



Puolustusministeriö
Försvarsministeriet
Ministry of Defence



www.defmin.fi

Industrial participation in defence procurements

Contents

1	Introduction	1
2	Industrial participation in the new statutory framework	2
3	Military security of supply and industrial participation	3
4	The scope and nature of industrial participation.....	6
5	Industrial participation responsibilities within the defence administration	8
6	In conclusion	9



Puolustusministeriö
Försvarsministeriet
Ministry of Defence

Cover photo and layout: Tiina Takala/Ministry of Defence

ISBN: 978-951-25-2897-4 (pdf)

ISBN: 978-951-25-2901-8 (print)

www.defmin.fi

INDUSTRIAL PARTICIPATION IN DEFENCE PROCUREMENTS

1 Introduction

Traditionally, buyers impose a 'compensation clause' in conjunction with major defence procurements from foreign defence contractors. Previously, the term offset¹⁾ was used for such compensation, but nowadays Finland uses the term 'industrial participation'. This is because the focus of the activity lies on cooperation between the Finnish defence industry and the foreign supplier, especially with regard to guaranteeing access to critical technologies in all conditions.

These days in Europe and, particularly, elsewhere many large defence procurements continue to include offset/industrial participation clauses. Alongside system performance and costs, offsets are an important element of the prospective suppliers' comprehensive tenders. In the global marketplace, offsets constitute a general prerequisite for major defence acquisitions and more often than not are the rule rather than the exception. They vary greatly in terms of form, objectives and ways of implementation.

Prior to the entry into force of the Act on Public Defence and Security Contracts (1531/2011) Finland normally required industrial participation in defence procurements exceeding the value of EUR 10 million. Starting from the time the Act entered into force the practice changed and the clause has no longer been automatically included in such acquisitions. These days the imposition of an industrial participation obligation is always considered on a case-by-case basis.

1 For instance during the F/A-18 Hornet acquisition

2 Industrial participation in the new statutory framework

The Act on Public Defence and Security Contracts (1531/2011), which entered into force on 1 January 2012, regulates defence acquisitions. The Act lays down the procedures to be followed in procuring defence or security supplies, services or works. The Act implements the EU Directive 2009/81/EC ('Defence and Security Procurement Directive').

Neither does the aforementioned Act nor the Directive contain any provisions on industrial participation. The Rules on Industrial Participation in Defence Equipment Procurement in Finland, adopted by the Ministry of Economic Affairs and Employment, entered into force on 1 January 2012². They take the current EU legislation into consideration. No legislative provisions on industrial participation existed in Finland prior to 1 January 2012. New industrial participation agreements are yet to be made following the Defence and Security Procurement Directive's entry into force. Presently the compensation rules on Finland's defence acquisitions from the year 2002 are being applied to contracts which are being implemented.

The 2012 Rules define the principles governing the use, objectives and areas of industrial participation as well as the transactions that qualify for industrial participation and the determination of their values. Furthermore, the Rules explain practical matters associated with the implementation of industrial participation, such as the provision of information to the Finnish Committee on Industrial Participation as well as the request process.

The goal of the Defence and Security Procurement Directive is to open up competition in defence acquisitions. Following its entry into force Member States are required to carry out their competitive bidding on defence and security acquisitions pursuant to the Directive when the contract is estimated to have a value exceeding the threshold³ set by the Directive. It is only permissible to deviate from the provisions of this Directive when some of its exclusions apply to the procurement, or if a Member State invokes Article 346 TFEU, which gives a Member State the right to derogate from the EU regulations if the protection of the essential interests of its security so require.

To protect the essential interests of its security a Member State, when necessary, has the right to invoke Article 346 TFEU and carry out its critical defence

2 Rules on Industrial Participation in Defence Equipment Procurement in Finland (Ministry of Economic Affairs and Employment, 1 Jan 2012, revised on 25 Apr 2013).

3 For supply and service contracts EUR 418 000, for works contracts EUR 5 225 000.

acquisitions without applying the Defence and Security Procurement Directive. Moreover, the obligation of industrial participation can be included in such procurements to protect the essential interests of the state. The imposition of the obligation is always considered on a case-by-case basis, and the justifications must meet the conditions under which Article 346 TFEU can be applied.

