F-16 Aircraft Sales to Greece: A Case Study of Offsets

By

The Office of Management and Budget

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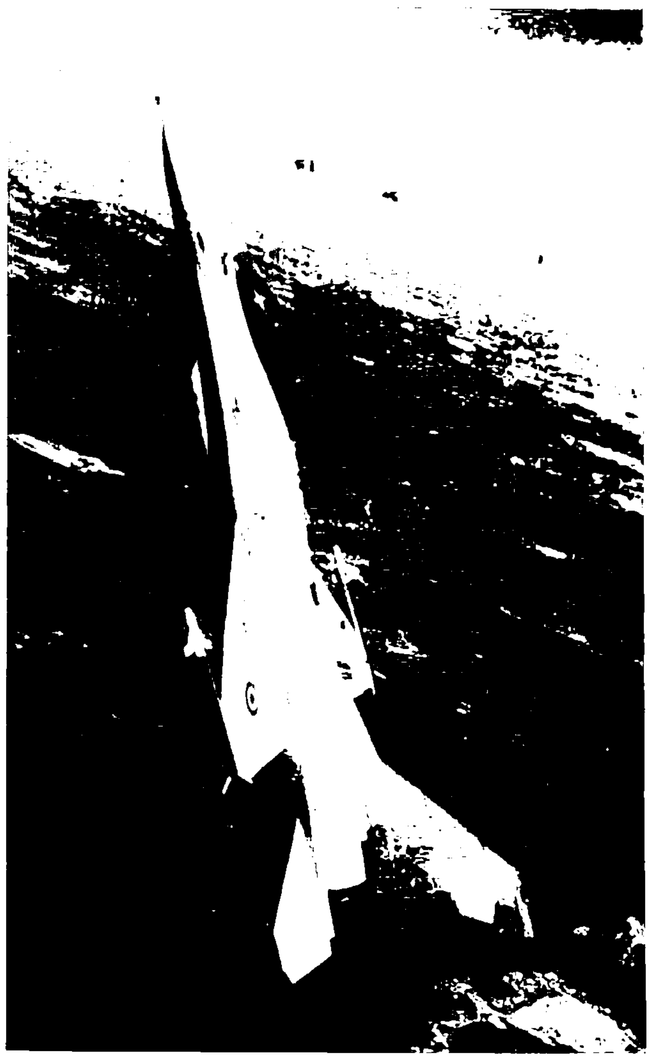
This study focuses on the General Dynamics Corporation's (GD) 1984 sale of forty F-16 fighter aircraft to the Government of Greece (GOG). This case was chosen because of its instructive value in understanding the potential scope of offset arrangements, the kinds of political and economic considerations involved in offset deals, and some of the relationships between offset policies and offset practices. This transaction's unusual offset arrangements also point out the many difficulties in attempting to quantify or to generalize about offsets and their effects. The data presented here are current as of December 1988.

On November 11, 1984, the Government of Greece (GOG) announced its decision to purchase forty F-16 fighter aircraft, including spares and support services, at a cost of $940 million. Accompanying the purchase would be a 100 percent offsets package, to be fulfilled by GD and its engine and avionics partners, General Electric (GE) and Westinghouse Electric corporations. The package would consist of a combination of direct and indirect offsets, including opportunities for coproduction and countertrade.



Hellenic Air Force F-16

In the two years between the decision to buy F-16s and the January 1987 finalization of the purchase agreement between the GOG and the F-16 partners, the nature of this offset arrangement changed considerably. The final sales contract still includes a nominal 100 percent offset agreement, with some coproduction opportunities. But in place of the traditional indirect provisions, and in place of many direct offset demands GD felt it would not be able to fulfill, the GOG and the F-16 partners have established a venture capital company that is unique in the world of offsets.

