

**A CONCEPTUAL FRAMEWORK FOR EFFICIENT DESIGN OF COUNTER-  
OBLIGATIONS IN  
GOVERNMENT CONTRACTS AND LICENSES**

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**ABSTRACT.** A number of countries impose counter-obligations on parties desirous of obtaining government contracts and regulatory licenses, generally on account of a strong desire and need to obtain reciprocal benefits for specific constituencies for the contracts so awarded or the privileges so accorded. These counter-obligations are generally applied in inefficient procurement markets; and could also serve as useful political instruments for mollifying domestic or local constituencies. An interesting feature, in most cases, is that the license or the contract is required to be granted or entered into upfront, whereas the counter-obligations are usually required to be discharged over much longer periods of time. Effective design of a counter-obligations framework is therefore a matter of critical concern for policy-makers and other stakeholders; and this short paper attempts a comprehensive review of various important aspects that need to be taken note of while designing policies and regulations, in order that the counter-obligations mechanism is able to effectively deliver expected public benefits.

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## INTRODUCTION

Most countries, both developed and developing, routinely impose obligations on government contractors and licensees to foster collateral concerns on enhancing public welfare through the contracting process. For instance, telecom services operators' licenses could contain rollout obligations, specifically for undeveloped areas; environmental clearances for infrastructure projects could contain royalty- or profit-sharing arrangements with residents of affected areas; permissions for bringing-in foreign direct investments in select areas could typically impose obligations on back-end infrastructure to be set-up; allotments of public land for hospitals and educational institutions come coupled with obligations to service marginalized groups; financial or subsidy packages for industrial promotion could be coupled with obligations on providing employment to displaced communities; and bidding eligibility in public contracts could impose obligations on minimum domestic manufacturing typically through an offsets route.

While a good amount of academic research exists on the economic efficiency or otherwise of many counter-obligations based approaches, the subject area has remained unaddressed by researchers on what specific elements need to be incorporated, *should such an approach be adopted*, if counter-obligations are to efficiently serve their intended purposes. This short paper seeks to identify, based primarily on practice and dialogue, certain elements critical to the efficient delivery of intended objectives under such counter-obligations based approaches.

## APPLYING PRINCIPLES OF ADDITIONALITY AND CAUSALITY

In the process of imposing counter-obligations, it is important for the Government to accurately determine if the activity imposed on the beneficiary of a contract or license is anyway being undertaken by that beneficiary out of his commercial or other interests. For instance, if certain exports are happening on their own on account of the inherent competitive strengths and advantages of a particular country's manufacturers, it may not yield any added benefits to that country if its counter-obligations framework allows such activities to

be captured by government contractors as eligible towards discharge of their counter-obligations in return for awards of specific government contracts.

Insightful academic work has established causality and additionality (Note 1) as fundamental aspects of a counter-obligations based approach (Balakrishnan, K., 2008; Botha, D., 2003), and some countries apply such additionality- or causality-based tests before any activity is considered as eligible for discharge of the expectations imposed on beneficiary contractors or licensees. These tests essentially force contractors and licensees to demonstrate two important aspects of their counter-obligations offers:

- a. that the transaction was clearly/ demonstrably brought about as a result of the contract/ license granted to the beneficiary; and
- b. that such a transaction probably would not have entered into if a counter-obligation had not existed.

In comparison, certain regimes do not contain any explicit provision requiring the establishment of causality vis-à-vis prime contractor transactions, sometimes leading to situations where a transaction already occurring in the commercial marketplace, on its own strength, is captured by a beneficiary to claim discharge of counter-obligations imposed. In order that such possibilities are avoided to the fullest possible extent, it is therefore important for regulatory jurisdictions to formally recognise and to incorporate these fundamentally essential principles of additionality and causality, in order that contractors and licensees are in substantial alignment with the ultimate objective of leveraging the award of a government contract or license towards attainment of collateral public policy objectives.