It is the task of the European Commission is to monitor compliance with EU Directives on the award of public contracts. According to the Commission's unofficial guidance⁴⁾ the Defence and Security Procurement Directive cannot allow or even regulate offsets. The underlying motive is the fact that offset requirements are intrinsically restrictive measures which infringe the EU's Internal Market legislation and the basic principles of the Treaty because they include a built-in bias towards the domestic industry. The Commission believes that mechanisms such as these are only permissible in circumstances when one of the exclusions of the Treaty applies to the situation at hand.

3 Military security of supply and industrial participation

In Finland, security of supply is defined in the Act on the Measures Necessary to Secure Security of Supply⁵⁾. Security of supply means safeguarding the functioning of critical production, services and infrastructures for the purpose of maintaining the population's living conditions, the national economy and the national defence in case of serious disruptions and emergency conditions. The Act also lays down the key points of departure, organisation and the financing of security of supply. Furthermore, the Government sets the overall goals for security of supply which determine the level of preparedness, taking into account the minimum requirements of the population, the essential national economy and the defence⁶⁾.

Military security of supply means safeguarding the needed resources, as well as the maintenance and overhaul of ancillary technical systems for the Defence Forces in case of emergency conditions or comparable disruptions. Military security of supply also guarantees the functioning of the Defence Forces' critical systems in situations which jeopardise the functioning of society.

4 The Commission's 2011 guidance on the application of the Defence and Security Procurement Directive and offsets ('Guidance Note on Offsets').

5 Act on the Measures Necessary to Secure Security of Supply (1390/1992).

6 Government Decision on the Security of Supply Goals (857/2013).

The Government Resolution on Securing the Finnish Defence Technological and Industrial Base⁷⁾ defines the technological and industrial competency and know-how for creating and maintaining critical defence capabilities. According to the Resolution, a well-functioning and internationally competitive Finnish defence industry is of utmost importance and, as a part of the comprehensive defence, elemental in the maintenance of the Defence Forces' many weapon systems, in peacetime and wartime conditions alike. At many levels the defence industry is an integrated part of Finland's defence system.

As a small country Finland is highly dependent on the access to and availability of defence materiel in the global market and many key weapon systems need to be procured from abroad. Nevertheless, Finland must sustain the necessary industrial and technological competency to maintain and tailor critical systems so that their independent use can be guaranteed in all conditions. In most cases it is the Finnish defence industry that has the required competency, and this must be supported and augmented in the course of new system procurements through long-term cooperative arrangements. As a buyer the Defence Forces must see to it that the necessary know-how for integration and maintenance is transferred to the domestic industry in the most cost-effective manner.

Pursuant to the aforementioned Government Resolution it must be made certain that Finland retain the needed critical technological competency. Critical technologies include those that play an exceptionally large role in the defence system's capabilities or those that are kept classified for the sake of national security.

The Resolution identifies the following technologies and associated systems as being critical for the national defence:

- 1) Technologies and engineering related to C4 and ISTAR
- 2) Material technology and structural engineering
- 3) Technologies and engineering for multi-technology systems, and
- 4) Bio and chemical technologies and engineering.

7 Adopted on 7 April, 2016.

For these technologies, it is necessary to ensure that Finland retain the necessary engineering expertise for life-cycle management, production, research and development, planning and design as well as the capabilities to integrate, maintain and repair systems in all conditions.

The Resolution also mentions several ways to preserve control and competency over the abovementioned critical technologies; one of them is industrial participation.

3.1 Direct and indirect industrial participation

Industrial participation is a part of safeguarding the critical technologies, and in Finland it closely associates with relevant technologies and associated competencies. By its nature, industrial participation can be direct or indirect. It is direct when the cooperation between the foreign and domestic industries involves a system that is to be procured: said cooperation can guarantee that the critical technology and expertise associated with the defence equipment, from the standpoint of security of supply, is also available to the Defence Forces in times of crisis and comparable emergency conditions.