GREEK OFFSET POLICY

The GOG has a defined policy regarding offsets in international trade. Specifically, offsets are mandatory in defense-related contracts, and are desired in all tender submissions, whether military or civil, in excess of approximately $1.5 million. As a practical matter, firms expecting to do business with the GOG should plan on reaching some form of offset arrangement. Indeed, in the area of military trade, the Greek Ministry of Defense has taken the position that all new procurements of systems that cannot be produced by Greek industry must include co-production or some other form of industrial cooperation. Outright purchases of foreign systems will no longer be considered.

Specific offset requirements are included in every RFP [Request for Proposal] that the GOG issues. Respondents are required to include their offset proposals with their bids, as the final offset package forms an integral part of the overall purchase agreement. Offsets in defense-related contracts are expected, though not required, to be in the range of 60-100 percent of the actual value of the sales contract, and they should not influence the selling price of the goods.

The GOG divides the range of possible offsets into three different "groups of items," and four different "categories of exchange." The GOG affords different weighted values to offsets falling in the various groups and categories. It also attempts to have its foreign suppliers distribute offsets throughout the various potential combinations of groups and categories.

The GOG's division of offsets into three groups of items roughly correspond to the distinction between direct and indirect offsets as used in this report. The three groups of items are:

> **Group 1**: Items of exchange directly related to the items being purchased (e.g., aircraft components for use on aircraft of the type being purchased);
>
> **Group 2**: Items of exchange related to other varieties of the items being purchased (e.g., aircraft components for aircraft of models other than those being purchased);
>
> **Group 3**: Items of exchange related to other domestic industrial products and services.

Within this latter group, the GOG places particular emphasis on items from engineering and advanced technology industries, though they do not specify what criteria define these industries. The four categories of exchange that the GOG identifies are:

> **Category 1**: Purchases of products and/or services from Greek enterprises (counterpurchase and subcontracting);
>
> **Category 2**: Transfer of high technology to Greek industries with parallel partial absorption of the resulting manufactured products (buyback);
>
> **Category 3**: Capital expenditure on behalf of Greek industrial firms;
>
> **Category 4**: Any other exchange approved in a particular case.

The following, taken from a recent aircraft procurement RFP, show typical weighting factors and desired distribution for the groups and categories. Using these tables, a capital investment in the aircraft industry could be credited at six times its actual value. Conversely, a purchase of goods from an unrelated economic sector would only earn the actual value of the purchase.

GROUPS OF ITEMS

	Offset Distribution	Weighting Factor
Group 1	20%	1.5
Group 2	30%	1.5
Group 3	50%	1.0

CATEGORIES OF EXCHANGE

	Offset Distribution	Weighting Factor
Category 1	60%	1
Category 2	10%	4
Category 3	20%	4
Category 4	10%	1

These groups and categories underscore and reenforce the four basic goals of the GOG's offset policy.

(1) The establishment of new plants or the upgrading of existing plants to make them internationally competitive;

(2) The inflow of foreign currency through transactions that are in the framework of offset agreements;

(3) The promotion of Greece's industrial and technological development, especially through the installation of companies engaging in industrial production and technology transfer; and

(4) The creating of programs for improvement of the country's defense ability, even if those programs are not profitable in a business sense.

The GOG also places domestic added value (DAV) restrictions on offset implementations. In order for purchases of goods and services to be eligible for offset credit, the DAV (the value added by the Greek economy) must comprise at least 40 percent of the purchase price. This provision applies to both individual purchases as well as to the total of all purchases.

Two other critical elements of the GOG policy are provisions related to eligible parties and to causality. In order to be acceptable for offset credit, an offset must be implemented by an eligible party. These parties are the manufacturer of the item being purchased, its subcontractors for that item, and other parties as approved on a case-by-case basis. Thus, subcontractors on systems other than the one being purchased, second-tier subcontractors (companies who do subcontract work for the manufacturer's subcontractors), trading companies, and other parties are not considered eligible, except when specifically approved by the GOG. However, the burden of managing the offset requirement remains with the seller, while the GOG retains the right to determine whether or not claimed offset implementations actually meet the criteria of the negotiated obligations.

