



INDUSTRY & MARKET DIRECTORATE  
IN-HOUSE STUDY



**ABATEMENTS:**  
A PRAGMATIC OFFSET TOOL  
TO FACILITATE THE DEVELOPMENT  
OF THE EUROPEAN DEFENCE  
EQUIPMENT MARKET

# ***Abstract***

---

## ***Acknowledgments***

---

This study has been conducted as an “in-house” effort by the European Defence Agency’s Industry and Market Directorate Offset Team. The I&M Offset Team was assisted by the Member States and Norway government offset experts that provided invaluable input and guidance. We greatly appreciate the time and cooperation they extended to us. We owe our thanks to all Member States and their officials from ministries of defence, ministries of economy and other institutions; and in particular to the “active abatements countries”. This endeavour would not have been possible without their commitment and insight.

## Table of contents

---

<b>EXECUTIVE SUMMARY</b>	<b>5</b>
<b>I. THE STUDY CONTEXT</b>	<b>8</b>
<b>V. APPLIED ABATEMENTS PRACTICES &amp; PROCEDURES</b>	<b>11</b>
<b>VI. ABATEMENTS ADDED VALUE – GOVERNMENTS’ PERSPECTIVE</b>	<b>14</b>
<b>CONCLUSIONS</b>	<b>16</b>

## **Executive summary**

---

Offset is one of the most contentious practices in defence procurement. While offsets can facilitate the development of the defence technological and industrial base and stimulate business opportunities, they have the potential to distort the defence market and do not always provide value for money.

Yet, offsets are persistent and increasing, remaining a global phenomenon of an imperfect marketplace unlikely to disappear in the near future, as long as defence procurement procedures are restricted and competition in the global defence marketplace is subject to an uneven playing field. Therefore, any unilateral intra-European decision to abolish offsets would severely hinder the competitiveness of the European defence industry in the global market.

Since 2005, the EDA Member States have sought consistently to act together to develop a more open and competitive European defence market.

As an enabler in helping to take this work forward, the Agency's Steering Board decided to undertake the necessary measures to limit the most harmful effects of offsets in the European defence market. The launch of the Code of Conduct on Offsets on 1 July 2009 with the participation of 25 EDA Member States and Norway is the first pragmatic and significant step towards this direction heralding a fundamental change in the way offsets are used in defence procurement and enabling a more effective use of resources.

The Code of Conduct on Offsets recognises mutual abatements as one of the means to reduce reliance on offsets. Nevertheless, abatements up until now remain an innovative measure used by only a number of participating Member States (pMS) and Norway.

*Abatements: a pragmatic offset tool to facilitate the development  
of the European Defence Equipment Market*

Following the Steering Board tasking to investigate further the possibility of the application of mutual abatements in offsets, the Agency's Industry and Market Directorate Offset Team conducted a study to identify abatements practices and their implications.

Mindful of the national sensitivities towards offsets, the Agency opted to carry out the study in-house, in close consultation with and supported by government offset experts from the Member States and Norway.

This report captures and examines the key issues that emerged during the bilateral consultations, which in particular illustrate abatements as one of the tools to facilitate the development of the European Defence Equipment Market.

Moreover, in an era when defence budgets are increasingly constrained, abatements can considerably lessen offset costs, facilitating a more effective allocation of resources. Furthermore, the study concluded that abatements can help retain key defence industrial capabilities and thereby reduce the fragmentation of the EDTIB; provide export assistance; and support the SMEs. Abatements also decrease the offset burden and help shift the offset focus from quantity to quality, providing genuine added value to leverage offsets. Nevertheless, it has to be kept in mind that not all offset obligations can be abated and nations may require a limit on the percentage of the offset obligation to be fulfilled through an abatement.

Abatements emerge as a best practice in offsets supporting the objectives of the Code of Conduct on Offsets and our collective endeavours towards the development of a more open and competitive defence equipment market. The extended use of abatements - whenever practicable - by the subscribing Member States and Norway would therefore be an important step forward in our efforts to limit the most harmful effects of offsets in the defence market.

