

CHAPTER 5

COUNTERTRADE POLICY AND STRATEGY GUIDELINES

5.1 INTRODUCTION

Most of the literature on the development of a countertrade policy and strategy is written from the perspective of an enterprise looking to trade with a foreign government. This study is however looking at countertrade from the perspective of government procurement. This chapter will thus look at the guidelines for the development of a countertrade policy and strategy mainly from the perspective of private enterprises as most authors from this sector developed it. However, in conclusion, the different approaches will be combined in a single guideline for the development of a countertrade policy and strategy for government procurement.

5.2 COUNTERTRADE POLICIES AND STRATEGIES

The first step for a company - and for that matter a government - in developing a countertrade strategy is to define its policy clearly to its divisions. It should then make periodic reviews and evaluations to ensure that the strategy being used is consistent with the policy. However, the divisions should have the flexibility to use contingency strategies, as long as these strategies are within the framework of company policy. It is also important that the divisions coordinate their countertrade operations in order to minimize conflict and improve cost-effectiveness (Alexandrides and Bowers, 1987: 56-57). Even though the previous section was written from the perspective of an enterprise it is equally important for a government and its departments when using countertrade.

Okoroafo (1994: 230-233) developed a model to facilitate the implementation of countertrade. The model borrows from the industrial organisation and macroeconomic theory. It deals with the key countertrade participants: firms and countries. The model shows a common case in which participants to a countertrade transaction consists of a firm on the one hand and a country on the other. However, it can easily accommodate

countertrade participants consisting of the “firm-firm” and “country-country” types. His model can be broken down into six steps:

Step 1: Determine your firm’s motivation.

A company interested in countertrade must understand its motivations. This is because the success of the countertrade deal should be subsequently measured against these motivations and not sales, return-on-investment, or market share. In this respect, industrial firms have used countertrade to achieve the following objectives:

- Build goodwill with foreign partners.
- Market penetration.
- Discovery of low cost sources of production and raw materials.
- Maintain market presence.
- Recoup foreign debt.
- Gain competitive advantage.
- Release blocked funds.
- Get rid of surplus production.

These motivations may vary depending on the countertrade type contemplated.

Step 2: Analyse your partner’s motivation.

It appears that motivation for countertrade varies between Developing and Developed Countries. Many discussions address motivation for Developing Countries and the East bloc; however, some objectives are relevant for Developed Countries. Below is a list of some incentives for countries to engage in countertrade;

- Reduce foreign debt.
- Conserve foreign exchange.
- Circumvent international agreements.
- Unload poor quality goods.
- Support overvalued currency.
- Stabilize foreign trade.

Managers can systematically analyse a country's balance of payment statements, policy statements, and other sources to determine countries' economic goals and their ability to fulfil those goals without countertrade.

Step 3: Internal analysis.

Internal analysis involves a systematic assessment of the firm's characteristics. Factors such as experience in international operations, negotiations and countertrade, firm size, product line, management attitude and commitment are relevant to countertrade participation and success.

Step 4: Review the countries' countertrade policy.

Some countries have formal countertrade policies, whereas others do not. However, when countries do not have formal countertrade policies, this does not mean that they do not participate in countertrade. Some countries do not have countertrade policies but would demand it for transactions of significance. Therefore, a country's policy could be explicitly written, or unwritten. In dealing with countries without formal countertrade policies, it is necessary to understand their motives and actions.

For instance the debt service ratio, commodity terms of trade, balance of trade, and foreign exchange reserves of Developing Countries could serve as predictors of imposed countertrade. It is therefore critical for managers to understand the macroeconomic circumstances of countries and consequently predict their countertrade participation

Another relevant group whose position, view, and policies could facilitate or hinder countertrade practice are home governments and international institutions.

Step 5: Review countries' past countertrade practices.

A country's countertrade strategy can be determined by reviewing past countertrade practices. Specifically, the products used in past countertrade deals, countertrade types, and price range are relevant. Typically, these products are ones that do not meet the

highest world standard. Despite their relatively low quality, markets could be found to dispose them. Countries have a schedule of products, price range, and restrictions.

Step 6: Establish your firm's strategy.

The final step in the process is to develop your strategy. There are many facets of a strategy. Elements of a countertrade strategy include decisions about choice of:

- Countertrade type. One of the perplexing problems associated with countertrade, to users and nonusers alike is that it takes on various forms. As could be seen in chapter two, in fact, the numerous definitions are often contradictory.
- Countertrade partners and intermediaries. Countertrade transactions can involve multiple parties that could be buyers, facilitators, or inhibitors. Understanding the motives of the various participants can develop appropriate strategies for negotiation. Government, for instance, could be buyers, facilitators, or inhibitors. Managers have considerable choice of countertrade intermediaries: specialised countertrading companies, switch trades, or barter merchants. Switch traders, such as ContiTrade Services, Inc., facilitate countertrade transactions by identifying and bringing parties together.
- Countertrade information systems. An information system is necessary for firms that are active countertraders. This information system will provide a systematic means of gathering pertinent information to countertrade transactions. It is necessary to know what firms/countries have goods to sell or buy. Also the motives and policies of countertrade participants need to be continuously monitored.
- Negotiation style. The negotiation style is influenced by culture. A negotiation style characterized by Eastern block partners is the “double trap door” in which negotiations are done under cash terms. After the final price quote is obtained, countertrade demands are introduced. It is known that the Japanese will not do business with a partner until they know and trust you. Similarly, the Chinese art

of negotiation is characterised as “Guanxi” relationships or connections can result in success or failure of countertrade negotiations with Chinese partners.

- International marketing mix variables. Countertraders need to consider the product, promotion, pricing, and distribution tactics necessary to support the countertrade deal. For instance, what level of product quality is acceptable to your firm? That decision has to be made in consideration of the markets the goods received would be switched. This is of particular importance when goods from the Eastern bloc and Developing Countries are being received. If the quality of goods is too poor to be attractive in Western markets, the firm can modify the type of countertrade.

According to Korth (1987, 95) the development of a corporate countertrade strategy involves four basic steps:

- Defining the countertrade objectives of the company.
- Analysing market potential in foreign markets.
- Develop a market-specific countertrade approach.
- Implementing that strategy.

As can be seen, both Okoroafo and Korth are looking at the development of a countertrade strategy and policy from the perspective of a private enterprise. Schaffer however looked at the development of policies and strategies for a governmental perspective. **According to Schaffer the following aspects might be useful when formulating an offset policy:**

Formulate objectives.

Start with formulating the objectives namely what we want to achieve. The major objective of the Spanish offset policy for example is to develop a national defence capability. Clear objectives will help steer the proceedings during negotiations in the right direction. Apart from that objective they set themselves the following goals:

- Full Spanish defence industry participation in multinational projects and national projects.

