

The Impact of Offsets on Defense Related Exports

by

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[The following are comments presented in a Security Assistance Seminar sponsored by The Dayton Council on World Affairs, June 2, 1988 by Mr. Hessler, Business Manager, Information Systems Division, The Boeing Company.]

The aerospace industry is, today, faced with ever increasing demands for offsets as a requirement by buyer countries in connection with their purchase of defense equipment. As pointed out in a recent article on the topic, "Defense offsets have come to look something like the bids in a poker game. . ."[1] [Editor's note. The term *offset* refers to a practice whereby a buyer requires compensating purchases, investments, etc. from a seller, thereby *offsetting* some mutually agreed upon portion of the cost of the original purchase. *Direct offsets* involve required purchases by the seller which are directly related to the seller's product; e.g., a U.S. aircraft company agrees to employ subcontractors from the purchasing country to produce components (landing assemblies, rudders, etc.) for the aircraft that are being sold. *Indirect offsets* involve compensation in goods or services which are unrelated to the items being sold; e.g., the U.S. aircraft company agrees to purchase oil, minerals, manufactured goods, etc. In many cases, sales arrangements have incorporated requirements for both types of offsets.]

Although Boeing has had experience with offsets since the late 1960s in marketing our commercial airplanes, a major offset program in a military context only first occurred with our successful bid in 1978 to sell the AWACS (Airborne Warning and Control System) to NATO. Offsets became an important ingredient in that competition, the objective being to put a pre-determined amount of business back into the NATO countries participating in the purchase.

Boeing has since encountered offsets in many foreign competitions. Two of the most significant were the sale of the Peace Shield ground command and control system to Saudi Arabia and the sale of AWACS to the United Kingdom and France.

These sales, together with a number of other large contracts for military equipment within the industry, for example the F-18 sale to Canada, the 5 billion dollar plus sale by the United Kingdom of Tornado aircraft to Saudi Arabia, and the F-15 co-production agreement by McDonnell Douglas with Japan, serve as clear illustrations that the growth of offsets as an element of defense sales is very real, that the magnitude of individual offset demands have increased, and that the practice is likely to continue.

In reading about the 1987 AWACS sales by Boeing to France and the United Kingdom involving offsets equal to 130 percent of contract value, I am certain that many of you must have found yourselves asking one or more questions: Why would Boeing agree to such a high percentage of offset? What direct effect will fulfillment of these commitments have on U.S. jobs? Assuming there is technology transfer involved, what long term effect will such arrangements have on the ability of U.S. industry to compete with U.K. and French industry.

These questions, as well as warnings from U.S. government circles about the potential downstream negative effects of offsets, raise very legitimate issues. I will attempt in my remarks to address these issues, in general, and to offer a Boeing perspective based on our actual experience to date, a perspective which I believe is shared by the aerospace industry as a whole.

However, before continuing, I would like to clarify several points as a foundation for my remarks. First of all, when we talk about "offsets" within Boeing, we are generally referring to any international business arrangement of a reciprocal nature tied to the sale of Boeing products or services. The offset could involve procurement, co-production and licensing, a joint program, equity investments, technology transfer, or the barter of goods. This broad concept of "offsets" is generally accepted in both industry and government circles. So far, in Boeing's case, offsets in connection with the sale of defense equipment has taken one of three forms:

1. Purchase of materials, parts, or subassemblies for use in the product which was the subject of sale, sometimes termed "direct offset" (e.g., NATO).
2. Purchase of a specified amount of related goods and services, or "indirect offsets" (e.g., U.K. and French AWACS).
3. Investment of a specified amount in the buying country's industry (e.g., Saudi Arabia).

The second point of clarification is that, while technology transfer is often mentioned in the context of offset, the form of offset may involve little or no transfer of technology and know-how, particularly in those developed countries with mature industries of their own (like France and the U.K.) where the primary objective is more jobs in high technology industries.

Finally, it should be kept in mind that, by its very nature, an offset requirement by a specific country is generally consistent with one or more stated national objectives. For example, France tailored its offset for AWACS to emphasize capability in identified areas (i.e., helicopters, missiles, space, and electronics). On the other hand, the Saudi offset program is designed to create high technology businesses consistent with that country's long-term objective to provide jobs for highly educated nationals.

