipment manufacturing	5,916,868	5,780,875	4,402,075,031
Propulsion units and parts for space vehicles and guided missiles	1,560,347	1,179,295	2,103,499
transportation and support activities for transportation	1,149,105	445,768	24,654,209
Secondary smelting and alloying of aluminum	336,628	206,676	5,118,386
All Other Industries	30,769,516	23,033,807	281,983,897
Total Inputs	1,360,497,391	688,693,636	5,498,630,990
Sources: BIS Offset Database and BEA's *Benchmark Input-Output Accounts of the United States*.			

Table 5-4: Net Inputs from Selected Industry Sectors Related to Reported Defense Export Sales Contracts and Offset Transactions in Aerospace Industrial Sectors, 2005-2008			
	Aircraft manufacturing	**Aircraft engine and engine parts manufacturing**	**Other aircraft parts and auxiliary equipment manufacturing**
	Outputs ($)		
Total Value of Reported Aerospace-Related Defense Export Sale Contracts Less Value of Reported Aerospace-Related Offset Transactions	9,243,709,987	65,459,968	1,673,296,601
Net Inputs from Selected Industries	**Inputs ($)**		
Air transportation	72,619,510	88,665,880	15,116,227
Aircraft engine and engine parts manufacturing	33,951,222	210,971	54,533,238
Aircraft manufacturing	9,440,509,497	12,836,922	220,472,222
Couriers and messengers	19,912,800	33,961	1,277,395
General Federal defense government services	287,793,667	602,494	14,951,407
General Federal nondefense government services	6,790,429	53,677	880,489
Guided missile and space vehicle manufacturing	21,411,205	181,344	1,153,236
Other aircraft parts and auxiliary equipment manufacturing	44,274,598	901,200	1,734,428,819
Propulsion units and parts for space vehicles and guided missiles	11,675,730	183,844	828,784
Scenic and sightseeing transportation and support activities for transportation	8,598,499	69,492	9,713,821
Secondary smelting and alloying of aluminum	2,518,911	32,219	2,016,657
All Other Industries	230,241,404	3,590,820	111,102,376
Total Net Inputs	10,180,297,473	107,362,825	2,166,474,671
Total Net Value of Inputs for all Aerospace Industry Sectors			**$12,454,134,968**
Sources: BIS Offset Database and BEA's *Benchmark Input-Output Accounts of the United States*.			

According to Census's *Annual Survey of Manufactures*, the annual average value added per employee in the U.S. aerospace manufacturing sector during 2003-2006 was $185,957.[28]

Dividing value added per employee into the net total value of inputs (sales contracts less value of offset transactions as shown in Table 5-5), results in a positive net employment opportunity of 65,464 for the four-year period (an annual average of 16,366). The aircraft manufacturing subsector benefited from an employment opportunity gain of 51,492 and the aircraft engine and engine parts manufacturing subsector from an employment opportunity gain of 540. A net employment opportunity gain of 13,433 occurred in the other aircraft parts and auxiliary equipment manufacturing subsector. See Table 5-5.

Table 5-5: Net Employment Impact Related to Reported Aerospace-Related Defense Export Sales with Offset Agreements, 2005-2008

	Aerospace Industry Sectors			
	Aircraft manufacturing	**Aircraft engine and engine parts manufacturing**	**Other aircraft parts and auxiliary equipment manufacturing**	**Net Impact for All Aerospace Industry Sectors**
Net Total Value of Inputs: Export Contracts Less Value of Offset Transactions	$10,180,297,473	$107,362,825	$2,166,474,671	$**12,454,134,968**
Average Value Added per Employee (2003-2006)	$197,708	$198,883	$161,280	
Net Employment Opportunity Gain or Loss (Number of Employees)	51,492	540	13,433	**65,464**

Sources: BIS Offset Database, BEA's *Benchmark Input-Output Accounts of the United States*, and Census's *Annual Survey of Manufactures*.

Aerospace-Related Research and Development and Offset Technology Transfer Trends

Comparing reported aerospace-related offset transactions involving technology transfer to U.S. aerospace-related research and development (R&D) expenditures provides, for purposes of context, a measure of the magnitude of this type of offset activity. Table 5-6 provides such data for the 2002-2007 period.[29] For example, in 2007, the value of reported aerospace-related offset transactions that involved technology transfers was $686.53 million, equivalent to 3.7 percent of total R&D spending for the U.S. aerospace industry.[30]

Table 5-6: Trends in Aerospace-Related R&D Spending and Reported Offset Transactions Involving Technology Transfer, 2002-2007			
Year	Reported Aerospace-Related Technology Transfer Offset Transactions ($)	Aerospace Industry R&D Spending (Federal and Industry)($)	Technology Transfer Transactions as a Percentage of R&D Spending
2002	$287,464,704	$9,654,000,000	3.0%
2003	$547,446,305	$15,731,000,000	3.5%
2004	$669,457,809	$13,086,000,000	5.1%
2005	$1,479,648,075	$15,005,000,000	9.9%
2006	$715,679,906	$16,367,000,000	4.4%
2007	$686,525,212	$18,436,000,000	3.7%
Sources: BIS Offset Database and the National Science Foundation, Division of Science Resources Statistics, *R&D: 2007.*			

BIS does not collect data from industry on the specific technologies transferred as a result of offset agreements and offset transactions. However, anecdotal information obtained from industry suggests that "cutting edge" or nascent technologies under development in the United States are less likely to be transferred to foreign companies in fulfillment of offset obligations than are mature technologies. Regardless, any transfer of export-controlled technology must be approved through the U.S. Government's normal export licensing processes. The existence of an offset agreement provides no circumvention of the established licensing process for the Departments of Commerce and State in consultation with DOD to rule on applications for the transfer of sensitive technologies.