- Improving the technological level of Spanish industry.
- Fostering national economic, commercial and labour interest (Schaffer, 1989: 74-75).

Exclude valuable commodities.

A country should exclude its more valuable commodities from countertrade transactions, in order to sell them directly for cash. This does not mean that a country should only include low value, low quality items in their countertrade deals. The emphasis should be towards a win-win situation to satisfy all parties involved (Schaffer, 1989: 107).

Specific details.

A countertrade policy should specify that:

- A detailed description of any countertrade should be given.
- Specific dates should be given for carrying out the program.
- Performance quantities or penalties for non-performance should be given.
- That the role players should be named for all transactions (Schaffer, 1989: 74).

Consider establishment of an import board.

An import board such as INCOMEX in Colombia can be considered to ensure that importees guarantee that a corresponding export takes place, and reimbursing the board if it does not (Schaffer, 1989: 106).

Specify the size of the offsets.

When formulating the policy, it should specify how big the offset should be as a percentage of the actual sales contract (Schaffer, 1989: 41).

State what should be direct and what indirect.

Lastly one should specify for every offset, what percentage should be direct and what percentage indirect (Schaffer, 1989: 38).

5.3 CONCLUSION

Most of the authors that write on countertrade policy and strategy formulation start the policy formulation process with the development of clear objectives. It thus seems logical that the first step in the formulation of a governmental countertrade policy should be the formulation of clear and unambiguous objectives. As was seen in Chapter two in most cases Developing Nations use countertrade to achieve objectives such as:

- To expand their markets and promote exports.
- To secure market expertise.
- To aid in regional development.
- To clear out surplus goods, etc.

Secondly it seems important to analyse the motives and policies of the potential partners or selling enterprises in the countertrade deal. Alexandrides *et al* (1987: 51-52) writes that there are two basic types of countertrade policies an enterprise can follow: company advantage and mutual advantage. Under a company advantage policy, countertrade/offset is used primarily for the company's benefit (to make a sale, to maintain market share, etc.), with the needs of the buyer country being met at the minimum possible level. Most companies follow this policy. The effectiveness of the company advantage policy varies. At best, it results in a satisfactory arrangement for both buyer and seller. At worst, it can be a disaster; companies may try to get out of their obligations once the sales contract is signed, on the theory that it will be easier to pay the penalty than carry out the offset, and then get into a lot of trouble with the buyer country. In contrast, companies with a mutual advantage policy give the need of the buyer country equal weight with their own. Under this policy, the company is concerned with the goal of the buyer country (i.e., modernization, industrialization, balancing trade, increasing living standards, etc.) and how the countertrade transaction will help achieve these goals. These companies are willing to meet the challenge of achieving mutual benefit through countertrade, and in most cases their efforts are successful. A government should thus investigate the countertrade history of potential countertrade enterprises and exclude enterprises that have proven to follow a company advantage policy.

The previous section indicated that a government should buy from an enterprise that follows a mutual advantage policy in which the enterprise is trying to achieve a mutually beneficial deal, thus work towards a win-win situation. In order to achieve this and in order to achieve the governmental objectives of expanding markets and increasing exports preferably over the long term, it should be policy not to only include low value low quality products in their countertrade deals. These low value low quality products won't create a sustainable long-term demand internationally. Countertrade will only create a temporary demand but as soon as the countertrade deal is completed the demand for these low value low quality products will go back to its previous level. High value product for which there is a cash market and that would have been exported in any case should also preferably be excluded from countertrade deals.

The policy should specify the size of the value of the countertrade requirements as a percentage of the total value of the original purchases, and in the case of the use of offsets the policy should state what percentage of the offsets should be direct, and what percentage should be indirect.

The countertrade policy should also specify that:

- a detailed description of any countertrade should be given,
- specific dates should be given for carrying out the program,
- performance quantities or penalties for non-performance should be given and
- that the role players be named for all transactions.

On the topic of performance penalties for non-performance Kamm (2000) says that internationally there is a move away from performance penalties, as both parties want to work towards a win-win situation. He suggests that other control methods be found like increasing the offset volume, extending the time allowed for performance or black listing suppliers for non-performance for future purchases.

Lastly the policy should require the establishment of a board or a body to evaluate compliance with the countertrade deals, and to ensure that the penalties are paid for non-performance according to the countertrade contract.

As far as the development of a countertrade strategy is concerned the following strategic process as adapted from Alexandrides *et al* (1987: 58-60) could be followed by a government. The first step is to analyse the countertrade/offset needs of both the buying government and the selling enterprise. The enterprise's needs may include entering a new market, maintaining market share, or releasing blocked funds. Some typical needs of buying governments are industrial development; export development, import substitution, employment, and the generation of foreign exchange.

The second step is the cost-benefit feasibility analysis. The government should establish the cost of:

- Human resources, which is the cost of doing the entire transaction in-house, versus giving it to a trading company or other service providers, or a combination approach.
- Other costs such as legal, insurance, shipping, and finance.

These costs must then be weighed against the anticipated benefits such as job creation, increased exports, technology transfers etc.

When the countertrade needs and cost-benefits have been analysed, the government is ready to request sale bids and accompanying countertrade proposals. After the proposals have been received the government enters into negotiations with the selling enterprises.

Areas covered in the countertrade/offset proposal negotiations may include the offset percentages, amount and type of technology to be transferred, amount of investment in joint ventures, degree of technical and management training to be provided, duration of the obligation, level of non-performance penalty, method of enforcement of the obligation and details about the counterpurchases (products available, quantities available, delivery dates etc.) In some countries, the countertrade regulations may specify such things as additionality (exports above the usual level), specific markets for exports, or prohibition of the use of third-party traders. These points must also be negotiated, if the company feels unable to carry out the proposed obligations under specific restrictions.

Two contracts will be signed when the negotiations are complete: one for the sale and one for the countertrade. This stage of signing contracts can sometimes be broken down even further, into the signing of three countertrade contracts. The first stage is the signing of the contract between the supplier and the buying country. The second stage is the signing of contracts between the suppliers and local enterprises in the buying country that are going to be involved in the countertrade. Lastly the local enterprises will sign contracts with local subcontractors also in the buying country (Campbell, 2000: 16).

In sales implementation, the enterprise should adhere to the promised delivery schedule. In the implementation of the countertrade/offset obligation (which may include counterpurchase, buyback, technology transfer, joint ventures, sourcing etc.), the enterprise should make periodic progress reports to the buying government. An authorised agency of the buying government will issue a certificate when the countertrade obligation has been fulfilled (Alexandrides, 1987: 60).