In addition to meeting national objectives, offsets can serve, as in the U.K. AWACS transaction, as a means by government to pacify local industry for having favored a foreign manufactured product over a competing U.K. product (the Nimrod). In other words, the motivation behind offset demands is always highly political in nature and this factor cannot be ignored.

I would like now to discuss in some detail the offset commitments which Boeing made in connection with the AWACS sales to NATO, the U.K., and France, as well as the Peace Shield investment program with Saudi Arabia. I think these transactions serve well to illustrate the evolution of offsets in Boeing's marketing efforts, which pretty much typify the phenomenon our industry is experiencing as a whole.

Twelve countries participated in the memorandum of understanding leading to the purchase by NATO in early 1978 of 18 AWACS airplanes. The genesis of the NATO AWACS program goes back to initial meetings in 1970 and a series of complex multilateral negotiations in the ensuing 8 years. Two signatories, the Federal Republic of Germany and Canada, tied their funding contributions to industrial collaboration. Following a comprehensive survey of industry in those two countries, Boeing was able to define subcontract offset packages which satisfied their national objectives.

The arrangements for subcontracts for the offset portion of the NATO contract were consistent with Boeing's offset policy, which is still in effect today, and to which I will make occasional reference. Simply stated, it is our policy not to solicit offsets; rather, we will only agree to consider such arrangements when we are convinced that we have no other choice if we want to

win the competition. Further, we generally negotiate offsets on the basis of satisfying as much of the total commitment as possible through direct procurement for the program involved. Finally, we strive to keep the percent of offset to a minimum, yet in balance with what we feel is required in terms of both the political and economic considerations surrounding the competition.

From our standpoint, we look back on the NATO AWACS program, including the offset arrangement, with some pride for a job well done. I should hasten to add, it was an accomplishment in which both the USAF and DOD share, for cooperation from both was essential to successfully conclude the contract.

Although the Saudi Arabian Peace Shield contract was the next chronologically, I am going to bypass it for the moment in order to talk first about our other AWACS sales entailing offsets for two individual NATO countries--those to the U.K. and France which were awarded to Boeing in February 1987 after an extensive competition. (These two countries had earlier opted not to participate directly in the NATO purchase in light of their own national objectives.)

These two transactions received a lot of attention in the press on both sides of the ocean. First of all, there was the unprecedented 130 percent offset for each country. Secondly, Boeing was faced with a huge wave of public sentiment in both countries against an American buy. Although the Boeing AWACS demonstrated superior capability, it was clear from the outset that national pride was as much at stake as system performance. The British had invested heavily in the Nimrod and there was, quite understandably, an extremely high level of political and public sensitivity about buying an American product with a resultant loss of business and jobs by U.K. and French industry. In essence, the outcome turned on the business arrangement. Boeing believed that in order to overcome very substantial competitive obstacles, we had to make an unusually attractive offset offer that would eliminate, or at least reduce, the bow-wave of public and hence political, resistance. A similar arrangement was then concluded with the French who were also negotiating to purchase AWACS.

At this point, it would be fair to ask: "How does the 130 percent offset commitment square with Boeing's internal offset policy?" which I outlined earlier.

There were a number of factors which tended to mitigate the high percentage. First, all purchases made pursuant to this commitment are subject to competitive terms and conditions, so it is far from a give-away subsidy program. Secondly, it is important to realize that Boeing and its subcontractors, who participate fully in fulfilling Boeing's commitment, historically purchase a high volume of parts, subassemblies and engines for the airplane and other aerospace production from both the U.K. and France on competitive terms. Thirdly, about 10 percent of the offset value will be directly related to the AWACS purchases themselves. Finally, the period of performance has been established at more than 8 years, with the possibility of extension.

All these factors taken together, weighed heavily in our decision to offer 130 percent offset.