Domestic Defense Productive Capability

According to a March 2009 report, DOD "desires that the industrial base on which it draws be reliable, cost-effective, and sufficient to meet strategic objectives." DOD's ultimate objective is not an "infinitely robust industrial base," but to have reliable, cost-effective, and sufficient industrial capabilities to develop, produce, and support the defense material necessary to support national defense.[31]

DOD is willing to use reliable foreign suppliers when such use offers comparative advantages in performance, cost, schedule, or coalition operations. DOD has negotiated bilateral Reciprocal Defense Procurement Memoranda of Understanding (RDP MOUs) with 21 countries. The RDP MOUs include procurement principles and procedures that provide transparency and access for each country's industry to the other country's defense market. The RDP MOU relationship facilitates defense cooperation and promotes rationalization, standardization, and interoperability of defense equipment. For example, based on these RDP MOUs, the Secretary of Defense or Deputy Secretary of Defense has made blanket public interest exceptions to the Buy American Act (BAA) (41 U.S.C. 10a-d) for 19 of the 21 RDP MOU partners. As a result of these blanket

exceptions, these 19 countries' products are evaluated on the same basis as domestic products in competitive DOD procurements.

DOD reports it is only acquiring a small number of defense articles at the prime contract level from foreign entities.[32] According to DOD, its prime contract purchases of manufactured items categorized under DOD Claimant Program codes A1A-A7 (which exclude most commercial manufactured items) totaled $126.48 billion in Fiscal Year 2008. Of the $126.48 billion, contracts made with U.S. entities totaled $123.73 billion, while DOD prime contracts made with foreign entities totaled $2.75 billion, accounting for approximately 2.17 percent of the total. For comparison, in Fiscal Year 2007, DOD's prime contract purchases for these program codes totaled $105.73 billion in value. Contracts made with U.S. entities totaled $104.25 billion and prime contracts made with foreign entities totaled $1.48 billion, accounting for approximately 1.58 percent of the total.

DOD reports that in Fiscal Year 2008, based on data from the Federal Procurement Data System – Next Generation, its prime contract purchases of manufactured items overall totaled approximately $161.93 billion. DOD reports that the value of its procurement of U.S.-origin goods (form U.S. sources) totaled approximately $153.44 billion in Fiscal Year 2008, compared with DOD purchases of manufactured goods from foreign sources which totaled $8.5 billion, (5.2 percent of the total).[33] In Fiscal Year 2007, DOD's prime contract purchases of all manufactured goods totaled approximately $140 billion, with approximately $129.68 billion procured from U.S. sources and $10.32 billion procured from foreign sources (7.37 percent of the total).

As the data shows, the dollar amount of defense articles procured by DOD (Claimant Program codes A1A-A7) is far greater than the dollar amount of offset agreements. Further, the vast majority of the items that DOD procures are U.S.-origin items. Consequently, U.S. defense firms maintain a dominant position in selling defense articles to DOD, their largest customer. This implies that despite gaining additional productive capacity that foreign firms have presumably gained as a result of offset agreements, foreign firms have not been able to leverage that capacity to make significant advances into the U.S. market.

Table 5-7 presents an overview of DOD's Fiscal Year 2008 prime contract purchases of manufactured items from U.S. and foreign firms, by Claimant Program codes.

BIS concludes that the value of the sale of foreign defense items has been and continues to be, a small percentage of the value of domestic defense procurements and that the international sale of at least some defense-related items, such as aerospace items, has a positive impact on those item sectors. Although it is difficult to pinpoint the impact of offsets on the domestic defense

industrial base, it appears that some portion of offset-demanding countries believe that offsets provide the tools and materials necessary to expand and improve their industrial bases. It is possible that any such expansions/ improvements may have occurred at a cost to U.S. companies, perhaps leading to one or more of the following: decreases in domestic defense R&D spending (as a result of industry's expenditure of funds to comply with offset agreements which might otherwise have been spent on R&D), decreased training and/or employment opportunities for American workers, and increased external competition for U.S. industry.

Further, BIS notes that since 1993, U.S. companies have incurred defense offsets-related costs with a total value of $49 billion. A significant portion of that sum could instead have been used to further the companies' in-house R&D or retain American workers if all these contracts had been awarded to U.S. companies without offset requirements.

Table 5-7: Department of Defense Prime Contract Purchases of Manufactured Items, Fiscal Year 2008				
DOD Claimant Program	**Total Purchases ($ millions)**	**U.S. Purchases ($ millions)**	**Foreign Purchases ($ millions)**	**Foreign Purchases as Percent of Total**
A1A – Air Frames & Spares	$32,513.48	$32,378.32	$135.16	0.42%
A1B – Aircraft Engine & Spares	$4,672.00	$4,611.28	$60.72	1.30%
A1C- Other Aircraft Equipment	$6,110.07	$5,970.02	$140.05	2.29%
A2 – Missile & Space Systems	$11,660.84	$11,637.34	$23.50	0.20%
A3 – Ships	$12,378.04	$12,340.36	$37.68	0.30%
A4A – Combat Vehicles	$20,008.59	$19,004.46	$1,004.13	5.02%
A4B – Non Combat Vehicles	$11,818.56	$11,635.08	$183.48	1.55%
A5 – Weapons	$3,627.12	$3,217.74	$409.38	11.29%
A6 – Ammunition	$4,157.90	$3,809.30	$348.60	8.38%
A7 – Electronic & Communication Equipment	$19,530.88	$19,126.11	$404.76	2.07%
A8C – Separately Procured Containers and Handling Equipment	$53.46	$53.32	$0.13	0.25%
A9 – Textiles, Clothing, and Equipage	$2,015.00	$2,005.21	$9.78	0.49%
B1 – Building Supplies	$42.99	$41.15	$1.84	4.28%
B3 – Transportation Equipment	$4.88	$4.81	$0.07	1.35%
B9 – Production Equipment	$487.10	$482.50	$4.60	0.94%
C9A – Construction Equipment	$444.01	$440.07	$3.94	0.89%
C9B – Medical & Dental Supplies and Equipment	$4,330.87	$4,305.81	$25.06	0.58%
C9C – Photographic Supplies and Equipment	$40.68	$40.35	$.33	0.82%
C9D – Materials Handling Equipment	$173.29	$171.43	$1.86	1.07%
C9E – All Other Supplies and Equipment	$27,863.43	$22,165.34	$5,698.09	20.45%
Total	**$161,933.18**	**$153,440.02**	**$8,493.17**	**5.24%**

Source: Table 7, "DOD Purchases of Manufactured Items – Fiscal Year 2008", *Department of Defense Fiscal Year 2008 Purchases of Supplies Manufactured Outside the United States – Report to Congress*, Deputy Under Secretary of Defense (Acquisition and Technology), September 2009.