These are some rough guidelines that can be used by a government when developing a policy and strategy for the implementation of countertrade.

CHAPTER 6

THE SOUTH AFRICAN SITUATION AND ARMS DEAL

6.1 INTRODUCTION

According to Kamm (2000) – President of the Asian Pacific Countertrade Association - when looking at the South African arms procurement deal and the fact that we are expecting countertrade worth R104 billion for arms purchases of R30 billion this countertrade deal will be a benchmark countertrade transaction for everyone in the world when it comes to countertrade deals.

In the South African case however the term countertrade is not used, instead the term Industrial Participation (IP) is used. The reason for this name change according to Jogessar (2000) – an assistant director in the IPS in the DTI - is that countertrade is normally associated with barter or some form of counterpurchase. The South African government is however trying to encourage more than just counterpurchases or barter, they are trying to encourage direct foreign investment, training programmes and technology transfers in order to help with the economic development of South Africa through government purchases. Van Dyk (2000) – a senior manager for defence industrial participation at Armscor - adds that the term IP is used, as the term countertrade is not acceptable to most of the signatories of the WTO because the use of countertrade is in conflict with the most of the agreements of the WTO. He also states that the term IP is commonly used by most European countries making use of countertrade, so the term IP can be seen as a synonym for countertrade.

This chapter will take a look at how IP is implemented in South Africa as well as look at the South African arms deal, how it was structured, its advantages as well as its disadvantages.

6.2 THE NATIONAL INDUSTRIAL PARTICIPATION POLICY

IP became obligatory on 1 September 1996. Cabinet fully endorsed the IP policy and its operating guidelines on 30 April 1997. In effect this means that all government and parastatal purchases or lease contracts (goods, equipment or services) with an imported content equal to or exceeding \$10 million (or the equivalent thereof) are subject to an IP Obligation (Department of Trade and Industry, 1997: 2). The IP policy was however just endorsed by government and since IP is not yet required by legislation a lot of IP opportunities are still not utilised because not all parastatals and government departments report purchases falling within the IP parameters to the Department of Trade and Industry to negotiate IP obligations (Jogessar, 2000).

The seller/supplier who incurs an IP obligation will be required to participate in the South African economy as suggested by these guidelines and evaluation criteria. All IP Projects/ Business Proposals must be based on the principles of mutual benefits and business sense (Department of Trade and Industry, 1997: 1).

6.2.1 Mission

The mission statement of the National Industrial Participation Programme (NIPP) is:
To leverage economic benefits and support the development of South African industry by effectively utilising the instrument of Government Procurement.

6.2.2 Objectives

The objectives of the South African NIPP are (Department of Trade and Industry, 1997: 2):

- Sustainable economic growth
- Establishment of new trading partners
- Foreign investment into South Africa
- Exports of South African “value added” goods and services
- Research and development collaboration in South Africa

- Job creation
- Human resource development
- Technology transfer
- Economic advantages for previously disadvantaged communities

6.2.3 Characteristics

The characteristics of the NIPP are (Department of Trade and Industry, 1997: 3):

- **Value threshold - imported content.**
 - Any single contract exceeding \$10 million, or
 - multiple contracts for the same product or service each exceeding \$3 million awarded to one seller over a 2 year period which in total exceeds \$10 million, or
 - a contract with a renewable option clause, where should the option be exercised the total value will exceed \$10 million.
- **Thirty (30) percent obligation.** The sum total of all commercial/industrial activity (subject to crediting criteria) must equal or exceed 30 percent of the imported content (Department of Trade and Industry 1997: 3). This means that any government or parastatal that buys goods, services or leases an item where the imported content exceeds \$10 million have a countertrade obligation to the value of 30 percent of the purchased amount over a period of seven years. In the case of the arms purchases the countertrade obligation was increased to 100 percent Defence IP (DIP) and 100 percent National or non-defence IP (NIP) over eleven years. So for every R1 spent on purchases the successful suppliers have a R1 DIP obligation and a R1 NIP obligation. Which comes to a 200 percent IP obligation (Jogessar, 2000).
- **Mainly performance based evaluation.** In order to receive IP credits the suppliers performance with regards to their IP obligations will be evaluated against the IP performance projections stated in their business plans (Jogessar: 2000).

- **Fulfilment period.** Seven years from the effective date of the IP Agreement (Department of Trade and Industry, 1997: 3). As was said previously in the case of the arms procurement deal the fulfilment period was extended to between seven and eleven years (Jogessar, 2000).
- **Banking.** Excess credits can be banked for a period of four years after the obligation is discharged. Only 50 percent of a new obligation can be fulfilled by banking credits (Department of Trade and Industry, 1997: 3).
- **Five percent performance guarantee.** The supplier will be required to pay in cash to the buying government department or parastatal an amount equal to 5 percent of the outstanding IP obligation if the supplier did not meet his IP obligation after seven years (Jogessar, 2000).

6.2.4 Principles

The principles of the NIPP are (Department of Trade and Industry, 1997: 4):

- **No increase in price.** The IP Obligation must not result in an increase in the price of the purchase.
- **Mutual benefit.** IP Proposals must be profitable for the seller and beneficial for the South African economy (Government of National Unity Objectives).
- **Additionality.** All IP Proposals must reflect incremental or new business to be considered for IP Credits. This means that the IP obligation must be additional to any other investments or deals that the successful suppliers might already be involved in, in South Africa. Saab for example suggested the expansion of another Swedish firm Electolux's plant in Bronkhorstspuit to produce products for the export market expanding its existing operations. This investment would be additional to the existing investment, where the plant is only producing for the local; market. It should thus create something new not previously done by

the supplier in South Africa in order to be eligible for IP credits (Jogessar, 2000).

- **Sustainability.** IP Projects must be economically and operationally sustainable, even after the purchase period.
- **Causality.** IP Proposals must result directly from the purchase contract. The IP Proposal would not have been initiated had it not been a condition of the purchase contract and a possible component in the adjudication process. The exception is the Strategic Partnership Agreement (SPA). The supplier have to prove that his IP obligation was the cause of a transaction in order to be eligible for the IP credits, so transactions already under way before the IP negotiations got under way will not be eligible for IP credits as the supplier or IP was not the cause of the transaction. A transaction has to be the result of the suppliers IP obligation in order to get IP credits (Jogessar, 2000).
- **Responsibility.** The fulfilment of any IP Obligation lies solely with the seller.