Also, the seller must prove that the implementation did not result from previously existing arrangements or commitments, but was caused by direct efforts made against the obligation. Absent an exception to this policy of causality, this provision prohibits a company from using banked credits earned through previous purchases, or for earning credits on purchases that would be made irrespective of the offset agreement. Both this provision, and the provision on eligibility prohibit the use of credits obtained through trade with other organizations.

The GOG includes penalty provisions in its offset policy. These provisions apply to the entire period of the offset obligation, as well as to intermediate periods. They cover delays and failures in contracting for specific offset implementation, and for delays and failures in the actual fulfillment of offset obligations. Penalties for delays in contracting for implementation and delays in fulfilling implementation contracts are imposed through percentage increases in the total offset obligation. Failures to contract for implementation, or to fulfill contracted implementations are penalized through monetary penalties equal to 50 percent of the actual unfulfilled offset obligation. However, such monetary penalties are limited to a maximum of 15 percent of the total offset obligation.

Another aspect of the GOG policy is the method of guaranteeing fulfillment of offsets and/or payment of penalties. Under the GOG policy, companies are required, at the time of the offset contract signing, to give the GOG an irrevocable letter of credit equal to 15 percent of the offset contract value (the maximum potential monetary penalty). The letter of credit, less any withholding for penalties, is returned to the company only after fulfillment of its obligations.

Finally, perhaps to suggest that other matters are not subject to negotiation, the GOG explicitly identifies certain aspects of offset agreements as items for negotiation. These include the intermediate and overall time periods within which individual offset programs must be completed, as well as the methods of proving fulfillment of offset obligations. However, as the F-16 case shows, all provisions are in fact negotiable.

THE F-16 RFP

[Editor's note: The following discussion of the F-16 RFP should be understood as the original offset proposal, which was subsequently replaced, as described later in the article.]

In the case of the GOG's purchase of F-16s , the offset requirements (which alone comprised 37 pages of the RFP) were much more extensive and detailed than the foregoing generalized policy. Furthermore, they were even less favorable from the aircraft seller's perspective in that credits for the different types of implementations were considerably less than those described in the above tables.

An example of the F-16 RFP's detail is the section addressing the distribution. Although the RFP only required that a minimum of 30 percent of the offsets be in groups one and two (F-16 or other aircraft items), it specified that this effort would focus on establishment of a Greek infrastructure to cost effectively support the Hellenic Air Force's weapon systems. This would be achieved through coproduction and subcontracting programs focusing on the final assembly and testing of the F-16 and on depot level maintenance. Moreover, the seller would be required to "offer Greek industry every opportunity to enhance its manufacturing, R&D, and depot level capabilities through production and developmental work in aeronautical activities in which the seller or other parties are engaged."

Language regarding the distribution of implementations in group three (other civilian, non-aircraft goods) was even more specific. The RFP required the seller's best efforts to achieve a distribution of: 50 percent purchases, 15 percent direct investment, 15 percent enhancement of Greek participation in construction projects and studies in third countries, 10 percent technology transfer, and 10 percent tourism.

To ensure GOG control over the offset program, the RFP required development of an extensive "export enhancement program" and a "tourism enhancement program." These programs would spell out in advance the specific measures to be taken to ensure fulfillment of the offset obligations. Moreover, they would require the approval of the GOG, and would serve as a basis for determining whether or not individual implementations were acceptable.

However, inclusion of implementation proposals in these programs would not ensure the GOG's acceptance of individual implementations, even if the overall program had been approved. In fact, even obtaining the GOG's prior approval for an individual implementation would not necessarily ensure its acceptability because the RFP allowed for the GOG to change its mind about implementations:

> If a transaction has been determined to be eligible and subsequently it is established that the transaction was not meeting the applicable eligibility criteria, then such transaction shall be declared ineligible and the credit previously given shall be subtracted from the seller's credits . . .

Likewise, the GOG reserved the right:

> . . . to deny acceptance of a proposed investment or technology transfer or royalty arrangement whenever such proposed transaction is in conflict with relevant policies, without such denial having any effect upon the sellers offset benefit obligations and/or credits.