6 Utilization of Annual Report

BIS is an active participant in the Interagency Working Group on Offsets' (IaWG) work to engage foreign nations on ways to minimize the adverse effects of offsets. BIS consulted with members of the IaWG in completing this report, and has briefed the IaWG on the report.

The data contained in this report is considered and utilized by representatives of the United States during bilateral and multilateral discussions with friends and allies to minimize the adverse effects of offsets in the coming year. For instance, aggregated data was used by IaWG members during discussions on offsets with the European Defense Agency (EDA) and the Letter of Intent-6 (LOI-6) countries.[34] These discussions are vitally important to the IaWG's work to limit the adverse effects of offsets because the foreign participants represented countries demanding a significant portion of the offsets provided by U.S. industry. In 2008, EDA countries accounted for over one-third of all new offset agreements entered into by U.S. defense industry and over one-quarter of the value of those agreements. The EDA countries also accounted for almost 40 percent of all offset transactions performed by U.S. defense industry in 2008 with a similar percentage of the overall offset transaction value. Similarly, in 2008 the LOI-6 countries accounted for approximately ten percent of both new offset agreements and the value thereof.

See Annex F for the IaWG's 2009 progress report on consultations with foreign nations on limiting the adverse effects of offsets in defense procurement.

Annex A - Not for Public Release

Annex B - Not for Public Release

Annex C – Overview of Offset Transactions by Category, 1993-2008 (*In thousands of dollars*)

	Co-Production			Credit Assistance			Licensed Production			Miscellaneous			Overseas Investment		
Year	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions
1993	$35,550	$35,550	6	$340,492	$366,794	12	$37,851	$41,451	8	$50,967	$68,168	17	$41,499	$41,500	13
1994	$111,895	$112,185	10	$3,494	$21,639	3	$45,424	$67,629	15	$148,742	$163,370	36	$93,265	$98,474	17
1995	$86,898	$86,898	11	$374,248	$468,930	20	$5,110	$4,965	2	$197,760	$295,647	51	$117,152	$363,556	9
1996	$16,952	$22,052	3	$244,270	$258,970	15	$26,425	$26,425	1	$113,266	$257,647	42	$10,656	$10,656	2
1997	$28,339	$28,339	22	$168,410	$168,410	20	$0	$0	0	$454,159	$487,010	64	$85,126	$271,538	6
1998	$94,332	$98,283	30	$43,920	$43,920	4	$0	$0	0	$144,550	$157,246	54	$0	$0	0
1999	$47,803	$47,803	19	$16,888	$16,888	3	$460	$23,000	2	$303,704	$713,077	65	$28,475	$219,079	9
2000	$27,691	$27,691	15	$9,952	$9,952	2	$9,816	$9,816	1	$302,950	$388,093	50	$56,233	$108,521	8
2001	$16,575	$80,300	2	$4,726	$8,027	3	$25,000	$25,000	1	$48,656	$82,960	14	$61,825	$91,837	8
2002	$0	$0	0	$29,453	$29,453	1	$0	$0	0	$135,848	$149,847	28	$24,484	$85,234	12
2003	$260,250	$266,465	18	$51,610	$51,610	6	$1,500	$0	1	$145,262	$297,232	34	$175,281	$228,813	14
2004	$1,395,766	$1,268,666	105	$141,234	$170,453	20	$13,679	$13,679	3	$211,266	$273,924	33	$162,077	$393,819	15
2005	$309,409	$322,204	74	$61,028	$76,828	10	$123,836	$268,326	5	$95,146	$152,360	34	$185,819	$192,387	19
2006	$383,587	$432,089	93	$442,028	$453,521	28	$62,000	$64,000	3	$174,010	$136,966	29	$118,733	$124,593	17
2007	$398,250	$496,255	83	$76,997	$84,164	8	$2,972	$2,972	1	$662,926	$1,046,377	64	$106,953	$158,986	21
2008	$243,889	$519,084	51	$41,641	$54,171	5	$10,393	$10,393	2	$226,486	$626,111	44	$116,063	$168,033	22

Overview of Offset Transactions by Category, 1993-2008 (Continued)

	Purchase			Subcontract			Technology Transfer			Training		
Year	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions	Actual Value	Credit Value	No. of Transactions
1993	$703,850	$865,524	226	$336,368	$405,101	109	$300,307	$320,504	32	$50,994	$69,027	21
1994	$694,506	$735,909	288	$267,518	$319,081	95	$462,569	$495,849	68	$107,448	$191,956	34
1995	$863,425	$932,133	367	$830,419	$887,985	147	$334,328	$395,024	71	$81,146	$157,453	33
1996	$1,090,104	$1,116,434	298	$721,298	$733,511	175	$476,657	$426,849	60	$176,196	$245,478	38
1997	$837,071	$894,517	245	$848,489	$868,412	141	$289,527	$492,451	67	$9,460	$61,636	13
1998	$582,198	$595,910	253	$1,215,476	$1,244,506	164	$196,765	$413,335	63	$34,929	$70,007	14
1999	$869,591	$883,930	203	$452,464	$476,331	140	$336,018	$396,856	69	$4,330	$31,370	3
2000	$840,845	$915,622	299	$598,427	$832,488	149	$293,377	$430,962	76	$68,887	$123,299	27
2001	$1,132,958	$1,250,367	331	$718,294	$918,340	154	$529,343	$788,885	89	$18,427	$28,710	15
2002	$1,302,590	$1,690,401	453	$809,852	$913,498	157	$287,465	$383,076	66	$26,344	$33,004	12
2003	$1,790,932	$1,835,692	422	$506,050	$602,280	100	$547,446	$563,306	75	$87,170	$165,247	19
2004	$1,351,878	$1,463,620	213	$847,191	$848,427	203	$669,458	$782,957	85	$140,524	$148,739	29
2005	$1,963,024	$2,380,682	277	$485,182	$508,394	87	$1,479,648	$1,504,264	100	$6,473	$21,167	5
2006	$2,011,351	$2,262,492	245	$690,014	$690,014	149	$717,680	$637,598	75	$88,558	$87,265	14
2007	$887,574	$934,058	180	$869,092	$910,692	164	$709,925	$905,483	56	$50,120	$162,998	12
2008	$897,013	$912,765	290	$661,507	$845,181	115	$958,314	$1,462,126	86	$73,283	$108,226	13