6.2.5 IP agreements

IP Agreements can include any one or more of the following (Department of Trade and Industry, 1997: 4):

- Investments
- Joint ventures
- Sub-contracting works
- Licensee production
- Research and development collaboration
- Export promotion
- Supply partnerships with South African industry

6.2.6 IP contractual agreements

In the South African NIPP there exists three broad types of agreements namely:

- **Confidentiality agreements.** Commitment to participating within the parameters of the IP programme and to respect the confidentiality of the discussions and negotiations that transpires between parties (Department of Trade and Industry, 1997: 13).
- **IP causal agreements.** The characteristics of this agreement is (Department of Trade and Industry, 1997: 13):
 - Conditional upon winning the tender
 - Linked to a single tender
 - Surplus credits can be banked for discharging a future obligation as follows:
 - Valid for four years after the discharge date
 - Only 50 percent of the new obligation can be satisfied with banked credits.
 - Performance guarantee of 5 percent

This means that for a single tender a supplier is allowed to bank his excess IP credits form one year and use them to meet his obligation in another year. He is however not allowed to use his banked credits to meet more than 50 percent of a future years obligation, and these credits can only be banked for a period of four years. The supplier is not allowed to bank credits that were obtained in one purchase contract and use them to offset his obligation in another obligation (Jogessar, 2000).

- **Strategic Partnership Agreement (SPA).** The characteristics of this agreement is (Department of Trade and Industry, 1997: 13):
 - Long term agreement between government and supplier

- Not linked to a single tender – can accommodate multiple tenders over a ten year period
- IP obligation can be offset by SPA provided the SPA’s proposed projects exceed the IP obligation
- SPA must be export biased – at least 60 percent of revenue/turnover must be from export business
- Banked credits can be used to discharge future obligations without restrictions
- All other conditions remain the same.

This is a proactive agreement whereby a current supplier with a view on future sales to the government which might require IP, begins to build up IP credits that he can use any time in a ten year period to offset his IP obligation of the future sales (Jogessar, 2000).

6.2.7 Business concepts and business plans

When tendering for a purchasing contract that requires IP the prospective supplier should submit a business concept and a business plan. The business concept should be provided to the DTI first for evaluation, this should include (Department of Trade and Industry, 1997: 13):

- A brief description of products or services
- A broad marketing strategy
- Broad financial projections: sales, cost of sales, profit
- A brief description of the technology/process

In other words the business concept states what the supplier proposes for his IP obligation. After this concept was evaluated and found to meet all the requirements of the DTI the prospective supplier is required to submit a business plan, which is a more comprehensive document than the business concept provided earlier. This document should include the following (Department of Trade and Industry, 1997:13):

- An executive summary
- A description of the business proposal:
 - Legal structure
 - Ownership structure
 - Mission and objectives
 - Description of products and services to be produced
 - Description of industrial sector, markets and customers
 - Processes, systems, technologies and equipment
 - Detailed employment projections, local and foreign
 - Technology transfer
 - Training
 - Exit mechanisms
- Marketing
 - Marketing research and analysis
 - Marketing strategy
 - Marketing plan
- Financial
 - Pro-forma balance sheet, income statement, cash flow statement
 - IRR, NPV, and payback period
 - Financial details of the project
- References of recent successes

These document will first be evaluated be the IP Secretarial and after they approved it, they will go to the IP Control Committee for approval, if they meat the requirements the buyer department or parastatal will be informed that they have complied with the IP requirements and that the purchase can go ahead (Jogessar, 2000).

6.2.8 IP Secretariat and IP Control Committee

As part of the South African government and the DTI's commitment to IP the IP Secretariat (IPS) and the IP Control Committee (IPCC) was founded. These bodies are responsible for the following:

- **IPS responsibilities.**
 - Keeping track of all relevant transactions in South Africa, which have IP potential.
 - Assist, guide and advise sellers in the fulfilment of their obligations.
 - Negotiate and evaluate IP proposals.
 - Make recommendations regarding IP to the IPCC for its approval.
 - Conclude IP contracts.
 - Administer and audit the performance of all IP projects.
 - Prepare status/performance reports for the IPCC that support or do not support the allocation of credits or penalties.
 - Submit an annual report containing information concerning all the activities of the Secretariat and progress with all IP obligations/agreements to the IPCC.
 - Assist the IPCC with its functions and where possible disseminate all decisions of the latter to all relevant parties (Department of Trade and Industry, 1997: 9).

- **IPCC responsibilities.**
 - Provide strategic guidelines and approve guidelines for the National IP Programme.
 - Ensure, with the assistance of the IPS, that all relevant government officials and parastatals are aware and enforce their obligation related to the NIPP.
 - Review, comment and decide on recommendations made by the IPS regarding IP proposals of prospective sellers.

- Evaluate the performance reports, as supplied by the IPS and award credits or penalties where justified.
- Ensure that all relevant IP agreements are monitored and audited by the IPS on a regular basis.
- The IPCC will meet as often as circumstances require, but at least once every two months (Department of Trade and Industry, 1997: 9).

6.2.9 Evaluation/Crediting methodology

In order to evaluate whether the supplier has met his IP obligations, IP credits are awarded to the supplier. Business plans/proposals will be evaluated and possible credits will be indicated. Credits will only be awarded upon successful performance. The following are the methods used to award credits (Department of Trade and Industry, 1997: 10):

Table 6.1 is presented on the next page

Table 6.1: Evaluation/Crediting methodology

	Objectives	Methodology	Factor
1.	Sustainable economic growth	Revenue accumulated over the fulfilment period	1 Unit = 1 Credit
2.	Export promotion	Export revenue = Additional Credits	1 Unit = 1 + LC*
3.	Job creation	Salaries & wages costs accumulated over the fulfilment period	1 Unit = 1 Credit
4.	Training and development	Training and development costs accumulated over the fulfilment period	1 Unit = 1 Credit
5.	Small Medium and Micro enterprise (SMME) promotion	Outsourcing to SMME's	1 Unit = 1 Credit
6.	Previously disadvantaged individuals (PDI)	Outsourcing to PDI SMME's PDI ownership% x revenue	1 Unit= 2 Credits Units x % = Credits
7.	Investment	Capital outlay or capital injection	1 Unit = 2 Credits
8.	Research and development expenses	All costs	1 Unit = 2 Credits
9.	Technology transfer	On a case by case basis linked to revenue	1 Unit = 1 Credit

*LC = Local Content

Source: Department of Trade and Industry, 1997: 10

6.2.10 NIPP summary

According to the South African NIPP the procedure followed can be summarised as follows (Department of Trade and Industry, 1997: 7):

- Liaison between IPS and purchaser regarding IP and the request for proposals.
- Tender invitation to include IP guidelines.
- Conclusion of the Memorandum of understanding/Confidentiality agreement.
- Seller submits business concept to IPS.
- Discussion with IPS regarding the business concept.
- Seller submits business plan to IPS.
- Discussion with IPS regarding the business plan.
- Evaluation of the business plan by the IPS.
- The IPS makes a recommendation to the IPCC.
- Discussion by the IPCC with further discussions if the IPCC disapproves of the business proposal.
- A conditional IP agreement will be signed between the IPS and the seller.
- The IPS would now notify the purchaser that the prospective seller has complied with the IP obligation, so the purchaser would now be in a position to award the contract.
- The IP obligation becomes effective when the purchase contract is concluded.
- Bi-annual progress reports are now required of the seller.
- The DTI will initiate audits if and when required.
- The seller is also required to submit independent audit reports annually.
- IP credits will now be allocated upon performance.
- The decision regarding IP credits will be communicated to the seller together with reports on the status of the seller's IP obligation.
- Upon fulfilment of the IP obligation, the seller will be notified in writing and in so doing, be discharged of the obligation.