The significance of these sections is that they necessitate the GOG's pre-approval and post-approval for all offset implementations.

The amount of credit afforded to different types of implementations was also considerably less in the F-16 RFP. For example, while the credit for a technology transfer might be several times the technology's actual value as shown in the tables above, the F-16 RFP, under its most generous provisions, only allowed crediting equal to the actual value of the technology. In the majority of circumstances, it did not even base the credit on the value of the transferred technology, but instead on a percentage of the value of new product sales realized through the technology transfer. Thus, a technology transfer could only earn credits if it actually resulted in new product sales during the time of the offset obligation period (15 years). In contrast, the previously described policy would give credits for the technology and for purchases of goods produced from that technology, both at rates in excess of the actual values of the technology and the purchased goods.

Similar circumstances prevailed in the case of capital investment in Greek industry. The maximum potential credit for an investment under the RFP would be three times the value of the investment, plus 80 percent of the firm's export sales and 40 percent of its domestic sales multiplied by the percent of total capital in the firm represented by the investment. Thus, if a capital investment represented 30 percent of the total capital in the Greek firm, the maximum offset credit would be three times the capital investment, plus 24 percent of export sales and 12 percent of domestic sales.

A final provision of the F-16 RFP relates to bookkeeping:

> The seller is responsible to ensure that no offset benefit transaction is credited, in whole or in part, more than once. It shall also ensure that sales or purchases of goods and services with respect to which credit has been received or should have been received by the seller or by any other eligible party as an offset benefit to Greece under any other agreement with the Government of Greece, is not credited against this contract.

Under this clause, not only is the seller obligated to be honest about its claims for offsets (a fair provision), it is also obligated to report any over-crediting, double-crediting, or otherwise erroneous crediting in its favor that the GOG, for whatever reason, including bookkeeping errors, might make.

GD judged the offset requirements outlined above to be unacceptable. Furthermore, GD felt that the structural limitations of the Greek economy would effectively prohibit the realization of many of the GOG's desires for industrial and high technology offsets. Thus, GD and the GOG were never able to come to terms on an offset program under the framework of the RFP.

Instead, GD and the GOG agreed on a two-part offset package. The first part consists of a fairly standard coproduction program under which the GOG will produce various components of the F-16 and its engines. The second part, and the primary focus of this study, is concerned entirely with the establishment of a venture capital company, singularly dedicated to the identification, development and implementation of profitable business transactions in Greece.

COPRODUCTION OFFSET

Under the first part of the offset program, the GOG's state-owned aerospace corporation, Hellenic Aerospace Industries (HAI), will produce several components and subassemblies for a portion of GD's existing F-16 orders. Additionally, HAI will become a potential second source for many of these items on any future F-16 contracts. GD estimates the total amount of the coproduction program at $240 million.

Coproduction is a primary concern of the GOG in any major military purchase. Through coproduction, the GOG hopes to obtain technology for industrial modernization, particularly for the modernization of its aerospace industry. For the F-16 purchase, as in most of the GOG's aircraft purchases, this implied the involvement of HAI, as it is Greece's only significant aerospace company.

The GOG founded HAI in 1976 through an agreement with an international consortium. The GOG's objective was the development of a modern aircraft maintenance and overhaul capability in Greece. The consortium, which included Lockheed, GE, Westinghouse, and Snecma, helped to establish HAI's facilities and train its workforce. It also agreed to provide HAI with future, regional aircraft maintenance work.

Since 1976, HAI has continually, if slowly, expanded its maintenance and overhaul capabilities. It now services fighter aircraft, helicopters, and transport aircraft, including the largest civilian and military transports. HAI's capabilities include maintenance, overhaul and testing of aircraft engines and electronics. Its manufacturing capability, however, is limited to relatively simple components.