*Abatements: a pragmatic offset tool to facilitate the development  
of the European Defence Equipment Market*

Accordingly, the study recommends that the Agency, in close cooperation with the participating Member States and Norway should develop a model for the application of abatements in offsets taking into account best abatements practices and lessons learnt from previous abatements experiences. To this end, the Agency will launch phase 2 of the study, including consultations with Member States that do not have previous abatements experience, industry and selected third countries.

Furthermore, the report acknowledges Member States' concerns over the broader issues, such as closer convergence of offset practices on the European level as well as the global dimension of offsets and market inhibiting practices that significantly affect the European offset practices.

Therefore, the study recommends that consideration should be given to address these issues in order to ensure that pMS and their defence industries are not placed at a competitive disadvantage in the international arena.

This abstract summarises the report capturing the study findings, noted by the Agency's Steering Board in National Armaments Directors formation on 19 March 2010.

## **I. The study context**

---

Offset policy and Industrial Participation have for decades been used as both political and economic instruments to cope with market access barriers and to compensate for the prospective loss of work to national defence industrial sectors. In some cases, offsets have helped develop defence technological and industrial base skills and stimulate work and business opportunities by generating long-term partnerships and facilitating market access. In others, they have been inefficient, unnecessarily duplicative and market distorting. And yet offset remains a global phenomenon, unlikely to fade away in the foreseeable future.

Nevertheless, the European defence market is undergoing profound changes to provide capabilities able to meet current security and defence challenges and respond to new threats, in the years ahead. What is more, driven by economic realities, it is in transition from historically closed national markets to more open and competitive markets where best value for money is the key procurement priority. These changes were accelerated when the European Defence Agency's participating Member States agreed on the need for decisive progress towards creation of an internationally competitive European Defence Equipment Market (EDEM), as a key means to strengthen the European Defence Technological and Industrial Base (EDTIB). The Regime on Defence Procurement in operation now for over three years has effectively been increasing competition and transparency in the European defence equipment procurement, for the benefit of all those involved: Member States' Armed Forces, taxpayers and industry alike.



*Abatements: a pragmatic offset tool to facilitate the development  
of the European Defence Equipment Market*

The Electronic Bulletin Board on the EDA's website, through which this agreement is facilitated, now carries nearly 500 contracting opportunities for suppliers across Europe and around the globe, with a total value pushing 20 billion euro, and these numbers are consistently growing. Furthermore, an increasing number of contracting opportunities and cross-border awards plays a crucial role in opening up of the defence market.

Similarly, the complementary EU Commission's initiatives in the field of defence procurement aiming at contributing to the establishment of a truly European Defence Equipment Market, where European suppliers can operate freely in all Member States foster transparency and openness of defence markets in the EU.

Nonetheless, the endeavours to open up the defence market have not stopped there. The EDTIB Strategy agreed by the Defence Ministers Steering Board on 14 May 2007 addressed, amongst other things, the issue of offsets and emphasised the need for further analysis and careful consideration. It also recognised that the ultimate aim is to create the market conditions, and the European DTIB structure, in which the practice of offset may no longer be needed – and, meanwhile, to consider how their adverse impact on competition and the EDTIB might be mitigated.

This decision laid the groundwork for our work on offsets. The Code of Conduct on Offsets that came into force on 1 July 2009 is a first pragmatic step in an incremental process to address offset practices in Europe. It aims at limiting adverse effects of offsets through consistently injecting more transparency; providing for evolving offsets to help develop capability driven, competent and competitive defence industrial capacities; clarifying offset requirements; and introducing a 100% cap in an effort to reduce reliance on offsets.

The Code also advocates, whenever practicable, the use of mutual abatements on a voluntary basis as a means to reduce reciprocal offset commitments.

Whilst adopting the Code in October 2008, the Steering Board in NADs formation tasked the Agency to propose a model for application of abatements in offset. This tasking was reiterated with the approval of the Reporting and Monitoring System as the Steering Board directed the Agency to investigate further the possibility of the application of mutual abatements in offsets.