Source: BIS Offset Database

Annex D – Statutory Provisions

Section 309 of the Defense Production Act of 1950, as amended (50 U.S.C. App. 2061, et seq.)

Section 309

(a) Annual Report on Impact of Offsets --

(1) Report Required -- Not later than 18 months after the date of the enactment of the Defense Production Act Amendments of 1984, and annually thereafter, the President shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, a detailed report on the impact of offsets on the defense preparedness, industrial competitiveness, employment, and trade of the United States.

(2) Duties of the Secretary of Commerce --The Secretary of Commerce (hereafter in this subsection referred to as 'the Secretary'
shall --

(A) prepare the report required by paragraph (1);

(B) consult with the Secretary of Defense, the Secretary of the Treasury, the Secretary of State, and the United States Trade Representative in connection with the preparation of such report; and

(C) function as the President's Executive Agent for carrying out this section.

(b) **Interagency Studies and Related Data --**

(1) Purpose of Report -- Each report required under subsection (a) shall identify the cumulative effects of offset agreements on --

(A) the full range of domestic defense productive capability (with special attention paid to the firms serving as lower-tier subcontractors or suppliers); and

(B) the domestic defense technology base as a consequence of the technology transfers associated with such offset agreements.

(2) Use of Data -- Data developed or compiled by any agency while conducting any interagency study or other independent study or analysis shall be made available to the Secretary to facilitate the execution of the Secretary's responsibilities with respect to trade offset and counter trade policy development.

(c) Notice of Offset Agreements --

(1) In General -- If a United States firm enters into a contract for the sale of a weapon system or defense-related item to a foreign country or foreign firm and such contract is subject to an offset agreement

exceeding $5,000,000 in value, such firm shall furnish to the official designated in the regulations promulgated pursuant to paragraph (2) information concerning such sale.

(2) Regulations -- The information to be furnished under paragraph (1) shall be prescribed in regulations promulgated by the Secretary. Such regulations shall provide protection from pubic disclosure for such information, unless public disclosure is subsequently specifically authorized by the firm furnishing the information.

(d) Contents of Report --

(1) In General -- Each report under subsection (a) shall include--

(A) a net assessment of the elements of the industrial base and technology base covered by the report;

(B) recommendations for appropriate remedial action under the authority of this Act, or other law or regulations;

(C) a summary of the findings and recommendations of any interagency studies conducted during the reporting period under subsection (b);

(D) a summary of offset arrangements concluded during the reporting period for which information has been furnished pursuant to subsection (c); and

(E) a summary and analysis of any bilateral and multilateral negotiations relating to the use of offsets completed during the reporting period.

(2) Alternative Findings or Recommendations -- Each report required under this section shall include any alternative findings or recommendations offered by any departmental Secretary, agency head, or the United States Trade Representative to the Secretary.

(e) Utilization of Annual Report in Negotiations --

The findings and recommendations of the reports required by subsection (a), and any interagency reports and analyses shall be considered by representatives of the United States during bilateral and multilateral negotiations to minimize the adverse effects of offsets.

Defense Production Act Reauthorization of 2003
(Pub. L. 108-195)

* * * *

(c) **RESPONSIBILITIES REGARDING CONSULTATION WITH FOREIGN NATIONS**.--Section 123(c) of the Defense Production Act Amendments of 1992 (50 U.S.C. App. 2099 note) is amended to read as follows:

(c) **NEGOTIATIONS**. --

(1) **INTERAGENCY TEAM**. --

(A) **IN GENERAL**. -- It is the policy of Congress that the President shall designate a chairman of an interagency team comprised of the Secretary of Commerce, Secretary of Defense, United States Trade Representative, Secretary of Labor, and Secretary of State to consult with foreign nations on limiting the adverse effects of offsets in defense procurement without damaging the economy or the defense industrial base of the United States or United States defense production or defense preparedness.

(B) **MEETINGS**. -- The President shall direct the interagency team to meet on a quarterly basis.

(C) **REPORTS**. -- The President shall direct the interagency team to submit to Congress an annual report, to be included as part of the report required under section 309(a) of the Defense Production Act of 1950 (50 U.S.C. App. 2099(a)), that describes the results of the consultations of the interagency team under subparagraph (A) and the meetings of the interagency team under subparagraph (B).

(2) **RECOMMENDATIONS FOR MODIFICATIONS**. -- The interagency team shall submit to the President any recommendations for modifications of any existing or proposed memorandum of understanding between officials acting on behalf of the United States and 1 or more foreign countries (or any instrumentality of a foreign country) relating to--

(A) research, development, or production of defense equipment; or

(B) the reciprocal procurement of defense items.

Annex E – Glossary And Offset Example

Actual Value of Offset Transactions: The market value of the offset transaction measured in U.S. dollars.

Co-production: Overseas production based upon government-to-government agreement that permits a foreign government or producer(s) to acquire the technical information to manufacture all or part of a U.S.-origin defense article. Co-production includes government-to-government licensed production, but excludes licensed production based upon direct commercial arrangements by U.S. manufacturers.