According to the Rules on Industrial Participation in Defence Equipment Procurement in Finland (2012) the object of direct participation is for the Finnish defence and security industry to have a well-balanced participation in the manufacturing of parts, the assembly, the integration, the testing or the development, etc. of the defence equipment to be purchased, to ensure that the defence and security industry will have all the necessary expertise at its disposal for the service, maintenance and further development of said equipment.

Industrial participation is indirect when the object involves the transfer of technology and expertise essential to the security interests of the state, to the Finnish defence and to the defence and security industry, e.g. in the form of industrial or technological co-operation. In such a case special attention must be paid to the manner in which the expertise and/or technology relates to the 'critical capabilities' for Finland's defence and to securing the Finnish defence technological and industrial base. Indirect industrial participation focuses on the aforementioned critical technologies. Only in exceptional circumstances can it focus on some other field of technology and, even then, such participation will safeguard the state's essential security interests. In addition, companies manufacturing dual-use items and critical supplies and systems from the standpoint of security of supply can, after careful consideration, be accepted to be a part of an indirect industrial participation arrangement.

Hence, industrial participation does not necessarily directly concern the defence equipment to be procured. Still, as a buyer Finland must be able to ensure that, through the acquisition, it can create such competency in country which makes it possible to operate, maintain and, if necessary, modify the system in all conditions throughout its service life. It is essential to clearly demonstrate that the industrial participation obligation entails the state's essential security interests. When the aforementioned condition is being evaluated, the contracting authority must be able to specify which essential security interest is being safeguarded, and demonstrate how the transaction will protect it.

Industrial participation arrangements normally include an obligation to sign a readiness agreement and/or a partnership agreement with the domestic operator, guaranteeing the availability of the capability created in Finland to the Defence Forces in emergency conditions as well. Finnish Defence Forces Logistics Command is responsible for preparing and managing these agreements.

4 The scope and nature of industrial participation

The requirement and scope of industrial participation is always assessed on a case-by-case basis. The justifications must meet the conditions of Article 346 TFEU as regards safeguarding the essential security interests of the state. This involves a comprehensive evaluation, and its point of departure entails securing military security of supply and the availability of critical technology and associated expertise. Neither the monetary value of industrial participation nor its percentage of the purchase price is paramount in the evaluation. The total scope of the obligation and its content will be further specified during negotiations.

Also the other means available for securing military security of supply and independent operations affect the comprehensive evaluation regarding the appropriate scope and nature of industrial participation. For example, it is possible to guarantee independent operations to a degree by imposing system overhaul and/or maintenance requirements in the Request for Quotation. Likewise, research and technology cooperation may turn out to be an appropriate vehicle for transferring critical technology expertise to Finland.

Requirements for security of supply are often associated with the availability of a given service and with 'critical response times'. For instance, when it comes to the defence equipment to be procured, the goal is to guarantee the needed repair capability in all conditions within a certain response time. The

requirements will be set to meet the needs of crisis conditions and, especially with regard to the Defence Forces' critical systems, they can be quite stringent.

It is also often the case that the requirements for security of supply largely dictate the procurement procedure. If they are stringent⁸⁾, it is impossible to carry out the procurement within the framework of European Union law applying to defence contracts⁹⁾.

As a rule, the multiplier applied for the value of industrial participation is one. However, according to the present Rules on Industrial Participation (2012), if the Finnish Committee on Industrial Participation deems it justified, it may apply a multiplier of 1.5 – 3 in the assessment of the value of a transaction to indirect industrial participation in certain cases¹⁰⁾. Using multipliers in these cases mostly serves the development and internationalisation of defence and security SMEs operating in areas of critical expertise and technology from the standpoint of state security.

As a rule, pre-performance arrangements in industrial participation are not allowed. Only in exceptional circumstances and in conjunction with major acquisitions is it possible for the contractor to launch compensation activities prior to the award of the contract. This, however, demands contractual arrangements between the tenderer and the Ministry of Defence. In these cases the compensation activities are to be carried out at the tenderer's own risk and they do not obligate the contracting authority to any reciprocal activities or reimbursement should the contractor providing the pre-performance not receive the award. In the same vein, it is not permissible to transfer any pre-compensations to a third party.