6.3 THE DEFENCE INDUSTRIAL PARTICIPATION POLICY, PROCESS AND PROCEDURE

Apart from the NIPP, developed and enforced by the DTI the Ministry of Defence (MoD) has developed a DIP policy, processes and procedures of their own based on the

statements in the NIPP. The following section will take an in-depth look at the DIP policy, processes and procedures.

6.3.1 Objectives

The main objective of all DIP programmes, in addition to those of the NIPP, address specific defence industry objectives, such as:

- The retention, and where possible, the creation of jobs, abilities and capabilities.
- The establishment of a sustainable defence industrial and economic base, with strategic logistic support capabilities.
- The promotion of defence exports of value-added goods.
- The promotion of like-for-like (equivalent types) technology transfer and joint ventures.
- The maintenance of skilled indigenous manufacturing capabilities.
- The provision of a sustainable local defence industry capacity.

The assessment of DIP proposals is based on the extent to which such proposals support the capabilities required by the Department of Defence (DoD) and the South African National Defence Force (SANDF) in the defence industry to provide a strategic, logical support and upgrade capacity for a technologically advanced and modern defence force, its doctrine and posture (Armcor, 1999:1-2).

6.3.2 Defence acquisition and DIP responsibility

All defence-related acquisition programmes abroad, which is subject to IP, shall be managed and administered by Armcor's DIP Division, as directed by the DoD. The

non-defence (NIP) portion of the IP programme, where applicable, is the full responsibility of the IPS of the DTI in accordance with the provisions of the national IP policy (Armcor, 1999: 2).

6.3.3 Principles

The principles of the DIP policy can be summarised as follows (Armcor, 1999: 3):

- **Price.** The DIP obligation may not result in an increase in the price of the purchase.
- **Mutual benefit situation.** DIP proposals must be profitable for the seller and beneficial for the SA economy and defence industry at large.
- **Additionality.** All DIP proposals must reflect incremental or new business in order to be considered for credits. Existing business or completed projects will also not be considered for credits.
- **Sustainability.** DIP projects must be economically and operationally sustainable and must support the main objectives of the DIP programme.
- **Causality.** Causality means that the seller shall demonstrate to the satisfaction of Armcor that DIP projects are/were effectively caused by the seller as a direct result of the DIP agreement (this also applies to a pro-active DIP agreement).
- **Responsibility.** Responsibility for the choice of DIP (and NIP) projects, the selection of local companies/suppliers and the subsequent fulfilment of any DIP obligation rest solely with the seller.

6.3.4 Terms and conditions

The terms and conditions of the DIP policy can be summarised as follows:

- **DIP programme**

DIP programmes are those that cover activities which are directly (by specification) related to the products, services, materiel and/or equipment which are the subject of the main agreement (purchase contract) and commonly referred to as direct DIP, as well as indirect DIP activities related to other products manufactured by or purchased from, or other services rendered by SA defence related manufacturers (industries) in accordance with acknowledged international industrial standards and/or military specifications. DIP programmes shall not include any non-defence related activities (Armcor, 1999: 3).

- **Value threshold**

An IP obligation (DIP or NIP) comes into effect when the value of a defence purchase contract abroad, is equal to or greater than \$10 million (or the equivalent thereof), and is managed separately on a proportional basis between the IPS and Armcor (this also applies to contracts locally and where the imported content equals or is more than \$10 million). The MoD also prescribes an in-house DIP programme, managed by Armcor, on all defence purchases abroad between \$2 and \$10 million (or the equivalent thereof) (Armcor, 1999: 3-4).

- **Obligation**

- For all defence purchases \$10 million or more the IP obligation will be a prescribed percentage of the value of such purchase contracts, which is split proportionally between national and defence industrial priorities and managed separately by the IPS and Armcor. The IPS will determine the NIP obligation, whereas defence will require an obligation of at least 50 percent (in most cases the combined requirement will be proportionally shared on the assumption that the total IP benefit will amount to 100 percent of the tender price) (Armcor, 1999: 4).
- The DIP obligation for defence contracts between \$2 and \$10 million can be up to 50 percent and is managed by Armcor (Armcor, 1999: 4).

- DIP shall be a firm commitment and not only a best effort and will in all cases be substantiated by a proper business plan (Arm Scor, 1999: 4).

According to Van Dyk (2000) in the past suppliers would have had to meet IP obligation or their best effort, so they didn't have to meet their entire IP obligation. It was however very difficult to determine what the supplier's best effort was as this is something subjective so the best effort has fallen away and suppliers have to meet their entire IP obligation.

- **Discharge period/fulfilment period**

A maximum of seven years (with agreed milestones within this period) is allowed for the seller to discharge his DIP obligation. For contracts with a value of less than \$10 million, a shorter period may be prescribed. Long-term acquisition programmes are subject to case-by-case negotiations (Arm Scor, 1999: 4). In the case of the current arms procurement deal however the discharge period ranges from seven to eleven years (Van Dyk, 2000).

- **Penalty**

- A penalty for non-performance will be levied or liquidated damages can be claimed, in terms of the DIP agreement.
- Penalties could be as low as 5 percent and could take the form of a non-performance penalty linked to specific milestones, or liquidated damages.
- The format and type of guarantee is normally specified in the Request for Proposals (RFP), and could refer to either a bank, corporate or sovereign type of guarantee. An acceptable guarantee will be required when the DIP agreement is signed, or prior to the signing thereof (Arm Scor, 1999: 4).

- **Evaluation**

- Proposals for defence projects of \$10 million or more are evaluated on the basis of prescribed business plans for both NIP and DIP.