Credit Assistance: Credit assistance includes direct loans, brokered loans, loan guarantees, assistance in achieving favorable payment terms, credit extensions, and lower interest rates. Credit assistance is nearly always classified as an indirect offset transaction but can be either direct or indirect.

Credit Value of Offset Transactions: The value credited for the offset transaction by application of a multiplier or other method. The credit value may be greater than or equal to the actual value of the offset.

Direct Offsets: Offset transactions that are directly related to the defense items or services exported by the defense firm. These are usually in the form of co-production, subcontracting, training, production, licensed production, or possibly technology transfer or financing activities.

Indirect Offsets: Offset transactions that are not directly related to the defense items or services exported by the defense firm. The kinds of offsets that may be considered "indirect" include purchases, investment, training, credit assistance, and technology transfer.

Licensed Production: Overseas production of a U.S.-origin defense article based upon transfer of technical information under direct commercial arrangements between a U.S. manufacturer and a foreign government or producer. In addition, licensed production almost always involves a part or component for a defense system, rather than a complete defense system. These transactions can be either direct or indirect.

Miscellaneous: An offset transaction other than co-production, credit assistance, licensed production, overseas investment, purchase, subcontract, technology transfer, or training.

Multiplier: A factor applied to the actual value of certain offset transactions to calculate the credit value earned. Foreign governments use multipliers to provide firms with incentives to offer offsets in targeted areas of economic growth. When a multiplier is applied to the off-the-shelf price of a more desirable service or product offered as an offset, the defense firm receives a higher credit value toward fulfilling an offset obligation. Conversely, a negative multiplier can be applied to discourage certain types of transactions not thought to be in the best economic interest of the receiving country.

> Example: A foreign government interested in a specific technology may offer a multiplier of "six" for offset transactions providing access to that technology. A U.S. 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 equaling $1.2 million. With a multiplier of six, however, the U.S. 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.

Offset Agreement: Contract specifying the percentage of the total sale to be offset, the forms of industrial compensation required, the duration of the agreement, and penalty clauses, if any.

Offset Transaction: Any activity for which the defense prime contractor claims credit in fulfillment of the offset agreement. For the purpose of analysis, BIS divides offset transactions into nine different categories.

Offsets: Compensation practices required as a condition of purchase in either government-to-government or commercial sales of "defense articles" and/or "defense services" as defined by the Arms Export Control Act (22 U.S.C. § 2751, et seq.) and the International Traffic in Arms Regulations (22 C.F.R. §§ 120-130).

Overseas Investment: Investment arising from an offset agreement, often taking the form of capital dedicated to establishing an unrelated foreign entity or expanding a subsidiary or joint venture in the foreign country.

Purchases: Procurement of off-the-shelf items from the offset recipient. Often, but not always, purchases are indirect by nature. Indirect purchases are similar in definition to countertrade, while direct purchases are analogous to buy-backs.

Subcontract: In the offset context, overseas production of a part or component of a U.S.-origin defense article. The subcontract does not necessarily involve license of technical information

and is usually a direct commercial arrangement between the defense prime contractor and a foreign producer.

Technology Transfer: Transfer of technology that occurs as a result of an offset agreement and that may take the form of research and development conducted abroad, technical assistance provided to the subsidiary or joint venture of overseas investment, or other activities under direct commercial arrangement between the defense prime contractor and a foreign entity.

Training: Generally includes training related to the production or maintenance of the exported defense item. Training, which can be either direct or indirect, may be required in unrelated areas, such as computer training, foreign language skills, or engineering capabilities.

OFFSET EXAMPLE

This example is for illustrative purposes only and in no way represents an actual offset agreement. The fictitious nation of Atlantis purchased ten KS-340 jet fighters from a U.S. defense firm, PJD Inc. (PJD), for a total of $500 million with 100 percent offset. In other words, the offset agreement obligated PJD to fulfill offsets equal to the value of the contract, or $500 million. The government of Atlantis decided what would be required of PJD in order to fulfill its offset obligation, which would include both direct and indirect offsets. The government also assigned the credit value for each category.

<u>Direct Offsets (i.e., related to the production of the export item, the KS-340 jet fighter)</u>

Technology Transfer: The technology transfer requirement was assigned 36 percent of the total offset obligation. PJD agreed to transfer all the necessary technology and know-how to Atlantis firms in order to repair and maintain the jet fighters. The Atlantis government deemed this capability to be vital to national security and, therefore, gave a multiplier of six. As a result, the transfer of technology actually worth $30 million was given a credit value of $180 million.

Licensed production: Atlantis firms manufactured some components of the KS-340 jet fighters, totaling $240 million, which accounted for 48 percent of the offset obligation. There was no multiplier associated with this activity.

<u>Indirect Offsets (i.e., not related to the production of the export item, the KS-340 jet fighter)</u>

Purchase: PJD purchased marble statues from Atlantis manufacturers for eventual resale. These purchases accounted for nine percent of the offset obligation, or $45 million. There was no multiplier associated with this activity.

Technology Transfer: PJD provided submarine technology to Atlantis firms, which accounted for seven percent of the offset obligation, or $35 million. There was no multiplier associated with this activity.

Annex F – Interagency Team Progress Report on Consultation with Foreign Nations on Limiting the Adverse Effects of Offsets in Defense Procurement

Report of the Interagency Team on Consultation with Foreign Nations on Limiting the Adverse Effects of Offsets in Defense Procurement

November 2009

2009 Interagency Team Annual Report on Offsets

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Annual Progress Report

Interagency Working Group

Continued Dialogue on Limiting the Adverse Effects of Offsets in Defense Procurement

Mandate, Purpose and Practice of the Interagency Team

In December 2003, President Bush signed into law a reauthorization of, and amendments to, the Defense Production Act of 1950 (DPA). Section 7 (c) of Public Law 108-195 amended Section 123 (c) of the DPA by requiring the President to designate a chairman of an interagency team to consult with foreign nations on limiting the adverse effects of offsets in defense procurement without damaging the economy or the defense industrial base of the United States, or United States defense production or defense preparedness. The statute also provides that the interagency team be comprised of the Secretaries of Commerce, Defense, Labor, and State, and the United States Trade Representative.