### **ADDRESSING VALUE-ADDITION ASPECTS**

Particularly in cases of imposing offset obligations requiring in-country manufacturing and exports, countries normally specify stringent value-addition requirements while evaluating transactions for the determination of monetary values to be recognised towards

the discharge of counter-obligations (Government of Norway, 2012; Balakrishnan, K., 2008). For instance, Defence Acquisition Programme Administration (DAPA) guidelines in South Korea require negotiations on offset value eligibility that appear to be based on the expected value addition in Korea (Korea, 2011). The Canadian Industrial and Regional Benefits (IRB) Policy similarly allows credit based on “Canadian Content Value”—CCV (Industry Canada, 2012a); and CCV is defined as the portion of the selling price of a product or service associated with the work that is actually performed in Canada. Essentially, only the Canadian labour and materials of a particular work package is counted toward an IRB contractor's obligations; and all foreign overhead, labour and materials for any particular transaction is excluded from the computation of CCV. This formula is clearly identified and disclosed in bid documents and otherwise; and applies equally to the determination of domestic value addition in both products and services (Industry Canada, 2012b). Turkey similarly requires the value of imported supplies, equipment and services to be reduced while computing the actual creditable value of discharged counter-obligations (Government of Turkey, 2012).

A clear formulation of principles to be adopted in assessing the value addition is important for incorporation in regulatory guidance, not only for ensuring that credit is given to the beneficiary of a government contract or licensee strictly for eligible values against products manufactured in-country and exported, but also to avoid serious disputes at the time of implementation. Given that value addition is routinely determined on the basis of well-established commercial practices for taxation purposes, the identification of formulation or principles for value addition should not pose any great difficulties for policy-makers in such cases.

#### **IMPOSING DIRECT AND/ OR INDIRECT OBLIGATIONS AND MULTIPLIERS**

Different countries implement fully direct to fully indirect (Note 2) offset programmes (Bureau of Industry and Security, 2010),

depending upon their respective negotiating strengths and their individual commitments to developing strategic manufacturing capabilities (Brauer, J., 2002). DAPA's offset guidelines impose a combination of *direct* and *indirect* obligations on the seller, in that at least 40% of domestic manufacturing is required to *directly* relate to the weapon system/ platform being procured, whereas the balance offset obligation can be fulfilled through purchase of other defence industrial products/weapon systems (DAPA, 2012). Israel's offset program, on the other hand, allows domestically manufactured products and offset projects to not relate to the subject-matter of procurement (State of Israel, 2012).

At the other extreme, the offsets program of a particular country can be completely *indirect*, particularly when in under-developed countries where capacities in particular areas of interest are so low that no worthwhile purpose may be served, at least in the short run, by strict imposition of manufacturing in a very narrow range of products or services. To overcome such short-comings, such countries could consider the adoption of a multiplier-based approach, where different multipliers are applied to different areas of permissible offset activity, so that focus in select areas of interest can be maintained simultaneously with limitations of domestic capabilities in other areas.

### **DETERMINING ELIGIBILITY OF TRANSACTIONS**

An interesting situation arises when a government contract or license contains within its scope certain specific activities that could simultaneously qualify towards discharge of counter-obligations by the contract-holder or the licensee. For instance, in a procurement contract, the main procurement contract could contain specific indigenised or localized purchases as buyer-nominated products or services, which may otherwise be eligible for discharge of offset obligations.

Since the cost of such local procurements, including integration thereof with the main item of supply, is already factored in the cost proposals of bidders against the main procurement contract; it would amount to double benefits to government contractors if such

in-country acquisition is simultaneously allowed to be treated as eligible for discharge of offset obligations. However, at the same time, it may be important for countries to reduce the estimated value of such local purchase component from the cost of the main item of supply, while calculating the offset obligation of the successful bidder in terms of required minimum domestic manufacturing, so that the successful bidder does not effectively incur a higher offset obligation.

Certain countries such as South Korea specifically require in their offset regulations that activities under the scope of the Request For Proposals (RFP) for the main procurement contract would not qualify towards the discharge of their offset regulations, while other countries adopt this principle more as a matter of common-sense principles. However, given the impact on both the government and contractors of any misunderstanding in regard to ineligibility of such local purchases towards the discharge of imposed counter-obligations, it would be worthwhile for regulatory regimes to explicitly state such principles upfront even if they are actually standard industry practice.