I would be less than candid if I did not acknowledge another key consideration in our willingness to agree to such a high percent. The British and French sales were key to the continued viability of the Boeing AWACS program. The last Saudi AWACS was delivered in 1986 and, without some firm commitments, the production program, which utilizes a Boeing 707 airframe no longer sold commercially, would have ended. The sales to the U.K. and France saved some 2000 jobs at Boeing, as well as avoided a resultant negative impact on a large number of Boeing suppliers. The largest subcontractor, Westinghouse, estimated that failure to win this competition would have affected 700 jobs directly. The successful conclusion of these contracts and the resulting extension of the AWACS program, enhance Boeing's opportunity to market this

system to other countries (Italy, Spain, Japan, Australia, Sweden and Pakistan), thus preserving the jobs dependent upon its success.

The U.K./French offset programs serve as the best examples of how misleading the announced percentage level of offset can be. They also serve well to illustrate that offset terms are set both by the marketplace as well as by politics and public pressure. In this regard, I would like to quote Mr. Joel Johnson, Vice President of the American League for Exports and Security Assistance: " For the U.S. company making a sale, its negotiating objective is to come up with the largest offset number possible with the minimum actual performance requirement. In many cases, the government purchasing the U.S. product may also decide that an inflated offset number is politically desirable as the country wants the product with a minimum domestic political cost."

The offset commitment by Boeing and its major subcontractors as a condition precedent to winning the \$1.2 billion Peace Shield contract in Saudi Arabia offers yet a third example of the evolution of offsets as experienced by Boeing.

After successfully winning the sale of AWACS to the Kingdom in 1981, a sale which involved no offset, Boeing found itself bidding for the Peace Shield contract consisting of a sophisticated ground air defense system designed to complement the AWACS and to coordinate the Saudi air defense system. The offset program, drawn up by the Saudis, called for the winner of the Peace Shield contract to also be responsible for starting a number of high technology aerospace related manufacturing and engineering firms in the Kingdom. This is, when you think about it, a revolutionary idea.

Quantitatively, the offset investment was specified at 35% of the technical content of the Peace Shield contract.

We finally elected to bid on the contract because we convinced ourselves that the investment contemplated under the offset program was realistic and could net us an attractive return on our money.

Since winning this important contract, the Boeing team, consisting of Westinghouse, ITT, Frank Basil and Company, and the Saudi Amudi Group, jointly with Saudi investors have formed four Saudi companies. These companies will become operational in 1988 and will offer high technology jobs in the fields of aircraft repair and modification, electronics, aircraft component overhaul, and computer services. The total value of the Boeing team debt and equity investment to satisfy the offset commitment will be in the neighborhood of \$30 million, which will be matched by Saudi Arabian investors. However, we are anticipating a good return on this investment based on the business projections for the joint ventures.

As you can appreciate from my remarks thus far, each of the above offset commitments by Boeing arose in the context of very special circumstances unique to each competition and were driven by the national objectives of each of the countries involved. Consequently, the trade-offs involved, including those benefits to U.S. industry, varied with each deal.

Although industry has had great difficulty with the dilemma presented by offsets, we have preferred thus far to deal with the issues on our own without direct government intervention.

Yet, we have now reached a point in time when members of our own government are showing a great deal more concern about offsets and are vocal about various alternatives which could effectively curb the growth of offset demands in connection with defense contracts.

On one side of the spectrum, Congress has shown increasing interest in focusing on whether offsets result in the loss of U.S. jobs, technology transfer establishing future competition to U.S. industry, and erosion of the defense industrial base. Various bills have been proposed which have as a central theme the control of U.S. industry and the requirement of "reciprocity" from countries demanding offsets. The latest bill proposed by Senator Dixon of Illinois (S.1892) [2] includes a section requiring DOD to establish an offset policy and begin multilateral negotiations with countries requiring offsets to end the practice.

The Senate Armed Services Committee has warned that offsets threaten the interests of U.S. industry and should be eliminated. As part of its proposed FY 1989 defense authorization bill, the same Senate committee would prohibit the transfer of U.S. technology in offset deals "if the agreements would significantly affect the U.S. industrial base and would result in a substantial financial loss to U.S. firms."