The DPA, as amended, requires the interagency team to send to Congress an annual report describing the results of its consultations and meetings. On August 6, 2004, President Bush formally established the interagency team chaired by the Secretary of Defense. Within the Department of Defense, chairmanship was delegated to the Under Secretary of Defense for Acquisition, Technology and Logistics. The interagency team subsequently established an Interagency Working Group (IaWG) to conduct the background research and prepare for the consultations, execute the consultations, analyze the results, and write the annual reports.

Continuing the Dialogue on Limiting the Adverse Effects of Offsets

In February 2007, the third report of the interagency team was submitted to Congress as Appendix H to the Department of Commerce's 11th Report to Congress on Offsets in Defense Trade. This report was a comprehensive account of the interagency team's findings and recommendations. Since then, these same IaWG findings have been briefed to various foreign embassy representatives and US defense industry associations. Since no new findings or recommendations are anticipated, progress reports will be submitted annually as long as progress continues on limiting the adverse effects of offsets in defense procurement. This is the third annual progress report submitted since the issuance of the comprehensive, third report. The interagency

team was able to conclude that the United States is not alone in its concerns about the use of offsets in defense procurement. Other industrialized nations, which also are major providers of offsets, expressed concerns about the adverse effects of offsets on their sales of defense weapons systems. These provider nations expressed interest in a multinational dialogue to address their concerns. From both providers and demanders of offsets, most nations agree with the United States' view that there is a real cost associated with offsets.

A key recommendation of the comprehensive interagency team report was that the United States Government (USG) should continue a dialogue with nations and international organizations to promote global understanding of how the different types of offsets impact the industrial base; encourage the development of global offset principles to limit the adverse effects of offsets; and encourage countries to provide defense contractors with maximum flexibility in fulfilling offset requirements. Building upon this recommendation, the IaWG on offsets has continued a strategy of engagement with relevant parties to facilitate the dialogue on reducing the adverse effects of offsets in defense procurement.

In fulfilling its legislative mandate, the IaWG continues with a multi-faceted strategy designed to allow various foreign and domestic entities to inform the IaWG of their views regarding offsets and to offer suggestions on possible ways to help limit the adverse effects of offsets in defense procurement.

Continuing the Approach

The IaWG articulated during its December 2007 report the following two-tiered approach for the United States to continue the dialogue on limiting the adverse effects of offsets: (1) to engage offset providers that espouse similar views to those of the United States to build consensus and further common goals, then leverage combined efforts of offset providers in further dialogue with offset demanders; and (2) to engage offset demanders bilaterally to encourage flexibility in offset demands.

The IaWG also concluded that the United States should actively engage multinational organizations and continue discussions with the European Defence Agency, the North Atlantic Treaty Organization and the Letter of Intent 6 (LOI 6) nations[35]. The intent of these engagements is to limit the adverse affects of offsets in defense trade. Additionally, the United States should consider further avenues of dialogue with other multinational organizations, ministries/departments of defense, other government agencies/ ministries, industry representatives, academia, and other actors responsible for offset policies in key nations having an interest in working with the United States to continue this dialogue.

European Defence Agency (EDA) Dialogue

On March 11, 2009, the IaWG met with representatives of the EDA in Brussels, Belgium. The IaWG included representatives from Defense, Commerce and State, as well as personnel from the US Mission to the EU. During the EDA meeting, information was provided by the EDA concerning the new Code of Conduct on Offsets. Subsequent dialogue will focus on the EDA implementation of this Code especially the emerging results of data gathering. Attached to this report (Annex A) is a copy of the EDA Code of Conduct on Offsets.

The EDA Code of Conduct on Offsets (Code) entered into effect on 1 July 2009. The Code makes a distinction between EDA participating member states (pMS)[36] and subscribing member states (sMS). A pMS is a member of the EDA, regardless of its subscription to the Code. An sMS is an EDA member fully subscribing to the Code. All pMS are sMS minus Romania, which has chosen to opt out. In addition, non-EDA member Norway has subscribed to the Code. The EDA reports that sMS will have until October 15, 2010 to make national legislative adjustments necessary to implement the Code.

This Code applies only when an sMS is making a purchase under an Article 296 derogation of the European Treaty. The Article 296 derogation allows EU Members to purchase articles essential to national security outside of normal EU procurement rules, including the new EU Defense Procurement Directive.

The Code states that offsets, both required and accepted, will not exceed the value of the procurement contract. It also states that offsets will be considered of a less significant weight (or used as a subsidiary criteria in case of offers with the same weight) in order to ensure that a procurement process is based on the best available and most economically advantageous solution for the particular requirement. Finally, the Code states that the sMS will allow foreign suppliers providing offsets to select the most cost effective business opportunities within the purchasing country for the offset fulfillment (subcontracting), enabling fair and open competition within supply chains where it is efficient, practical and economically or technically appropriate.

The EDA considers the reporting and monitoring provisions of the Code to be critical to the effectiveness of the Code's working to meet the desired effects, which are:

a. Gradually reduce reliance on offsets;
b. Increase transparency; and
c. Where offsets are demanded, evolution towards use of offsets that help support the European Defense Technology and Industrial Base (EDTIB).

The Code includes purchases from the United States under the Foreign Military Sales system or through direct commercial sales. The Code applies equally in all sMS cases, and an sMS cannot discriminate against non-sMS by requiring an offset package from a non-sMS that it would not be able to require from an sMS.

The EDA will prepare a yearly Report on sMS offset activity, including data reported to the EDA by each sMS on offset agreements signed by such states and offset transactions conducted to implement offset agreements. The EDA will collect statistical data on signed offset agreements throughout the year. The EDA anticipates collecting statistical data from each sMS on offset transactions once a year, in addition to narrative information from each reporting state on "positive" and "negative" offset-related experiences from an industrial base perspective. The EDA is also finalizing templates that an sMS will use to report data to the EDA through a secure network. Each sMS has designated a national point of contact to be trained to report such data to the EDA. The EDA will provide Commerce a copy of the templates once approved by the Steering Board. Commerce will also advise the EDA if it publishes any proposed revisions to Commerce's Offset Reporting Regulation.