- DIP proposals on defence projects between \$2 and \$10 million are likewise evaluated on the basis of prescribed business plans, in which the seller is to clearly state his proposed activities and milestones of how he intends discharging his commitment.
 - An evaluation model/value system, as devised and used for the total evaluation of the RFP, forms the basis for DIP evaluation in which the DIP (and NIP) portion forms but one of the factors/elements taken into consideration. The evaluation of DIP proposals will address aspects such as to what extent they support defence, industry, skills, product/services and DIP strategic imperatives. A value model will be devised for each RFP and approved by the DIP committee on a case-by-case basis.
 - DIP proposals and commitments in excess of stated expectations will attract a higher rating. Vague, dubious and non-committed proposals will be disregarded and may even result in the disqualification of a RFP.
 - The seller must apply sound business principles when contracting with defence related industries in South Africa. Armscor and the MoD will not except any responsibility for such contracts and can merely provide a mechanism through the DIP agreement; to advance and promote reciprocal defence related business.
 - The generic aspects taken into consideration when evaluating DIP proposals are based on defence strategic considerations (Armscor, 1999: 5).
- **Banking**

Credits in excess of the seller's indirect DIP obligation may be banked after the initial obligation has been discharged, subject however to a separate pro-active DIP agreement being entered into with Armscor. Excess indirect credits can be banked for a period of four years, after being awarded and may be used for

fulfilling any future possible indirect DIP obligation. In certain cases where direct DIP activities result in foreign exports such may, at the discretion of Armscor, also be considered for possible banking. Defence and non-defence credits are not interchangeable (Armscor, 1999: 6).

- **DIP credit assessment**

Depending on the circumstances pertaining to a DIP transaction, either an input or an output model, or a combination thereof, will be applied by Armscor.

- An output-based evaluation process may be used as this allows the encouragement of sustainable business. Output-based evaluation implies that DIP proposals are evaluated and linked to performance and the realisation of specific goals and benefits gained, at which time credit claims will be considered.
- It might also be necessary to use the input-based evaluation to allow the necessary flexibility for business decisions to be taken by the seller, which in term may be imperative to make such DIP programmes viable. The input-based model implies that credits realised at the time of placing of order by the seller with a local supplier in terms of the DIP agreement. Seller remains however under obligation till such time DIP contracts placed are fully executed/completed (Armscor, 1999: 6).

- **Investment**

Investment may manifest in the following manner (Armscor, 1999: 6):

- It can be the amount of foreign equity capital and/or value of capital equipment that the foreign seller invests, for purposes of performing his DIP obligation, by physical transfer from the seller's country to South Africa, for the benefit of the relevant industries. Investment should be for a period of at least five years in order to qualify for credits. No multiplier will be allowed for determining DIP commitment or subsequent credit.
- It can also mean the accrued interest differential advantage gained by the local supplier/entity for foreign loan capital granted by the seller as part

of his DIP obligation. Such loan repayments must be for a period of at least five years to be considered for granting of credits on the interest advantage portion gained or benefited from. Such credit will typically be considered in accordance with the output principle. Armscor will take the interest rate, method and manner of repayment and the possible direct effect of export credit guarantee and the rate of exchange into consideration.

- **Technology transfer**

Technology transfer for other defence purposes, and other than that to be paid for as covered by the main agreement (purchase contract), which increases the efficiency of defence related companies in South Africa or helps to develop goods not previously manufactured in South Africa, must have an inherent value to South Africa. Armscor, in co-operation with the MoD and where applicable the industry, will determine the value of such transfers for the purpose of granting credits. In the case of DIP programmes such determinations shall be made in accordance with military strategic consideration. As a rule no multipliers will be considered for the purpose of granting credits for technology transfers. Technology transfer proposals shall at all times be addressed on a case-by-case basis (Armscor, 1999: 7).

- **Strategic considerations**

Facilities, products and skills, which are regarded by the MoD as being of strategic value to South Africa, are very costly to establish, retain and maintain. Local industry and SANDF requirements cannot always provide for profitable sustainability in these areas. Foreign contractors are therefore encouraged to consider these areas in the drafting of business proposals. Special emphasis is placed on defence strategic facilities (Armscor, 1999: 7).

- **Main agreement (purchase contract)**

Main agreement shall mean the main agreement or purchase contract concluded between Armscor and the seller for the supply of goods/services which places

the seller under a DIP obligation and, where applicable, a NIP obligation (Armcor, 1999: 7).

- **Agreement**

Agreement could mean two separate agreements for separate NIP and DIP projects (for defence contracts of \$10 million or more), which contains the Seller's defence and non-defence IP obligation, resulting from the main agreement (purchase contract), and signed concurrently with or prior to the latter by all the parties concerned. These agreements set out the scope, definition, commitment, terms and conditions of the respective IP obligation, and contain details of project proposals, all of which shall be in accordance with the respective NIP and DIP policies (for defence contracts of between \$2 million and \$10 million only one DIP agreement shall apply) (Armcor, 1999: 7).

- **DIP contract(s)**

DIP contracts shall mean either orders or contracts placed with Armcor and/or defence related industries in South Africa by the seller and/or industries in the seller's country, for which the seller qualifies for credits in terms of the provisions of the respective DIP and, where applicable, NIP agreements (Armcor, 1999: 7).

- **Buyer/Purchaser**

Buyer/Purchaser shall mean that party defined as buyer/purchaser in the main agreement (purchase contract), and who signed the latter and is responsible for the foreign or local acquisitions/procurement project. In the case of all defence acquisition projects the buyer refers to Armcor, acting for and on behalf of the DoD/SANDF as directed (Armcor, 1999: 8).

- **DIP credits**

DIP credit shall mean the value granted by the DIP committee for the seller's agreed performance, which results in the subsequent reduction in the seller's obligation, and shall normally consist of and be subject to those elements and

conditions specifically or otherwise agreed to in terms of the DIP agreement (credits relating to the NIP agreement are managed separate by the IPS) (Armcor, 1999: 8).

- **DIP Committee**

The DIP Committee is responsible for assessing all DIP proposals in accordance with the procedures prescribed for the evaluation of RFP's. The DIP Committee is furthermore responsible for approving all DIP credit claims and the imposition of penalties. This Committee will be constituted by Armcor DIP Division (the Chair), Armcor's audit and legal experts, the Chief Acquisition of the Defence Secretariat (MoD acting as co-chair) as permanent members. Other members of the MoD, organized defence industry and the Armcor Programme Manager will be co-opted in certain cases (Armcor, 1999: 8).

