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Trade, industrial and technology offsets in contracts with the Brazilian Armed Forces

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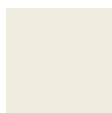
When the Brazilian Armed Forces procure defense materials from foreign suppliers, the commitment by prospective suppliers to offer trade, industrial and technology offsets to the Brazilian public and private sectors is usually a determining factor for selection.

The Brazilian Ministry of Defense regulated this issue by means of Normative Ordinance No. 764 of December 27, 2002 (Ordinance 764). Article 2 of Ordinance 764 provides for the objectives of the Ministry of Defense Offset Policy, which comprises (i) improvement of the technology and quality standards in the Brazilian defense industry by incorporating state-of-the-art methods and processes and by acquiring new technologies; (ii) strengthening specific segments of interest to the Ministry of Defense by fostering the conditions for improvement of the defense industry and development of its technology framework, thus increasing its competitiveness in the international market; (iii) expansion of the Brazilian labor market by creating new high-end job opportunities due to the greater specialization and improvement of human resources in the defense area; (iv) foreign funding to improve industrial and technology capabilities in strategic segments; and (v) an increase in the domestic content of high-end defense products, leading to a progressive autonomy vis-à-vis the foreign markets.

Ordinance 764 establishes that defense product import contracts being negotiated with any of the three Armed Forces at an amount exceeding US\$ 5 million must always include the execution of offset agreements “duly supported by prevailing laws” (article 8). The express reference in Ordinance 764 to the need for legal backing is instrumental because the Brazilian Public Bidding and Procurement Act (Law 8666/93) does not expressly require potential bidders to offer any trade, industrial or technology offset conditions. Besides, the Brazilian Armed Forces usually procure defense materials on bidding waiver or unfeasibility conditions prescribed by the Brazilian Public Bidding and Procurement Act itself. In these cases, upon proper justification for selection of a given supplier and for the procurement price vis-à-vis such bidding waiver or unfeasibility conditions, the contracting Armed Force

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is free to negotiate the other procurement conditions with actual or potential suppliers. It is under the aegis of such procurement discussions in a bidding waiver or unfeasibility scenario that there is leeway for negotiation of offset agreements, and the Armed Forces enjoy a strong bargaining power before suppliers in these multimillion dollar transactions being negotiated in the highly competitive international defense market.

Even in cases of direct contracting (i.e., without bidding procedures preceding it), the Armed Forces may carry out competitive procedures between prospective suppliers, without being required to follow any type of bidding procedure prescribed by law (competitive bidding, auction, etc.). Also in these cases – as it happens in Project FX-2 for acquisition of fighter jets by the Air Force – offset provisions may be requested from competitors, and the Armed Forces may ascribe the weight and importance they find suitable to the offset values and conditions offered by each potential supplier.

Ordinance 764 states that implementation of offsets should, to the extent possible, be coterminous with implementation of the major supply contract. The value of offset offers should – to the extent possible as well – correspond to 100% of the underlying supply contract.

Offset agreements must primarily meet the interests and needs of the contracting Armed Force in the following areas: (i) technology; (ii) manufacturing of materials or equipment; (iii) development of local maintenance capabilities; (iv) personnel training; (v) export; and (vi) financial incentives to the Brazilian defense industry. Under extraordinary circumstances, these benefits may pass to another Brazilian Armed Force or to government or private entities (Ordinance 764, article 18, sole paragraph). In practice, most offset agreements contain benefits to other government and private entities. Within the realm of the Air Command, all major projects underway or under analysis and involving offset conditions – Project F5-BR (revamping of aircraft F5-BR), VC-X (acquisition of presidential aircraft Airbus ACJ-319), P-3BR (revamping of aircraft P-3BR), CL-X (acquisition of aircraft C-295BR) – envisage benefits to Brazilian private companies or foundations. Under the € 6 billion-plus Submarines Development Program (PROSUB), the Brazilian Navy has recently reported that the respective offset agreement is already reaching over 30 Brazilian companies.

It is thus clear that the Brazilian Armed Forces have intensified the execution of offset agreements as a condition for procurement of defense materials from foreign suppliers, which is expected to bring positive trade and technology consequences for the Brazilian Government as a whole and for local private entities and companies.

São Paulo, October 16, 2009.