Offset – the compulsory inward investment imposed on foreign defence suppliers by a purchasing government – is tolerated as a feature of the market rather than embraced. Tolerance of offset has become increasingly important over the last ten years. Since 1999, 22 countries have introduced formal offset legislation or policies. The scope of offset obligations is also increasing in terms of both the quota required by the buyer and the range of contractors obligated. This helps to explain why the European Commission (EC) and the US Department of Commerce (DoC) view offset as legally and commercially problematic.

The United States is particularly vocal in its criticisms of offsetting. According to one US executive offsetting merely encourages the setting up of an additional competitor. The DoC echoed this sentiment by highlighting the risk of creating or enhancing future competition. There is also concern that offset obligations are increasingly placed on smaller companies. Furthermore, offset obligation triggers around the globe show marked levels of inconsistency. Within the European Union, for example, offset obligation can be triggered on contracts worth as little as EUR400, 000. In comparison, Australia's offset regime has a threshold of $45 million.

Alongside concerns of increased competition and declining thresholds, US executives are critical of falling offset discharge periods. Where some countries used to allow up to ten years for the fulfilment of offset obligations trends suggest that time periods are being reduced. Often such reductions equal that of the main contract fulfilment period. Declining discharge periods have been matched by an increase in the imposition of penalties. A board level figure within a major US company observed increasingly higher offset penalties, the emergence of escalation clauses and interim milestone penalties.

Echoing similar sentiments to the United States, the European Defence Agency (EDA) argues that offsets distort competition, are frequently inefficient and rarely deliver value for money. To improve conditions the EDA's non-legally binding Code of Conduct on Offsets highlights that the European defence, technological and industrial base requires an offset regime compatible with EU law. The regime must also not lead to an adverse impact upon trans-border competition. Furthermore, the regime should also reflect the EDA's commitment to harmonisingEurope's offset requirements. Currently such requirements are subject to an east-west split.Western Europe, for example, regards offsetting as an opportunity to develop defence industrial participation and the development of domestic military industrial capabilities. However, Central andEastern Europe see offsetting as an opportunity to stimulate economic growth and employment.

According to the UK consultancy Offsets 2000, whilst the EDA's commitment to harmonisingEurope's offset requirements is a good idea, every country will continue to have its own priorities. As a result, a 'one size fits all' approach to offsetting is likely to be problematic. This is demonstrated by how offsetting reflects the status of 'local' defence industries. Both Norway and the Netherlands, for example, use offsetting to encourage foreign defence

companies to work with their smaller supplier bases. If a foreign contractor partners with a small-to-medium enterprise, a higher multiplier will be allocated to the offset project. By comparison, Italian offset policies allocated the highest multipliers if the technology transfer is 'totally new.'

Attempts to harmoniseEurope's offsetting requirements are further complicated by the EC's defence and security procurement directive. 2009/81/EC indicates that offsets entail discrimination by their very nature and are in direct contrast to the EC's commitment to single and free European markets. Instead the directive states that the contracting authorities may ask the successful bidder to subcontract up to 30% of the contract to third parties. The subcontracting process must, however, be subject to fair, EU-wide competition.

According to a UK-based industry figure, the winner of a contract will still want to use their proven supply chain for subcontracting regardless of the EC directive. The directive is, therefore, a challenge to this arrangement in that it obliges the successful bidder to subcontract throughout the entire European Union. However the same source also posed the question would contractors be prepared to complain about those states that are prepared to protect their defence industries from subcontracting. Should a contractor raise such disputes in the European Court of Justice, there is potential that the company many never do business in that country again

Despite being party to the EC and EDA directives, the United Kingdom does not operate a legally binding offset policy. Under the Industrial Participation (IP) scheme – an offset policy in all but name – the UK typically seeks a 100% return within all contracts. However, direct IP is seldom achieved and foreign contractors are encouraged to meet the remainder of their obligations through indirect military offset. In 1999, for example, Lockheed Martin satisfied 30% of its 100% offset obligation regarding the C-130J airlifter procurement programme by identifying UK suppliers of components. The remaining 70% was met by UK companies that could be employed on other Lockheed Martin programmes.

The UK's also emphasises that offsetting must prioritise military participation over commercial non-military business activities. This suggests that the UK is unlikely to fall foul of the EDA's insistence that offset should be used to develop the depth and diversity ofEurope's defence supplier base. The UK's commitment to cap offset at 100% also puts the country in line with EDA objectives. However, the Ministry of Defence's (MoD) response to 2009/81/EC is a potential source of dispute with some of the UK's European partners. According to one MoD source, the UK does not 'intend to mandate subcontracting' to 30% of the contract value. Instead the MoD considers the winning contractor as best placed to manage sub-contracting issues. The MoD's attitude towards offsetting has been questioned by some UK defence businesses. According to Andy Thomis, chief executive of Cohort plc, other countries actively conduct offsetting whereas the UK seems more reluctant. What theUK does in terms of offset, it does so with a lack of enthusiasm

Despite criticisms from the United States and ambivalence within the United Kingdom, the emergence of formal offsetting policies has resulted in a shift from vague recommendations of practices to longer-term coherent strategies. According to Saab, whilst offset policies may be

inflexible there is now a much more structured framework. Another consequence of formal offset policies is the greater emphasis on the transfer of technology as opposed to relatively straightforward subcontracting. This approach is particularly attractive to states with developing defence industries, such as the Central European states and Brazil.

Defence contractors such as Saab also regard changes to offsetting policies as windows of opportunity. Offsetting offers the potential to 'bed down' in domestic markets via the transfer of technology and the formation of long-term partnerships. Consequently the current trend towards greater proliferation of offsets is unlikely to recede. Successful strategies will generally hinge on an ability to absorb the work requested and – in the case of the EU – a coherent approach to achieve best advantage.