- **Imported content**

This means that a portion of the tender price is determined by the main agreement (purchase contract) which represents the costs of service, component parts or materials which have been or are still to be imported (whether by the seller or its supplier or subcontractor), based on free-on-board (FOB)/free carrier (FCA) or cost-insurance-freight (CIF) calculation, plus any other foreign direct importation cost and cost relating to royalty or licensing fees (Armcor, 1999: 8).

- **Joint venture**

For the purpose of the main agreement (purchase contract) joint venture shall mean an agreement between the seller, or industries in the seller's country, and Armcor, or defence related industries in South Africa, in terms of which each party contributes for the purpose of achieving a common and mainly defence industrial interest by establishing a third company/business entity (Armcor, 1999: 8)

- **Cancellation**

Should a DIP contract be cancelled, in whole or in part, solely due to the fault of the supplier, no amount shall be deducted from the credit originally granted to the seller. Should such contract be cancelled in whole or in part for any other reason, however, the credit will be adjusted pro rata to the price paid for the goods delivered and/or services rendered (Armcor, 1999: 9).

- **Pro-active DIP agreements**

Armcor also engages in pro-active DIP agreements with foreign suppliers, through which the objectives of defence industrial participation are advanced and simultaneously providing the opportunity for such foreign supplier to accumulate and bank credits that might be used in future defence acquisition programmes where such foreign supplier becomes the successful seller (Armcor, 1999: 9).

6.3.5 DIP procedure

In the case of defence purchases the defence-related portion of the IP obligation is administered by Armcor and evaluated in accordance with the prescriptions governing the evaluation of RFP's and the adjudication of tenders. The non-defence industrial participation obligation portion is specified, administered and evaluated by the IPS in accordance with their procedures for such defence projects where the purchase value is \$10 million or more.

Armcor's DIP Division, in due consultation with the Chief of Acquisitions, DoD, will set up a meeting with the IPS and discuss the interactive action plan to be drawn up for the IP programme, before a request for information (RFI) or Request for Proposal (RFP) is released. The RFI shall at all times include defence and non-defence IP guidelines to enable prospective bidders to submit relevant IP proposals as prescribed in the respective IP and DIP guidelines. A formal business plan is however not required at the RFI stage. The RFI is dispatched by Armcor to all possible contenders. Response

within the prescribed period is mandatory, and late submission shall be excluded from the formal tender (RFP) process.

Each contender will be required, at the RFI stage already, to confirm compliance with the defence and non-defence industrial participation requirements. Armscor will evaluate RFI submissions in collaboration with the DoD, except for the non-defence IP obligation portion, which will be evaluated independently by the IPS. Given the results of the RFI evaluation, Armscor, incorporating the input from the IPS, will draw up a list of possible contenders (shortlist). A formal RFP is drawn up by Armscor in collaboration and with the approval of the Chief of Acquisitions, DoD and dispatched to all possible contenders. Contenders must respond within a specific period. Comprehensive details of the defence and non-defence IP requirements will also be included in the RFP.

Bidders conferences will be organised by Armscor where all prospective sellers will be able to ask questions relating to the RFP. Both Armscor and the MoD relevant line and technical functionaries will attend these conferences. The IPS will also be invited to these conferences in order to answer queries regarding the national IP policy and the non-defence IP obligation (it must be noted that such bidders conferences are not necessarily applicable to all defence projects and may take place separately, each addressing its specific domain interests).

Discussions surrounding defence and non-defence IP proposals will be held between Armscor, the DoD, IPS and the prospective seller. It must however be noted that Armscor and DoD will not be involved with any discussions between the prospective seller and the IPS on business concepts etc.

In response to the RFP the submission by the prospective seller of detailed business plans is mandatory, in accordance with the respective defence and, where applicable, non-defence IP guidelines. Evaluation of the final IP business proposal(s) will be done by the DIP Evaluation Team, consisting of Armscor and DoD officials as part of the prescribed RFP assessment and approval process, and by the IPS where applicable. The

IPCC (of DTI) makes decisions regarding NIP business proposals only. The IPS notifies Armscor of the IPCC's decision so as to enable it to award the tender and to finalise the main agreement (purchase contract) and DIP agreement. In certain cases the NIP and DIP results will be combined and consolidated into a single IP result.

The NIP agreement, preceded in most cases by a "SPA" – Strategic Partnership Agreement, is then concluded between the IPS and the seller, stipulating the terms and conditions of performance to discharge the NIP obligation. Neither Armscor nor the MoD shall be involved in the latter activity. The main agreement (defence purchase contract) will not be concluded by Armscor, unless the prospective contender has fully complied the respective DIP and NIP requirements and have signed the prescribed agreement. The seller is expected to furnish Armscor with six monthly reports on progress with the DIP obligation. Armscor may also demand or initiate audits, as and when deemed fit (Armscor, 1999: 9-12).

6.3.6 General

Companies which have already been accredited through the MoD (Armscor) prescribed Accreditation Programme need not furnish or duplicate information in the prescribed business plan that has already been covered by the accreditation questionnaire. In such cases proof of accreditation must however be furnished by the prospective bidder. Companies not yet accredited must furnish the required information as well as complete the prescribed Accreditation Application.

Prospective bidders are encouraged and advised to consult in advance with South Africa's Aerospace, Maritime and Defence Industry Association (AMD), the MoD or Armscor, to provide them with assistance on information on defence industrial capabilities in order to draft the required defence-related IP business plans. Prospective suppliers to South Africa are furthermore advised to discuss the South African Government's requirements and expectations regarding non-defence IP projects in advance, with the DTI's IPS.

Pro-forma DIP agreements (active and pro-active) are available on request from Armscor Countertrade Division. Prospective suppliers to the MoD are strongly advised to carefully study the contents of these aforementioned agreements and to discuss any uncertainties well in advance with Armscor's Countertrade Division. Usually a copy of the pro-forma active DIP agreement is furnished with the RFP and forms the basis for negotiations and eventual contracting for DIP. The DIP programme is also intended as an instrument for furthering the initiative of capacitating and empowering Black entrepreneurs and business into the defence related industry. Foreign companies participating in the programme with Armscor will be considered for granting additional DIP credits.

It must be noted that the responsibility for negotiations in respect of and eventual contracting for DIP are ultimately that of the Armscor DIP Division (Armscor, 1999: 15).

6.4 THE ARMS DEAL IN DETAIL

South Africa will be spending R30 billion on arms for the Defence Force but in the process is hoping to gain R104 billion in countertrade benefits in return over the next eleven years. The deal takes three forms (Barrell and Streek, 1999: 4):

- Defence related offsets, R14, 5 billion, with local defence firms earning over R4 billion through direct participation in the production of aircraft and ships. Suppliers will also transfer technology worth about R3 billion in royalties and licence agreements to South African firms and will direct export orders to South African firms for more than R7 billion.
- Counterpurchases by the defence equipment suppliers of South African goods, worth R31 billion, including automotive components, furniture, fabricated metal goods including railway wagons and electronic goods.