Through the F-16 coproduction program, the coproduction program with France's Dassault-Breguet corporation tied to the purchase of 40 Mirage 2000 fighter aircraft, and several other military and commercial aircraft subcontracts, the GOG plans to upgrade HAI as an aerospace manufacturing company. The GOG also expects that the new work acquired through coproduction will simultaneously ensure stable or increased employment rates for the HAI workforce, including over 700 new jobs by 1991.

Under the coproduction agreement, HAI will coproduce several components of the F-16, including 230 aft fuselage sections and 485 air inlets compatible with the F110-GE-100 engine. Additionally, HAI will produce four yet-to-be-determined components of the engines and will develop a depot capability and test cell for the repair, maintenance, and testing of the engines. As many as eighty-one (also yet-to-be-determined) pieces of the necessary support equipment for the engine work will be produced in Greece.

These provisions represent a scaling down of the initial coproduction program. That would have involved production of eight engine components, as well as various electronics and avionics components supplied by Westinghouse. However, the investment cost for these items made them too economically unfeasible, even considering the employment, technology, and domestic political benefits involved.

Limited capabilities at HAI have also complicated the remaining coproduction plans. Although construction of a new manufacturing facility by March 1989 is essential to on-schedule production at HAI, this work is considerably behind schedule. Similarly, as much as 50 percent of the production of the necessary start-up tooling has been subcontracted, with much of that having been awarded back to GD, who was the lowest bider. This could cause additional delays if funding is not available. As a result, HAI risks losing some of its coproduction orders if GD is forced to place work elsewhere in order to ensure on-time aircraft production.

All of the coproduction opportunities that have been made available to the GOG are based on GD's current projection for F-16 orders from the U.S. Air Force and other customers around the world. Should additional orders materialize, HAI would be able to compete for additional work. However, should projected orders not materialize, HAI would share in the loss of work. This is of particular importance in the area of engines, as the Pratt and Whitney division of United Technologies Corporation makes an alternate engine for the F-16 that does not use the same air inlet that HAI will be set-up to produce. If customers opt for the Pratt and Whitney engine, HAI would not receive any air inlet orders. Similarly, if budget restraints force the U.S. Air Force to reduce its purchases, HAI's workload would decline accordingly.

INDIRECT OFFSET

In addition to the coproduction program for HAI, the Greek F-16 purchase includes a second offset arrangement that is unique in the world of international military trade. This arrangement, which is codified in Greek law, creates a venture capital partnership between the sovereign state of Greece on the one side, and the "sovereign" multinational corporations of GD, GE, and Westinghouse on the other. This venture capital company fulfills all of the offset obligations of the three multinationals in connection with the F-16 sale that are not fulfilled through the coproduction program.

The venture company, formally knows as the Hellenic Business Development and Investment Company, S.A., is established as a stock company, wholly owned and operated by the four partners. Its purpose is to "provide near- and long-term direct and substantial benefits to the Hellenic industry and economy and [to] improve the balance of payments." It has the power *inter alia*: to make investments that seek to improve the infrastructure of Greek industry, mainly for the production of modern and high technology products; to facilitate and secure technology transfers under favorable terms for Greek companies; to facilitate and promote Greek exports, mainly industrial products, to new markets abroad; and to develop methods for better utilization of existing tourism capacity and to help increase tourism in Greece. To achieve these ends, the company will develop and implement business development projects, including joint ventures, partnerships, equity investments, technology transfers, technical and marketing assistance agreements, loans, feasibility studies, and other lawful activities.