The EDA will only make aggregate data available to the EDA Steering Board and the concerned Member States, but not data at the transaction level. A summary might be made available to the US Government in the future, although this was left open. The purpose of the EDA report is not only to publish statistical data, but to convince nations to better use offsets to support the EDTIB (termed "intelligent offsets"). The first Report is expected to be submitted to the EDA Steering Board in April 2011 after a full calendar year of data has been reported to the EDA by all sMS. The Code could be reviewed and updated, based on findings after the first Report. Further dialogue will be scheduled between the IaWG and the EDA, after the EDA has sufficient time to effectively implement their Code of Conduct on Offsets.

European Union (EU)/European Commission (EC) Dialogue

Last year, Commerce led an interagency delegation to Brussels to meet with EU officials to discuss offsets in defense procurement in the context of the New EU Defense Procurement Directive in order to increase understanding of the initiative, assess its impact on the U.S. defense industrial base, and to continue a dialogue with EU officials as the Directive moved through the legislative process. A follow-on meeting then occurred between the IaWG and representatives from the EC on March 11, 2009, that coincided with the EDA meeting that same day. During the meeting, both sides discussed the trans-Atlantic impact of this Directive, approved by the European Parliament on January 14, 2009.

Although it does not explicitly mention offsets, the Directive has as its objective the creation of a more competitive and transparent internal market for defense procurements in the EU. As a practical matter, achieving this objective would result in fewer instances where Article 296 of the EC Treaty is invoked to enable procurements to proceed without regard to the normal EU requirements for competitive procurements. Originally intended to apply to relatively few highly specialized defense requirements, Article 296 has in the opinion of the EC been used increasingly to avoid international competition.

The IaWG will pursue further dialogue with the EC representatives on the results of limiting the use of Article 296 exemptions.

LOI 6 Multilateral Dialogue

As reported in the December 2007 report of the interagency team annual report on offsets, on November 6, 2007 the IaWG engaged in dialogue on limiting the adverse effects of offsets in defense procurement with the LOI 6. Two representatives of the EDA were in attendance as observers. The dialogue was conducted in Madrid, Spain, as Spain then chaired the LOI 6. At the conclusion of the dialogue, there appeared to be a consensus that further dialogue among offset providing nations was warranted. The IaWG agreed to provide additional information and clarification regarding continued dialogue on offsets, and re-engage the LOI 6 at a later date.

In July 2008, the former chairman of the LOI 6 wrote back to the chairman of the IaWG. The former LOI 6 chairman stated that he is in favor of further USG/LOI 6 dialogue on offsets. He also informed the IaWG chairman that as of July 1, 2008, Italy assumed the chair of the LOI 6 from Spain. The IaWG responded that they intended to engage the LOI 6 at the margin of the LOI 6 meeting in Spring 2009.

The IaWG met with the LOI 6 in Italy on May 19, 2009. The main topic for discussion was the LOI 6 views on the new EDA Code of Conduct on Offsets. There was also discussion on expanding the dialogue beyond offsets. This expansion includes a further discussion on export controls, as well as other items related to cooperation between the US and LOI 6 nations.

Bilateral Dialogue with Canada

On September 2, 2009, members of the IaWG met with the Director of the Industrial Regional and Benefits Industry of Canada at the Department of Commerce. The main topic of discussion was changes to their Industrial Regional and Benefits (IRB) Policy, as well as guidelines of implementation. Canada presented their enhanced IRB policy and stated that it will remain supportive of its two main principles: 1. All Client Department operational requirements must be met. 2. All IRB transactions must make business sense to all parties involved. This includes offsets not exceeding 100% of the value of the contract. Setting the parameters to this policy, these principles would apply to major defense or security procurements valued at over $100 million Canadian Dollars. The overall Canadian goal would be to have a long term industrial and regional economic development strategy. Canada is implementing this new policy due to its new "Canada First" Defense Policy, which is expected to result in a substantive increase in defense procurement over historical levels

To implement this strategy, Canada is also remaining committed to the current set of IRB eligibility criteria:

- **Causality:** ***Benefits must be brought about due to IRB obligation to Canada.*** The work would not have been placed in Canada otherwise.

- **Timing:** ***Benefits must be completed within the contract period.*** Benefits must be accrued within a fixed time period.

- **Canadian Content Value:** ***Only Canadian Content of work is credited towards the IRB obligation.*** Only Canadian Labor and Canadian materials.

- **Incrementality:** ***Must be NEW work in Canada.*** Existing work, even if causal under the IRB policy, is not admissible.

- **High Value-Added Activities:** ***Benefits must be high value- added and sustainable in nature.*** Similar or higher level of technology and/or services as being procured.

The Government of Canada announced the updated IRB Policy on September 24th 2009. Changes are posted on the IRB website at www.ic.gc.ca/irb.

European Union/European Defence Agency Conference

On September 3, 2009 the Departments of Commerce, State and Defense members of the IaWG attended a one day conference at the Institute for Defense Analysis (IDA) concerning the current and future state of US/EU/EDA acquisition, technology and logistics in defense procurement. The conference was sponsored and hosted by the Chairman of the IaWG, and EDA representatives including the Chief Executive of the EDA. Presentations included the implications of EU reforms in the broader context of transatlantic defense industrial cooperation, EDA-US armaments dialogue, and issues in future European defense.

Also included was a presentation on EU reforms in defense procurement and export controls given by a DOC representative of the US Mission to the EU. This presentation further clarified to the IaWG a European perspective on the role of the EU Defense Procurement Directive and the EDA Code of Conduct on Offsets. Most notable was the point that the EU Defense Procurement Directive now targets indirect non-military offsets, with the aim of eliminating them, and offsets linked to subcontracting practices.

