



Extract from the report to the
Public Accounts Committee on
offsets imposed by Denmark on
foreign suppliers of defence equipment

April
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I. Introduction and conclusion

1. This report is about offset when contracts are placed with foreign suppliers of defence equipment. Offset is the counter-purchase obligation imposed by Denmark on foreign suppliers of defence equipment to buy defence-related products from Danish companies. Offset is a means of promoting industrial growth and is also in Denmark referred to as Industrial Co-operation (IC).

2. In Denmark, the Danish Enterprise and Construction Authority (DECA) under the Ministry of Economic and Business Affairs is responsible for negotiating, entering and managing IC contracts. A circular issued by the Ministry of Economic and Business Affairs defines the tasks that the Danish Defence (Defence) is required to perform. Tasks include keeping DECA informed of procurements of defence equipment from foreign suppliers to ensure that IC contracts may subsequently be entered into with the suppliers. The Danish Defence Acquisition and Logistics Organization is procuring civilian and military equipment on behalf of the Ministry of Defence and is also performing the tasks imposed on the Defence in relation to IC contracts.

3. Rigsrevisionen took the initiative to the examination in March 2010.

4. Offset is a global phenomenon that occurs in most small European countries also. The objective of entering offset contracts is to sustain national production of defence equipment and to put the national defence industry on an equal footing with industries in large European countries and in the United States.

Denmark has requested offsets as part of government defence procurements since the acquisition of the Draken fighter aircraft in the mid-1960s in order to support Danish defence-related companies and ultimately create jobs in Denmark. Thus offset obligations have been part of Danish defence procurements for more than 40 years, and in the course of the two Defence Agreements covering the periods 2000-2004 and 2005-2009, respectively, the Defence has entered IC contracts worth close to DKK 20 billion.

5. According to the Circular on Industrial Co-operation (the IC circular), DECA is required to enter IC contracts with foreign suppliers covering 100 per cent of the value of the contracts, when the Defence is procuring defence equipment from foreign suppliers worth in excess of DKK 25 million. Procurements worth less than DKK 5 million are below the threshold limit. For procurements between DKK 5 million and DKK 25 million, the foreign supplier commits to signing a proper IC contract if the value of the equipment delivered exceeds DKK 25 million within a five-year period. 1 November 2010, the Ministry of Economic and Business Affairs increased this threshold from DKK 25 million to DKK 50 million.

According to the IC circular, the following procurements do not imply any offset obligation:

- used equipment;
- civilian equipment;

Danish Defence

Is a collective designation for all the authorities under Defence Command Denmark including the Danish Defence Acquisition and Logistics Organization, which is responsible for procurement of civilian and military equipment.

Defence Agreement

The development of the Danish Defence is governed by five-year political agreements referred to as defence agreements. Based on the expectations of the political parties behind the agreement to developments in security and defence policy, the agreement prioritizes the tasks that the Danish Defence is required to perform over the course of the agreement. Also the defence budget is determined in the agreement, and it may also include instructions on structural development of the Danish Defence.

- project administration and documentation, official journeys and training in relation to tender activities;
- building and construction works.

The Ministry of Economic and Business Affairs and the Ministry of Defence have in the period 2008-2010 discussed the interpretation of the regulations governing Industrial Co-operation and agreed on the future offset practice in June 2010.

6. The objective of the study is to assess whether the Ministry of Defence and the Ministry of Economic and Business Affairs in the period 2007 to mid-2010 have ensured that the offset policy had the intended effect. Rigsrevisionen's assessment is based on the answers provided to the following questions:

- Has the degree to which the Defence in the period 2007 to mid-2010 complied with the regulations of the Circular on Industrial Co-operation been satisfactory?
- Has the degree to which the Ministry of Economic and Business Affairs and the Ministry of Defence contributed to establishing a joint interpretation of the offset regulations been satisfactory?