The multinationals will capitalize the company at $50 million over a ten year period according to the following schedule:

Capitalization Schedule
(U.S. Dollars)

Year	Capital Contribution 30 Mar	30 Sep	Total for year	Cumulative Capitalization
1987	2,000,000	*(upon signing of the Articles)*		
1987	------------	7,220,000	9,220,000	9,220,000
1988	3,116,500	3,116,500	6,233,000	15,453,000
1989	2,823,000	2,823,000	5,646,000	21,099,000
1990	2,854,000	2,854,000	5,708,000	26,807,000
1991	2,846,500	2,846,500	5,693,000	32,500,000
1992	1,908,500	1,908,500	3,817,000	36,317,000
1993	1,890,000	1,890,000	3,780,000	40,097,000
1994	1,808,000	1,808,000	3,616,000	43,713,000
1995	1,711,500	1,711,500	3,423,000	47,136,000
1996	1,432,000	1,432,000	2,864,000	50,000,000

The company's capitalization may only be increased by a unanimous resolution of the shareholders. These contributions represent the entire financial obligation of the multinationals toward to GOG, and replace the approximately $700 million obligation (the difference between the sales price of $940 million and the $240 million value of the coproduction program) they would have incurred under the RFP. Each of the multinationals will pay the following percentages toward the capitalization of the company:

Multinational Capitalization

Shareholder	Percentage
General Dynamics	65.7%
General Electric	21.3%
Westinghouse	13.0%

Each multinational is allotted shares in the company and voting rights in proportion to its contribution to capitalization. The multinationals must transfer one-twentieth (1/20) of their shares to the GOG as partial offset for the purchase of F-16 aircraft and F110 engines. The multinationals retain control of their remaining shares throughout the fifteen year life span of the company.

It is the intention of the shareholders to operate the company as a money-making entity. During the first five years of operation, five percent of all profits will be paid into an ordinary reserve, until the reserve equals one-third of the paid-in capital. All remaining profits will be retained for formation of an extraordinary reserve. After the fifth year, the first five percent of profits will again be paid into the ordinary reserve until the reserve equals one-third of the paid-in capital. Fifty percent of the profits will be paid out to the shareholders as dividends in proportion to their capital interests. The remaining profit will be paid into the extraordinary reserve. The articles of association do not specify the exact nature, functions, or limitations of the two reserves.

The supreme authority of the company is the general meeting of the shareholders. Its unanimous vote, with 100 percent of the shareholders or their proxies in attendance, is required to: amend the articles of the association; extend the duration of the company; increase shareholder obligations; increase capital contributions; and approve dissolution and liquidation of the company. A two-thirds vote of the general meeting is required to: approve the annual financial statement; release board members and their auditors from their liabilities; and approve distribution of profits. Two-thirds of the shareholders, including at least one representative of the GOG, constitute the quorum required to conduct all business except votes requiring unanimous approval.

The company is managed by an eight-member board of directors. GD controls four board positions, one of which is the chairman, the GOG controls two positions, one of which is the vice chairman, and GE and Westinghouse control one position each. The board establishes the organizational and operational policies and procedures of the company. A quorum of one-half plus one, including a representative of the GOG, is required to hold a meeting, and simple majorities are required for passage of resolutions, except that the board's unanimous approval, with all members present or represented, is required to approve any and all projects undertaken by the company, any in-kind capitalization payments, and the annual extension of the term of the managing director. The day-to-day operations of the company are managed by a small team of professionals employed and salaried by the multinationals.

The duration of the company is fifteen years from the date of incorporation. At the end of the fifteen year term of the company, unless the shareholders unanimously agree to extend its duration, the company will be dissolved and the net proceeds distributed among the shareholders. Under the distribution plan, the entirety of the proceeds, up to the first $50 million will be paid to the GOG. Proceeds (if any) in excess of $50 million will be distributed 50 percent to the GOG and 50 percent to the multinationals as a group, to be divided in proportion to their capital interests.

Alternately, if the GOG desires to continue the company beyond the fifteen years without the continued participation of the multinationals, it may redeem the multinational's stock in one of two ways. First, if the fair market value of the company (as fixed by unanimous agreement of the shareholders) exceeds $50 million, then the redemption price would be one-half the amount by which the value exceeds $50 million. Or, if the company's value is less than $50 million, the GOG would acquire the other shareholders stock at no cost.

