Appendix F: Glossary and Offset Example

GLOSSARY AND OFFSET EXAMPLE

***Offsets*:** Industrial compensation practices required as a condition of purchase in sales of defense articles and/or defense services.

***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. These are also the required categories for the offset reporting requirement.

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.

***Subcontractor Production*:** 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.

***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.

***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.

***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.

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

Investment: Investment arising from the offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country.

Marketing: Marketing assistance to foreign companies in either defense or unrelated industries. In some cases, countries require marketing in addition to the offsets. Also encompasses export assistance.

Other: Any other form of offset required or offered by a defense company/foreign government.

Offset Recipients: Foreign firms that receive the benefits of offset transactions from defense firms. For example, a U.S.

company sells a defense item to a foreign country, with an offset obligation requiring that components worth 50 percent of the export contract be built in the foreign country. The foreign companies manufacturing these components would be the "offset recipients."

Offset Fulfiller: The company that provides the offset compensation, which is usually the defense firm who signed the offset agreement. However, there are times when the obligation is not related to the defense firm's specialty and therefore is contracted out. For example, if marketing is a component of the offset requirement, the defense firm may hire a marketing company to satisfy the obligation. The marketing firm would then be the "offset fulfiller."

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

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.

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.

> 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.

***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 are considered "indirect" include purchases, investment, training, financing activities, marketing/exporting assistance, and technology transfer.

Penalties: Measures used to motivate defense firms to fulfill their offset obligation within the timeframe allotted by the contract.

Liquidated damages: If a firm fails to fulfill all required offsets by the stipulated deadline, it must pay a percentage (usually 5-20 percent) of the total value of the export contract. The percentage for liquidated damages is specified in the contract.

Non-performance penalties: Firms must pay a prearranged percent (2-10 percent) of all obligations not fulfilled within the allotted time.

***Best efforts clauses*:** With a "best efforts" clause, there is no penalty for non-fulfillment of the contract; the firm is judged to be acting in good faith to meet its obligations. However, firms' reputations can be jeopardized if offset obligations are not fulfilled as stated in the contract; non-fulfillment would likely result in the U.S. defense firm being excluded from future procurements by that purchasing government.

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 compensation. The government also assigned the credit value for each category.

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

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.

Co-production: Atlantis firms manufactured some components of the KS-340 jet fighters, totaling $220 million, which accounted for 44 percent of the offset obligation.

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

Purchase: PJD purchased marble statues from Atlantis manufacturers for eventual resale. These purchases accounted for 7 percent of the offset obligation, or $35 million.

Financing Activities: PJD made investments in non-defense related industries in Atlantis; this accounted for 4 percent of the offset obligation, or $20 million.

Technology Transfer: PJD provided submarine technology to Atlantis firms, which accounted for 6 percent of the offset obligation, or $30 million.

Marketing: Commercial assistance was provided for Atlantis fisheries to market their fish in the United States, which fulfilled the remaining 3 percent, or $15 million of the offset obligation. In this example, the Atlantis fisheries are *offset recipients* because they received marketing services for their product. PJD hired an American advertising firm, the *offset fulfiller*, to market the Atlantis fish.

The duration of the offset agreement was 10 years with a three-year grace period. A timetable was created by the Atlantis government outlining which obligations should be fulfilled, to what extent, and when. If PJD did not meet the deadlines given, the company was required to pay the Atlantis government 5 percent of the unfulfilled offset amount in liquidated damages. For example, if after 10 years, only 98.5 percent of the offset obligation of $500 million was fulfilled, PJD would be required to pay liquidated damages in the amount of 5 percent of the 1.5 percent unfulfilled portion of the offset obligation, or $375,000.