Guy Anderson, editor and lead analyst, Jane's Defence Industry

The United Arab Emirates is one of the world's true "frontier" defence markets. It is courted by Western firms seeking to offset slumping spending at home; emerging exporters like South Korea seeking to establish a foothold beyond their own borders; and Russia and China under their arms-for-energy-access strategies.

A precarious geographical position, buoyant oil revenues and strong defence expenditure growth (military funding leapt 276 per cent between 2001 and 2010)[1] make the UAE an attractive prospect. There is both the means and the rationale to continue spending on national defence.

The UAE, meanwhile, knows its value to the world market and is looking for a healthy return on its investments. It is looking to defence expenditure to help overcome two pressing problems: firstly, the twin demographic challenges of a young population in need of meaningful employment and a strong reliance on foreign labour (20.9 per cent of UAE nationals were under the age of 15 in 2008 and 73.9 per cent of those of working age were non-nationals)[2] and, secondly, continued high reliance on oil revenues (oil exports accounted for 40 per cent of GDP in 2008).[3]

It is unsurprising that the UAE overhauled its offset regime this year [2010] in order to maximise the social and economic returns on its investment in military materiel.

The reforms have created numerous challenges for foreign industry, however, and may yet backfire by alienating the very firms which the UAE is seeking to work with. Indeed, there have been reports that international defence trade associations are considering sending a jointly-signed letter to the UAE's offset bureau to vent their frustrations (there is a precedent - a similar letter on a similar subject was recently despatched to India)[4].

UAE Offset Policy

The UAE Offset Group (now the Offset Programme Bureau) can claim a degree of success since its inception in 1992. The Abu Dhabi / Dubai controlled body has led to the creation of 40 joint venture projects; attracted investment of USD2.2 billion; and has led to four initial public offerings (most notable was the Abu Dhabi Shipbuilding Company).

The regime was not perfect, of course. There have been reports – as in other emerging markets – of burdensome bureaucratic processes; a lack of investment opportunities; and the perception that procuring bodies and the offset programme offset haven't been quite as "joined up" as might have been desired.

The 2010 reforms added more challenges. Principal areas of concern were the new offsets penalty formula; the new 'one-year' offset credit 'milestones'; multipliers; foreign investment rules; and the fact that aspects of the new regime appear to be retro-spective.

Milestones

The new policy sets 12 months project milestones, with percentage achievements of 5%, 10%, 10%, 15%, 15%, 20%, and 25% expected for each year of the typical seven-year obligations. Previously progress was assessed at the three, five and seven year milestones. The challenge is that offset in the UAE is largely based on the number of locals employed and the earnings of the offset project. Given that few start-up enterprises enter profit immediately, the potential for early milestone penalties is strong

Penalties

Penalties are ostensibly set at 8.5%. The imposition of penalties on unfulfilled balances at the end of each milestone, however, can push the real penalty to 17 per cent of the project value.

Foreign investment

The UAE appears keen to achieve an "optimum" level of foreign participation in domestic joint ventures. In practice, this means that JV with a foreign holding greater or less than 49 per cent can be penalised, thus pointing to limited flexibility. This issue may be subject to revision, however, as there are indications that foreign ownership guidelines remain under review.

Targeted investment

Given that the UAE has tied its offset policy to the wider Economic Vision 2030 plan – the blueprint for what it calls the "transformation" of its economic base – it is not surprising that it has published multipliers to guide investment. Advanced materials, electronics and precision manufacturing, for example, attract the top multiple of five. Oil and gas systems and the development of public infrastructure, on the other hand, attract the lower multiplier of two. Given that offset credits are awarded on the basis of "output" (ie, earnings), targeting the top multipliers is challenging given the nature of the highest priority areas.

Retro-spective rules

A further headache for those charged with meeting offset obligations is that the reforms appear to be retrospective. Contractors face converting existing outstanding obligations under the new terms and conditions, thus adding another layer of complexity.

A positive development?

The reforms of 2010 are not entirely bad news. The previous system was based entirely on output (again, earnings and the percentage of locals employed). The new regime allows for hybrid packages based on up to 30 per cent "input" (ie, initial investment) with the remainder judged on output.

The UAE view – "flexibility" and "ease of project implementation"

The UAE Offset Bureau does, of course, take issue with the view that its latest reforms may be problematic. The office has been keen to stress that its new policy was "developed following extensive discussions among all stakeholders" and has been the "fruitful outcome for years of hard work." Indeed, it takes pain to stress that the reforms were introduced to ease the "challenges defence contractors face in implementing their obligations".

About the author

Guy Anderson is the lead analyst of the Jane's Defence Industry division within I H S Jane's. He is also editor of Jane's Defence Industry News; Jane's Industry Quarterly; and Jane's World Defence Industry, in addition to his role of business editor of Jane's Defence Weekly.

A frequent commentator on defence industrial matters in the national and international media (including Time magazine and CNN), Anderson is also a research fellow of the UK Defence Forum (UKDF) and a regular contributor to the UK Royal United Services Institute (RUSI).

Prior to joining I H S Jane's in 2004, Anderson was an award-winning financial journalist. He has written for a number of national titles, including the Daily Mail.

[1] Jane's Defence Budgets

[2] US CIA World Fact Book 2008

[3] US CIA World Fact Book 2008

[4] "International industry unites, calls on India to reform offset policies" - Jane's Defence Industry News – 20 August 2010 –