8 For example, a given maintenance service shall reside within Finland's national borders, and the employees of the service provider must have appropriate security clearances.

9 Defence and Security Procurement Directive.

10 Cf. the detailed description of the Rules on Industrial Participation (2012), Sections 5.4 and 3.1.2 (b).

5 Industrial participation responsibilities within the defence administration

The need for industrial participation will be evaluated in concert with the contracting authority, Defence Command Finland and the Ministry of Defence; with the MoD bearing overall responsibility. The assessment will pay special attention to securing military security of supply and/or the critical technology and associated expertise in a manner which guarantees the use and maintenance of the new system in all conditions.

The Ministry of Defence will take a separate decision on the obligation for industrial participation. The decision must include the justifications for the obligation and support the key goal of materiel policy, which is securing military security of supply in all situations. Moreover, the obligation aims to ensure that the domestic defence industry is integrated into Finland's defence and security of supply, and that it promotes international defence industrial cooperation.

Notification of the obligation for industrial participation must be made, at the latest, when the Request for Quotation is submitted. Nonetheless, the defence administration must already assess the need for the obligation during the preparatory phase of the acquisition, as part of analysing and planning the future system's security of supply. The required industrial participation included in the Request for Quotation should be described as precisely as possible, especially when the industrial participation will be direct.

If the procurement includes an obligation for industrial participation the tenderer must be able to present a plausible plan for meeting the obligation, or an alternative model for guaranteeing military security of supply and/or critical competency.

When the acquisition is implemented through a negotiated procedure it is also possible to negotiate the content of industrial participation with the tenderers. Already at this stage the tenderer must take into account and attempt to demonstrate the relationship between the proposed transaction and the essential security interests of the state. The weight of industrial participation as a factor in the decision will be assessed on a case-by-case basis.

The selected contractor and the Ministry of Defence will sign the industrial participation agreement. The agreement stipulates the total value and content of the obligation and its annexes define the transactions in further detail. Likewise, said Parties will agree upon any possible changes or amendments to the contract. The Finnish Committee on Industrial Participation, reporting to the

Ministry of Economic Affairs and Employment, is responsible for the practical management and monitoring of contracts¹¹).

When it comes to the materiel to be procured, Finnish Defence Forces Logistics Command is responsible for its usability and life-cycle maintenance arrangements. The Logistics Command plays a significant role, especially, in the planning of direct industrial participation. In this respect it bears overall responsibility for utilising the results of cooperation while taking into account, particularly, the materiel policy guidance provided by Defence Command Finland and the Ministry of Defence.

6 In conclusion

Despite its high-level of technology and expertise Finland's own defence industrial capacity is limited and many key weapon systems need to be procured from abroad. Nevertheless, Finland must sustain the necessary industrial and technological expertise in maintaining and tailoring critical systems so that their independent use can be guaranteed in all conditions. In most cases the Finnish defence industry retains the required competency and the defence industry is integrated into Finland's defence system at many levels. Preserving and developing this competency calls for close international cooperation, especially, with the foreign defence industry. Industrial participation is one key method of its implementation.

Industrial participation arrangements safeguard military security of supply and the availability of critical technologies in all conditions. Industrial participation can be either direct or indirect. It must predominantly focus on the capability and technology areas that are critical to Finland's defence as defined by the Government Resolution on Securing the Finnish Defence Technological and Industrial Base, published in the spring of 2016.

The new statutory framework is reflected in the Rules on Industrial Participation in Defence Equipment Procurement in Finland. At the present time it is possible to impose an industrial participation obligation for procurements when the conditions of Article 346 TFEU are met with regard to safeguarding the essential defence and security interests of the state. Imposing the obligation is based on a case-by-case consideration, wherein the guiding principle is to secure and safeguard the essential security interests of Finland.

11 More detail can be found in the 'Rules on industrial participation in defence equipment procurement in Finland' <https://tem.fi/en/industrial-participation>.

www.defmin.fi



Puolustusministeriö
Försvarsministeriet
Ministry of Defence

Eteläinen Makasiinikatu 8
PL 31, 00131 HELSINKI
Puhelin: 0295 16001 (vaihde)