Consequently, from November 2009 through February 2010 the Agency has sought to thoroughly address the issue of abatements in close consultation with the participating Member States and Norway.

## **II. Applied abatements practices & procedures**

---

In recent years offset officials noted a significant rise in requests for abatements. This trend can be credited to the positive outcome - both for governments and industry – of previous abatements arrangements and increasing awareness of opportunities aimed at reducing offset commitments.

Abatements are usually not regulated by offset guidelines and they are applied on a customary basis. This enables offset authorities to find the most practical and effective solutions to execute specific offset arrangements. A well balanced and flexible offset policy allows therefore for a greater scope of implementation and fosters long term industrial relationships and partnerships.

There are two ways of carrying out abatements:

- ⇒ Abatements agreed in advance, as a part of the offset proposal;
  
- ⇒ Abatements applied at some stage during the fulfilment of existing offset obligations.

Although an abatement is usually initiated by industry, the decision to pursue an abatement is taken by government offset authorities. This helps prevent offset trading between defence companies and thereby ensures that abatements are applied as a measure to reduce negative effects that offsets generate and not as a means to circumvent the fulfilment of agreed offset obligations.

It is also worth noting that the nations made it clear during the consultation process that abatements do not affect in any way procurement decisions. In

other words, the possibility of an abatement is not used as an award criterion.

Typically, an abatement procedure takes from 1 to 6 months and is carried out as follows:

**Step 1: Initiation/Launch of the procedure:**

In most of the cases, abatement is instigated on a request from industry for assistance in fulfilling offset obligations.

Occasionally, the procedure can be also initiated by governments whenever they are aware of mutual offset obligations.

**Step 2: The decision:**

If the offset authority finds the request valid, it would first check if there are any mutual offset obligations committed by the industry of the respective country. If this is the case, the offset authority would evaluate added value of an abatement and subsequently contact another party respective government offset authority to discuss the possibility of a mutual abatement.

**Step 3: The procedure:**

Once both government offset authorities decide to proceed with an abatement, they would determine specific rules and procedures.

The procedure is usually quite simple. In cases of abatements agreed before the defence procurements are made the procurement value serves as a basis for the abatement. Where procurements have already been made and offset obligations have been agreed and partially fulfilled, the value of the remaining offset obligations provides a basis for the abatement. The obligations are usually abated 1: 1.

However, not all offset obligations can be abated and nations may require a limit on the percentage of the offset obligation to be fulfilled through an abatement.

The abatement is carried out by exchange of letters stipulating the principles and conditions of the mutual abatement agreement.

In addition, abatement can also be carried out through setting up a banking account between countries. This way abatement can be applied more independently from the timeframe of procurements.

#### **Step 4: Finalisation**

When the conditions of the agreement are met, the government authorities inform the companies that the offset obligation is abated by letter. Thereby, the respective mutual offset are waived or reduced.

#### **Other cases:**

In essence, an abatement is an agreement between two countries. Nevertheless, there are examples of multilateral abatements with three or more countries involved. In such cases, there are no mutual offset obligations between two countries and their industries; therefore there is no possibility of a direct abatement. However, if both parties can identify parallel offset obligations with a third country and its industry, an abatement is still feasible provided positive attitude of all parties involved. This can allow even greater scope for abatements to be carried out.

### III. Abatements added value – Governments' perspective

---

The nations applying abatements view them as a useful tool to leverage offsets and thereby to engage in offsets in a more pragmatic and effective way in order to foster the utmost benefit for their countries. Ultimately, the net results are beneficial both to governments and industry making abatements a win-win solution.

During the bilateral consultations, the nations emphasised the following advantages of applying abatements:

⇒ **Abatements lessen the offset burden**

Abatements provide an economically sound solution that can significantly help lessen the offset burden and cost associated with defence procurement.

⇒ **Abatements can help retain key defence industrial capabilities and thereby reduce the fragmentation of the EDTIB**

Abatements can help ensure that key defence industrial capabilities and technologies are retained in the EDTIB. Furthermore, abatements can help European industry to stay focused on developing their core skills and not be diverted into other areas.