#### **HANDLING ACTIVITIES ALREADY COVERED UNDER OTHER CONTRACTS AND AGREEMENTS**

A similar issue of equal concern is the need for regulatory regimes to make explicit provisions disqualifying activities that are specifically paid for against other contracts, either awarded by the same authority, or awarded by any other public or private entity, including government-to-government (G2G) agreements. As an example, if the acquisition of certain technology has been paid for by a domestic private industry, then the transfer of such technology should not be permissible towards the discharge of counter-obligations by the government contractor or licensee. Such cases raise the same moral hazard discussed in the previous section, in that the government contractor gets both payment and offset credit if such eventualities are not specifically accounted for and suitably addressed. Such situations will also arise for actions taken in discharge of G2G agreements, since one party would get extra

benefits, sans reciprocity, if such arrangements are consciously or unintentionally permitted.

### **ADDRESSING CORE ISSUE OF BENEFICIARY SELECTION**

An important area of policy concern is which party retains the choice of beneficiary selection under imposed counter-obligations. For instance, if a telecom service license specifies minimum coverage of rural areas without ensuring their even geographical distribution, a provider may be more inclined to create islands of counter-obligations discharge. Similarly, if the beneficiary of land-allotment for constructing a hospital is not required to provide medical services to a specific area of underprivileged population, such beneficiaries may spread the benefits so thin that they lose value in the process, and/or that the counter-obligations become impossible to monitor. In cases of offset contracts, if an offset contract leaves the choice of selecting a domestic industry partner to the government contractor, such provisions could reduce the commercial negotiating capabilities of domestic manufacturers to virtually nil, leaving them no option but to go along with any offered projects even if they may not serve the intended purposes very well.

### **UNIFORMITY IN APPLICATION OF REQUIREMENTS**

The Canadian IRB Policy does not exempt domestic bidders from offset obligations; and any company that wins a Canadian Government contract that is subject to IRB Policy must fulfill commitments at par with those imposed on foreign vendors, including requirements for value addition in Canada (Industry Canada, 2012b). The Canadian system thus relies on the value addition requirements as a strong and reliable means to ensuring indigenisation and self-reliance, irrespective of the country of origin of bidders.

In practice, however, the Canadian IRB Policy of applying uniform IRB obligations seems to be an excellent model for policy-makers, in the sense that the Government of Canada has a greater role in identification of useful IRB transactions resulting in indigenisation in areas of national and strategic priority. Under such

formulations, it becomes difficult for non-Canadian bidders to defeat the very purpose of the IRB regulations by registering small legal entities, and getting an exemption from the strict manufacturing requirements in the process.

### HANDLING THIRD-PARTY TRANSACTIONS

A somewhat contentious issue on contracts and license has been the eligibility of “third-party transactions” towards the discharge of counter-obligations. These transactions relate to activities that may otherwise qualify for discharge of offset obligations, except for the fact that actual purchases or exports are undertaken not by the seller, but by *related* third parties (such as sub-contractors of the prime contractor) or by *unrelated* third parties. Typically, countries treat such transactions as ineligible for discharge of offset obligations, based on the thesis that permitting such third-party transactions grants undue benefits to prime contractors by allowing them to capture normal transactions between domestic manufacturers and foreign importers as “offset” activities. As mentioned earlier, the twin elements of “causality” and “additionality” have been considered by some researchers as essential ingredients of a successful offsets programme (Balakrishnan, K., 2008); and in scenarios allowing third-party transactions as eligible offset activities, the seller may have virtually no incentive or motivation to undertake any additional manufacturing activities in the procuring country (Note 3).

DAPA offset guidelines of South Korea do not allow third party transactions, unless specifically approved in advance, although it appears that no such cases have actually been approved in that country. Such practices ensure that transactions by “nominees” of the seller remain out of the eligibility zone, so that situations of prime contractors claiming offset eligibility for transactions that may not really have been *caused* by the government decision to award the main procurement contract to the prime contractor are completely avoided.

### **IMPORTANT IMPLEMENTATION ASPECTS**

An efficient counter-obligations framework must necessarily include the terms and conditions under which modifications can be made to applied value, particularly those relating to changes in the terms and conditions of the prime contracts or licenses. For instance, if the scope and coverage of a telecom license are changed, the changes must necessarily result in modified and enhanced obligations if parity amongst initial and existing licensees is to be maintained. Similarly, the regulatory framework must differentiate between government-mandated changes and licensee-initiated requests for changes to the prime license, so that the time- and quantity-schedule of the counter-obligations agreement can be amended in a manner that is able to correctly differentiate amongst these two categories of changes and modifications, and the risk of licensee-initiated changes adversely affecting the delivery schedule for counter-obligations is not disproportionately retained by the Government.