At the other extreme, DOD has thus far maintained its traditional role of avoiding any direct involvement in offsets except as an advisor on the issuance of any related export licenses for technology transfer. However, in April of this year, Defense Secretary Carlucci, speaking with the apparent endorsement of Secretary Shultz and Secretary Verity, openly called for multilateral negotiations to halt the spread of offsets. At the same time, Carlucci also reflected the Administration's adamant stance against unilateral sanctions, a position which the defense industry strongly supports.

In mentioning the attention in Washington to offsets, I should not fail to also mention the Third Annual OMB report on offsets, released in January of this year. In its report, OMB focused on the U.K. and French AWACS transactions. Although the report contained a balanced account of the advantages and disadvantages flowing from the arrangements, one of its conclusions is without meaning; i.e., that absent politics, the AWACS could have sold itself. There are always politics in connection with offsets, and as I have tried to illustrate in my remarks on the U.K./French deals, we could not have won if the political factors had been ignored. [A reprint of the OMB report appears in *The DISAM Journal*, Spring, 1988, under the title, "Recent AWACS Sales: A Case Study of the Impact of Defense Exports," pp. 87-100.]

There is a large segment of our industry which feels that offsets are not as important as some in Congress and the Executive Branch believe in terms of technology transfer and future competition. Generally, most firms, and this would include Boeing, believe we are in the best position to judge what is needed to win a particular competition and, if technology is involved, then what technology can be transferred without jeopardy to our future competitive position. On the jobs issue, no U.S. company would favor "exporting U.S. jobs," everything else being equal. However, we feel that there is a case to be made for winning contracts and thus on balance preserving and increasing U.S. jobs.

Frankly, it is my personal belief that the solution to offsets does not lie with legislation. Any legislation, no matter how well intended, is likely to lead to further complications rather than relief. For example, the requirement proposed by the Senate Armed Services Committee in its FY 1989 Authorization Bill that the Secretary of Defense establish a comprehensive offset policy bothers me. This proposal is an open invitation to regulation in an area where regulation can only lead to controls over U.S. industry's freedom to compete effectively in the world market. I simply do not believe that tying industry's hands or burdening it with reporting requirements is the answer to the offset issue. Reporting the details of offset transactions as proposed in various bills will only lead to further notoriety and could escalate future offset demands.

Offset is a concern of international proportions. It is too politically and economically sensitive to be dealt with other than by artful negotiation in the give-and-take of multilateral trade discussions. The mechanisms for such discussions are already in place. Nothing new need be created. If it really wants to help, our government need only utilize the existing structure for trade negotiations and/or disputes. In this sense, I favor Secretary Carlucci's recent proposal.

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To sum up, it is our belief, and this a belief generally held throughout the aerospace industry, that offsets are here to stay. Given this reality, it should remain within the purview of U.S. firms faced with offset demands to negotiate a realistic agreement in each instance in light of all relevant circumstances, including all competitive considerations. Industry is, after all, going to do everything reasonable to win a competition. As the U.K./France AWACS experience illustrates, the terms of offset will be adjusted to meet the political reality existent in the buying country. More importantly, winning that particular competition adequately demonstrated that U.S. jobs were retained by extension of the AWACS program, and purchases made in the U.K. and France will only be secured under terms and conditions which are competitive in the marketplace. We believe that absent the flexibility to negotiate a tailored offset arrangement, the AWACS sales to the U.K. and France would have been lost to the Nimrod.

Intervention by the U.S. Congress, no matter how well intended, will in all likelihood lead to undesirable results. It is important that Congress not lose sight of the fact that export sales involving offsets are better for the economic health of our industry as well as for the preservation of the defense industrial base than no sales at all.

Finally, we support the current administration's position that the mechanism for controlling the spread of offsets lies, not with unilateral action, but with multilateral and enforceable trade negotiations among those industrialized nations which are demanding offsets.

Notes:

- 1 "Upping the Ante in the U.S. Defense Trade," *Countertrade & Barter*, Oct/Nov, 1987.
2. Defense Industrial Base Preservation Act of 1987.