Future Activities

Dialogue with foreign nations should continue take place into 2010 and beyond on limiting the adverse effects of offsets in defense procurement. Notional measures of success will be largely contingent upon the outcome of such meetings, and nations' responsiveness to these cooperative

endeavors. Ultimately, the goal for continuing the dialogue is to achieve multilateral agreement on the creation of principles which will serve to limit the adverse effects of offsets and encourage flexibility and equitable treatment for all participating nations.

In addition, the IaWG, with the cooperation of the EC, will monitor usage of the Article 296 "national security" exception that allows a member to conduct a procurement without applying the current EU government procurement directive and/or the new Defense Procurement Directive when it enters into force (members will have two years to amend national laws to reflect the new Directive and an additional year for entry into force). Implementation of the EDA Code of Conduct and the EU Defense Procurement Directive will be key in limiting the adverse effects of offsets. The IaWG will also continue to request the EDA to provide its statistics on offsets.

ANNEX A: The Code of Conduct on Offsets

Brussels, 24 October 2008

Introduction

Participating Member States (pMS) of the European Defence Agency strive to ensure that their Armed Forces are supported, and, indeed, that the European Security and Defence Policy is underpinned by a strong and globally competitive defence technological and industrial base. To this end, the European Defence Ministers adopted on 14 May 2007 a landmark Strategy for the European Defence Technological and Industrial Base (EDTIB). This Strategy reflects the clear and unequivocal objective of the pMS to develop and sustain a DTIB in Europe that is capability–driven, competent and competitive. Moreover, pMS have agreed to develop a truly open and competitive European Defence Equipment Market (EDEM) as a key means to strengthen the EDTIB, "which ensures security of supply and dependably supplies pMS Armed Forces' needs even in times of conflict, and which provides for appropriate national sovereignty and EU autonomy".

The pMS share the ultimate aim to create the market conditions, and develop a European DTIB in which offsets may no longer be needed. Nonetheless, the present structure of the European DTIB and our early open market efforts require, in the short term, evolving offsets, compatible with EU law, whilst mitigating any adverse impact they may have on cross-border competition.

Objectives and scope

The Code of Conduct on Offsets sets out a framework for evolving offsets, whilst ensuring the right balance between developing the EDTIB and the need to achieve a level playing field in the European and global defence market.

This voluntary, non-legally binding Code of Conduct on offsets applies to all compensation practices required as a condition of purchase or resulting from a purchase of defence goods or defence services. It is therefore an integral part of the European Defence Agency's Regime to encourage competition in the European Defence Equipment Market and it also encompasses Government-to-Government off-the-shelf defence sales.

The principles and guidelines of this Code will be applied equally to all bidders from sMS and non-sMS including third countries.

Overarching Principles

Within the framework of EU law, the subscribing Member States (sMS) commit themselves to implement this Code on the basis of the following principles:

Procurement in the defence market remains different than procurement in purely commercial markets and is strongly influenced by political considerations that affect the level playing field.

In a perfectly functioning market offset would not exist. Nevertheless, we recognise that today's defence market is not perfect. Therefore, as a first step, we have to develop and implement measures to both mitigate any adverse effects of offset in our collective endeavour towards developing a fair and competitive EDEM and to use offsets mainly to help shape the aspired EDTIB of the future.

The effects of offset on EDEM and EDTIB should not be considered in isolation. There are other, not offset-related, practices distorting the European and global defence market and influencing the development of the EDTIB that need to be addressed by the Agency and pMS through various work-strands.

Offsets are a global phenomenon, required and offered for many purposes, and unlikely to abate in the foreseeable future. Hence, while addressing offset on the EU level, cognisance will need to be taken of the global practice of offset and in particular the involvement of third parties and their effect on European industry competitiveness.

Guidelines

This Code of Conduct on Offsets sets out the guidelines that will help us progress towards closer convergence of offset policies and practices and to gradually reduce the use of offsets. The following guidelines will apply equally to all compensation practices within the scope of the Code.

Increased transparency:

−To increase transparency and mutual confidence, the sMS will provide to other sMS through the Agency information on national offset practices and underpinning policies, where they exist. Each sMS will regularly review the information it has provided to ensure that it remains current.

–The sMS will provide the Agency with information on all offset commitments (including the percentage and types of accepted offset) with effect from the implementation date of this Code, whether part of the procurement contract or agreed upon otherwise.

Evolving use of offsets:

–Offsets will be used to help develop industrial capabilities that are competent, competitive and capability driven. Therefore, offsets will help shape the aspired EDTIB of the future, notably by facilitating the development of globally competitive Centres of Excellence and avoiding unnecessary duplication.

–Offsets should, wherever possible, contribute to developing depth and diversity of the European defence-related supplier base, in particular by supporting the full involvement of SMEs and non-traditional suppliers in the EDTIB, fostering the industrial cooperation and help promote efficient and responsive lower tier suppliers in line with the principles of the CoBPSC.

–Evolving use of offsets by the sMS will help ensure the right balance between developing the aspired EDTIB and the need to achieve the level playing field in the EDEM. Therefore:

- Those sMS requiring offsets as part of the defence equipment contract will clearly stipulate offset requirements in the contract notice.
- Those sMS accepting offsets will make clear from the outset if offset is a factor in the consideration of a company's bid during the procurement process.
- When used as a criterion for tenderer selection or award of contract, offsets will be considered of a less significant weight (or used as a subsidiary criteria in case of offers with the same weigh) in order to ensure that a procurement process is based on the best available and most economically advantageous solution for the particular requirement.
- Offsets, both required and accepted, will not exceed the value of the procurement contract.
- The sMS will allow foreign suppliers providing offsets to select the most cost effective business opportunities within the purchasing country for the offset fulfillment, enabling fair and open competition within supply chains where it is efficient, practical and economically or technically appropriate.
- The sMS will use, wherever practicable and on a voluntary basis, mutual abatements to reduce reciprocal offset commitments.