CONCLUSIONS

That the GOG accepted this venture capital partnership approach to offset obligations, despite the demands contained in the RFP, is a testament to the potential benefits this approach offers the GOG. By the same token, that GD would propose such an innovative program indicates its belief, and the belief of its partners, in the soundness of the program from a business perspective, especially *vis-a-vis* the offset obligation detailed in the RFP. Indeed, the joint venture company does hold out substantial immediate benefits and potential opportunities for all parties involved.

Perhaps the most innovative aspect of this venture arrangement is the creation of a common interest between the GOG and the multinationals in carrying out the offset. The provisions for profit distribution, share liquidation, and company dissolution provide all of the shareholders, including the GOG, with incentives to seek to operate the company as a money-making venture. The composition of the board of directors, the voting procedures, and the structures for the day-to-day operations of the company ensure that all shareholders will have influence in determining the kinds of business ventures the company undertakes. They further ensure that all shareholders can protect their interests in operating the company for profit.

For GD and its F-16 partners, the venture company also means the elimination of a substantial burden in the implementation of an unwieldy offset program. While the RFP left the interpretations and decisions on fulfillment of the offset obligations to the GOG, the venture program is very specific in defining in advance the entirety of the obligations assumed by the F-16 partners. Moreover, while the $50 million investment may in fact be a larger amount of cash outlay then would have occurred under the RFP (though that is by no means certain when considering the penalty provisions), it represents a substantial saving in implementation efforts, program management, and potential legal costs involved in ensuring realization of implementation credits.

Additionally, the venture capital company frees the multinationals from technology transfers outside of those related to implementation of the direct (coproduction) offsets. It also eliminates problems associated with moving and/or absorbing goods obtained through countertrade and subcontracting activities that, by the terms of the RFP, presumably would not otherwise have taken place. For even if the range of goods and services eligible for countertrade were not restricted, the quantities involved could make countertrade an expensive proposition.

Most important for the multinationals, however, is the potential for achieving offset obligations on a profitable basis. The original GD concept paper developed in 1983, estimated than an "offset development company" in Greece (such as the venture capital company) could achieve annual sales of $74 million, [earn a] net annual income of $7 million, [achieve] positive cash flow by the fourth year, and [obtain] a 17.5 percent internal rate of return over fifteen years. And while this program's arrangement for profit sharing with the GOG reduces the potential return to the multinationals, it nevertheless represents a substantial improvement over the more traditional approaches to offset implementation.

At the same time, the venture company represents an excellent opportunity for the GOG, as it is one of the few (if not the only) venture capital companies in Greece. This has the potential over time, to be a major stimulus to an otherwise sluggish economy that is historically--aside from a few wealthy, individual entrepreneurs--starved for business development capital. If this initial experiment proves successful, the GOG could expand upon it as a vehicle for future offset programs. The economic activity promoted by the company is also likely to be of greater long term value, profitability, and efficiency than that which results under traditional offset implementations.

Furthermore, under this arrangement, the GOG has a much closer role in developing, evaluating, and implementing the individual offsets. Although it had retained the right of prior and post approval under its original RFP, it had done this in an adversarial, auditing mode rather than in the role of a partner with a common, vested interest in achieving success. In contrast, the venture company formula shifts the GOG from a position of merely enforcing the completion of the offset program (though it certainly must still ensure that the multinationals live up to their commitments) to that of constructively participating in its realization.

Equally important for the GOG, the structure of the company ensures the fulfillment of the multinational's offset obligation, irrespective of the success of the company. The articles of association guarantee investment of $50 million capital in the Greek economy. This type of investment is a critical goal of the Greek offset policy. However, if the company proves to be successful, the Greek economy could realize benefits greatly in excess of the $50 million capitalization.

At the same time, there are risks for GOG. If the company is unsuccessful in developing new business and improving Greek trading opportunities, the GOG would in effect have given up the benefits of the traditional type offset program it had demanded for a failed experiment. However, such a conclusion would assume that GD, GE, and Westinghouse, acting as individuals with an unwanted but required burden, would have been more successful in providing economic benefits for Greece than an integrated, tight organization singularly dedicated to that end on a for-profit basis.