MAIN CONCLUSION

Denmark has requested offsets as part of government defence procurements since the 1960s in order to sustain a certain defence-related industry and secure jobs for Denmark. In 2005, offsets were authorised in the Industrial Promotion Act and a circular instructing the Defence to inform the supplier of the offset obligation and inform DECA of contract signing to ensure that IC contracts may subsequently be entered with the foreign suppliers. In the course of the two Defence Agreements covering the periods 2000-2004 and 2005-2009, respectively, the Defence has entered IC contracts worth almost DKK 20 billion.

The Defence has in the period 2007 to mid-2010 not to a satisfactory degree complied with the regulations of the IC circular. As a consequence of the practice followed by the Defence, Denmark has not leveraged offsets to the extent prescribed in the circular.

In June 2010, after having negotiated for two years, the Ministry of Economic and Business Affairs and the Ministry of Defence entered an agreement on the future offset practice, which makes it clear that the Defence is required to inform DECA of all defence procurements from foreign suppliers, and that DECA is authorised to determine the offset quota.

In principle, Rigsrevisionen is of the opinion that discussions of future practice should not have suspensory effect on current regulations. Rigsrevisionen therefore finds it unsatisfactory that the Ministry of Defence did not ensure that the Defence complied with the existing regulations during the two-year discussion period.

Rigsrevisionen finds the course of events very unsatisfactory and considers the handling of offset in the period 2007 to mid-2010 illustrative of the importance of recognizing the special challenges that may arise when several authorities under different remits are required to cooperate.

The main conclusion is based on the following findings:

Defence's compliance with the IC regulations

The Defence has in the period 2007 to mid-2010 not to a satisfactory degree complied with the regulations of the IC circular, as the Defence – for other reasons than those stated as legitimate exemptions in the circular – failed to inform DECA of contracts placed with foreign suppliers of defence equipment. As a consequence of the recording practice of the Defence, it has not been possible to establish in how many instances the Defence failed to inform DECA about contracts. As a consequence of the practice followed by the Defence, Denmark has not leveraged offsets to the extent prescribed by the IC regulations.

Information provided to DECA

- Rigsrevisionen's audit of the offset obligations in relation to 10 projects that were disputed by the Defence and DECA shows that the Defence in only one particular case informed DECA that it was planning to sign a contract with a foreign supplier. In the remaining cases, DECA either actively sought information on contracts signed by the Defence, or was informed hereof by the foreign supplier.
- Rigsrevisionen's audit of a statement prepared by the Defence listing 55 contracts entered with foreign suppliers worth in total approximately DKK 2 billion also shows that the Defence informed DECA only of eight contracts, representing approximately 20 per cent of the total contract value. Rigsrevisionen is aware that these 55 contracts may include also contracts that are exempted from the offset obligation according to the IC circular. Yet, Rigsrevisionen concludes that the information provided to DECA by the Defence was inadequate.
- Rigsrevisionen finds it unsatisfactory that the Defence failed to inform DECA when defence equipment was procured from foreign suppliers. Rigsrevisionen is of the opinion that offsets have not been leveraged to the extent prescribed by the IC regulations.

Exemptions from the offset obligation

- The Defence and DECA interpreted the offset obligation differently, and on the basis hereof the Defence exempted seven types of equipment from the offset obligation. Among the exemptions made by the Defence were spare parts for recently procured rifles, helicopter motors and training of personnel for the Danish Air Force's Hercules aircraft carriers. DECA found that none of the equipment and/or services should have been exempted from the offset obligation.
- In 2010, the Minister of Economic and Business Affairs exempted procurement of spare parts for the EH-101 helicopters from the offset obligation. In the opinion of Rigsrevisionen, the Ministry of Economic and Business Affairs should consider incorporating a dispensation section in the circular, specifying the circumstances in which exemptions can be granted. The Ministry has informed Rigsrevisionen that procedures for dispensation from the offset obligation will be specified next time the Ministry is revising the IC circular.