⇒ **Abatements provide export assistance to European defence companies**

Abatements can provide an important vehicle for defence export assistance. They help maintain good relationships with other governments and uphold European industry standing as reliable partners. Abatements can also help

generate future business and foster partnerships.

⇒ **Abatements provide SMEs support**

SMEs often face challenges in fulfilling offset obligations and complying with the requirements imposed by the primes' current supply chain management practices, especially with regard to delegating partial fulfilment of offset obligations to sub - suppliers.

Abatements not only ease the offset burden on SMEs but can also encourage them to bid with more confidence, thereby ensuring the MoDs' access to new innovative solutions in less time and often at a lower cost.

## Conclusions

---

Offsets are a reality of an imperfect market and unlikely to disappear in the near future, as long as defence procurement procedures are restricted and competition in the global defence marketplace is subject to an uneven playing field. The Member States have already undertaken considerable endeavours towards the creation of a more open and competitive defence marketplace and the development of reciprocal and equitable relationships to level the defence market playing field.

In the same way, whilst bringing their collective weight the Member States can shape the way offsets are used in defence procurement. The Code of Conduct on Offsets that came into force on 1 July 2009 launched an incremental yet pragmatic process aimed at limiting the adverse effects of offsets and provided a framework to introduce transparency and direct offsets towards shaping capability-driven, competent and competitive European Defence Technological and Industrial Base.

The bilateral consultations with the nations applying abatements and the analysis described above have demonstrated the following:

- ⇒ Abatements are one of the key means to minimise adverse effects of offsets, whilst enabling more pragmatic and efficient use of offsets to the benefit of both Governments and Industry;
- ⇒ In an era when defence budgets are increasingly constrained, abatements can considerably lessen offset costs, facilitating a more effective allocation of resources;
- ⇒ Moreover, abatements can help retain key defence industrial capabilities and thereby reduce the fragmentation of the EDTIB;



*Abatements: a pragmatic offset tool to facilitate the development  
of the European Defence Equipment Market*

- ⇒ Abatements also provide export assistance and support the SMEs;
- ⇒ Last but not least, abatements can help also to shift the offset focus from quantity to quality, providing genuine added value to leverage offsets;
- ⇒ Abatements should therefore be recognised as a best practice in offsets supporting the objectives of the Code of Conduct on Offsets and our collective endeavours towards developing a more open and competitive defence equipment market;
- ⇒ Consequently, the extended use of abatements - whenever practicable - by the subscribing Member States and Norway would be an important step forward in our efforts to limit the most harmful effects of offsets in the defence market and thereby will facilitate the development of the European Defence Equipment Market.

The Member States stressed during the consultation process that whereas working towards enhanced use of abatements, it is essential that other issues affecting offset practices in Europe should be addressed in parallel:

- ⇒ The provisions embedded within the Code of Conduct on Offsets will help us progress towards closer convergence of offset policies and practices and to gradually reduce the use of offsets. Its implementation will thus facilitate the development of a common understanding of the use of offset with the aim of avoiding those practices that have the distorting effects on competition in the defence market. In this context, it is vital to level up best offset practices;

*Abatements: a pragmatic offset tool to facilitate the development  
of the European Defence Equipment Market*

- ⇒ Offsets are often a response to the barriers to defence markets, frequently faced by European exporters in the form of protectionist measures. On the way to reducing reliance on offsets, it will be useful to investigate further market access barriers that hinder the development of an open and competitive defence marketplace;
  
- ⇒ The Steering Board, when adopting the Code of Conduct on Offsets, agreed that one of the overarching principles providing the basis for the Code's implementation is the need to address the global dimension of offsets and bring key offset players together. Both the EDA Offsets Reporting and Monitoring System's initial results and the 14<sup>th</sup> Offset Report to U.S. Congress demonstrate that the bulk of offset agreements are reached between EDA Member States and U.S. companies. Therefore we need to address this issue further, in particular through developing an EDA - U.S. Government Offset Dialogue.