As a corollary, a counter-obligations agreement must contain strict penalties for delayed or non-performance, and must be equally strictly followed at the implementation stage. Any other formulation, quite obviously, renders the imposition of counter-obligations as meaningless; and in addition, may create potential for abuse and associated integrity problems.

Transparency and audit of counter-obligation agreements are the two remaining important aspects of an efficient and accountable regulatory framework. In most cases, it is possible to disassociate the from a counter-obligations agreement from the prime contract or license, and there should therefore be no concerns for any adverse commercial impacts on prime contractors of licensees if the counter-obligations agreement is fully disclosed to the intended beneficiaries. Such disclosure, including the manner and pace of implementation and compliance with originally agreed schedules is a critical aspect from a transparency perspective, as well as enhancing understanding of implementation aspects amongst existing and potential contractors and licensees as well as amongst the beneficiary populations. Concurrent audit, in particular, is important for continuous feedback for course-correction and policy reform, and is

an area that should not be neglected both in stated and practical terms if such agreements are to deliver beneficial outcomes as intended.

### **ENSURING EFFECTIVE ADMINISTRATION AND MONITORING**

Specific aspects of DAPA's offsets programme in South Korea are administered through specialised teams with clearly assigned roles and responsibilities (Note 4). Given that counter-obligations may typically involve a large number of activities in the domain of multiple government departments, it becomes necessary to provide for jurisdictional clarity and finality of decisions for ensuring efficiency and avoiding disputes in the discharge of counter-obligations requirements (Chandola, A, 2011). In addition, such lack of clarity could have an added effect of creating uncertainties amongst potential bidders, potentially discouraging submission of meaningful offset offers by competing bidders, while also creating undesirable vagueness in ensuring accountability of various government stakeholders in the implementation process. Both from an internal administrative efficiency viewpoint, as well as from a transparency viewpoint of potential bidders, it may be therefore desirable to have a single, empowered administering authority to negotiate and implement counter-obligations programmes.

### **SUMMARY AND CONCLUSIONS**

Imposition of counter-obligations necessarily imposes added costs on a prime contract or a license: requiring hospitals and schools, as a condition of land allotment or licensing, to provide subsidized services to disadvantaged sections, or the imposition of offset obligations in government contracts necessarily makes costs higher for non-disadvantaged users or for citizens in terms of higher procurement costs. It is therefore critical that imposition of counter-obligations needs to be appropriately structured, so that expected benefits actually accrue to the intended beneficiaries.

The foregoing analysis highlights critical aspects of counter-obligation arrangements from an efficiency perspective; and the

conceptual framework outlined therein can be easily and quickly applied by various country practitioners to identify areas of concern and to suggest possible solutions and approaches for reform. As countries engage in more intense and in-depth international negotiations on investment, trade and procurement issues, they would be well advised to correctly identify aspects of critical importance so that applied counter-obligations do not remain as paper promises, and are actually translated in practice along intended outcomes.

#### NOTES

1. The “causality” principle requires that the offset transactions undertaken by the seller are caused by its participation (or potential participation) in the main procurement contract; and the “additionality” principle requires that the offset transactions undertaken by the seller must be other than the normal commercial market transactions that are taking (or would have taken) place anyway.
2. When the buying country requires the manufacture of components that form a part of the subject-matter of procurement, the offset obligation is classified as “direct”, while absence of such relationships is classified as “indirect”. See, e.g., Bureau of Industry and Security, U.S. Department of Commerce (2010).
3. In fact, such scenarios could therefore actually encourage rent seeking between prime bidders, existing importers and domestic manufacturers by camouflaging existing or imminent purchase or export transactions as “additional” activities undertaken pursuant to a public procurement decision by the Government or a covered entity.
4. Examples of such specialised teams being an “Integrated Project Team” (IPT—which also oversees the implementation of the main procurement contract), an “Offset Trade Team”, and a “Legal Affairs Support Team”; see DAPA (2012).

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