Statement of offset obligations

- According to Rigsrevisionen's review of 10 projects, worth in total DKK 599 million, that were disputed by the Defence and DECA, the Defence estimated the suppliers' offset obligation at approximately 41 per cent, whereas DECA estimated the offset percentage at 96 per cent of the total contract value.
- The audit also shows that as per 1 February 2011, DECA has succeeded in signing offset contracts worth in total DKK 294 million of the total contract value of DKK 599 million, which is a 19 per cent increase over the Defence's estimate of the offset obligation. DECA has, for instance in connection with the procurement of rifles, signed offset contracts worth DKK 110 million, thereby exceeding the Defence's estimate of the offset value by DKK 37 million.
- The Defence did not state the reasons for its decision to deviate from the regulations of the IC circular, but referred to the fact that the defence procurements did not fall within the scope of the IC circular, because they concerned new equipment, civilian equipment, or were of an intangible nature.
- The recording practice followed by the Defence makes it impossible to produce a statement of all contracts signed with foreign suppliers in the period 2007 to mid-2010. According to Defence Command Denmark one of the reasons for the incomplete recording is that the Defence has not consistently adhered to the existing procedures for registration of contracts in the administrative IT system, DeMars. Rigsrevisionen finds this very unsatisfactory. First, because it made it difficult for DECA to sign offset contracts with suppliers who had signed various minor additional contracts which over a five-year period exceeded DKK 25 million. Second, because the practice reduced the transparency in administration of the IC contracts and made it difficult to assess the Defence's performance in the area.

Agreement on future practice

Rigsrevisionen notes that two years passed before the parties could agree on the interpretation of the IC regulations. In the opinion of Rigsrevisionen, the Defence should have acted in compliance with DECA's original interpretation of the regulations during the two-year discussion period, and the Ministry of Defence should have ensured that this practice was being followed. Rigsrevisionen finds the overall course of events very unsatisfactory.

Discussions between the ministries

- For two years, the Ministry of Economic and Business Affairs and the Ministry of Defence strived to agree on a joint interpretation of the IC regulations. And in June 2010 they succeeded in reaching an agreement.
- According to the Ministry of Defence, the issue of authority was unresolved until the agreement clarified that DECA has the authority to decide whether a specific procurement triggers an offset obligation. However, Rigsrevisionen is of the opinion that any doubts concerning the interpretation of the contents of the IC circular should ultimately be resolved by the authority that issued the regulations, which in this context is the Ministry of Economic and Business Affairs.

- In principle Rigsrevisionen is of the opinion that discussions of future practice cannot have a suspensory effect on current regulations, and finds that the Ministry of Defence should therefore have ensured that the Defence complied with the regulations.
- The Ministry of Economic and Business Affairs as well as the Ministry of Defence have emphasized that their respective departments agreed that the task of arriving at a joint interpretation of the IC circular should be resolved at agency level. Rigsrevisionen finds that the departments should have intervened when it became clear that the Defence and DECA were unable to reach an agreement.

Agreement on future practice

- The agreement settles the dispute between DECA and the Defence concerning the interpretation of the offset obligation, and specifies the procedures regulating signing of IC contracts. In the opinion of Rigsrevisionen, the Ministry of Economic and Business Affairs should, on the basis of the agreement on future practice, have defined the allocation of authority between the Defence and DECA in the revised IC circular that took effect in November 2010. The Ministry has informed Rigsrevisionen that the allocation of authority will be defined next time the circular is being revised.
- The agreement specifies that DECA has the authority to determine whether concrete procurements of defence equipment fall under the scope of the offset obligation. The two ministries have also agreed on the types of defence equipment that fall under the scope of the offset obligation.
- Moreover, the agreement specifies that the offset obligation always applies to four of the seven types of equipment that were discussed by the parties, and that two of the seven types of equipment fall under the scope of the offset obligation if the service provided is related to the procurement of equipment or has a specific function in relation to a military assignment. It does not appear from the agreement whether the offset obligation should apply also to the seventh and last type of equipment (dual-use materiel). However, the Ministry of Economic and Business Affairs has stated that the offset obligation will apply also to dual-use materiel that has a specific function in a military assignment, and this will be specified in the IC circular next time it is being revised.