- Foreign investment in South Africa by companies associated with the equipment suppliers, estimated at R24 billion.

The South African arms deal and the related countertrade obligations of the successful supplies can be divided and discussed according to the different products being purchased, the countertrade obligation is also further divided into defence IP (DIP) and national or civilian IP (NIP). DIP is further subdivided into direct DIP – the production and/or assembly of components of the weapons systems ordered by the South African National Defence Force (SANDF) – and indirect DIP, which is not connected to the systems for the SANDF, and is intended to benefit other defence related companies. The specific information on a number of the countertrade obligations could however not be divulged at the time of the study, as the negotiations was still at a crucial and sensitive stage.

6.4.1 Aircraft

South Africa contracted SAAB of Sweden and BAE Systems of the United Kingdom (UK) for nine two seater and 19 single-seater Gripen International advanced light fighters, and BAE Systems for the supply of 24 Hawk 100 lead-in fighter-trainer aircraft with an option to cancel some of the aircraft in case of a severe economic recession, for a total value of R15, 77 billion (Campbell, 2000: 16). The first twelve Hawk aeroplanes will be delivered by 2005 and the next twelve by 2006 while nine Gripen aeroplanes will be delivered between 2006 and 2008 (van der Westhuizen, 1999: 4).

IP for the Gripen and Hawk form a combined programme. The IP programme started with DIP, with weapons pylons for the Gripen, which are being manufactured by Denel for installation on all Gripens for the export markets, not just those for the South African Air Force (SAAF). Denel is subcontracting the pylons to Camau, of Port Elizabeth. Saab has installed an aircraft design centre at Denel, using 3D computer modelling, which can be used for all aircraft.

In addition, Denel will assemble 23 of the 24 Hawks on order, or on option, for the SAAF, here. Denel will also manufacture 23 tailplane sets for the South African Hawks and another 48 for the Royal Air Force Hawks. In addition AMS is producing the health and usage management system (Hums) for South African, Australian and Canadian Hawks. AMS's Hums is now offered as standard on all Hawks and as an option on all other BAE aircraft. In future the Hums will be extended to cover the engine as well – it will be fitted to the Adour 951 power plant, to monitor its behaviour. At the moment this feature is just for the SAAF, but it will be available to any other customer who desires it. ATE is developing the avionics suite for the SAAF Hawks, and this suite will be offered as an export variant for other countries.

Indirect DIP is likely to include work on the Eurofighter Typhoon advanced fighter and the BAE Nimrod maritime patrol aircraft. Denel's tooling manufacturing capability is being looked at to make production jigs for the Eurofighter. Also part of DIP, BAE contracted Denel to supply rudders and ailerons for the Avro RJ regional jet airliner. This contract was for some 18 sets a year, for the duration of production of the RJ. But it has now been extended to include other structural components as well, and Denel will also produce these, as well as the rudders and ailerons, for the new Avro RJ-X, a new aircraft, which was launched in March 2000.

Grintek would supply the communications management systems for the Gripen International fighter aircraft. With regards to the NIP Saab commented that it is still early days and that they are talking to local industries (Campbell, 2000: 17). Saab suggested the expansion of the Swedish firm Electrolux's plants in Bronkhorstspuit and Cape Town to produce products for the world market. The Swedish producers of fish Swedfish will according to a proposal by Saab go into partnership with the South African fishing community for the development of a fish processing plant. Saab will supply the financing for the plant and also help with the training of the employees. In a proposal aimed at the disadvantaged sections of the South African community Saab and BAE will help with the development and manufacturing of sun heating systems and devices for determining electricity consumption. Finally Saab will help with the upgrading of existing sawmills, help market South African furniture in the international

market, and help with the development of new furniture manufacturers in South Africa. BAE will invest in the South African industry with the acquisition of a 20 percent stake in Denel Aviation for a sum of R6, 5 billion (Gibson, 1999: 21).

Small, medium and micro enterprises could expect up to R3, 8 billion worth of export orders over the next eleven years in the non-defence portion of the government's R15, 7 billion arms deal with BAE Systems and Saab. The programme was expected to result in nearly R350 million of export orders a year for manufacturers of non-defence products. These include basic manufactured goods such as bolts; industrial consumables, safety equipment and work wear through to automotive components, sophisticated hi-tech electronic goods and industrial equipment. The consortium had formed a partnership with DNA Sherwood, a South African group specialising in finding supply chains, industrial procurement and making export arrangements. An export promotion drive would be launched with the support of the DTI. DNA Sherwood would identify and match foreign customers with South African suppliers and partners. There would be particular emphasis on helping small, medium and micro businesses to enter the export market for the first time. This facility will unlock new business potential for many South African manufacturers with the ability to export who have been unable to find appropriate markets for their products (D'Angelo, 2000: 20).

6.4.2 Helicopters

Agusta of Italy was chosen to supply 30 Agusta A109 Power light utility helicopters with an option on another ten for R1, 949 billion (Campbell, 2000: 16). The first light Agusta helicopters will be delivered by 2003 (van der Westhuizen, 1999: 4).

In the area of NIP Agusta is planning to build a mini-steel mill which will be built by an Italian company Danieli. Agusta is also making progress on two other major NIP programmes, for the manufacture of high-value mohair products, and for the production of gold chains in conjunction with Filk Gold, the world's third-largest gold jewellery manufacturer. Denel is also involved with Agusta's NIP, through the manufacture of the commercial Koala helicopter, which Denel will market with them (Campbell, 2000: 17).

Finally Agusta proposed the establishment of an ostrich leather tannery on an ostrich farm in the Potgietersrus area (Gibson, 1999: 21).

6.4.3 Ships

The German Frigate Consortium will supply four Meko A-200SAN corvettes worth R6, 917 billion to South Africa (Campbell, 2000: 16). The German corvettes will be delivered between 2003 and 2005 while the battle equipment will be mounted in South Africa (van der Westhuizen, 1999: 4).

One of the local companies known to be a DIP beneficiary from the corvette programme is African Defence Systems, better known as ADS, which is 60 percent owned by Thomson-CSF of France. Thomson-CSF is responsible for the combat suits for the new corvettes, and prospects for securing exports of elements of the South African combat suit to other Meko customers are reported to be good. As with Agusta, an important part of the consortium's NIP programme is a mini-steel mill (Campbell, 2000: 17). The steel mill will focus on the manufacture of galvanised steel and more specifically plate steel for the motor industry. The steel mill is expected to help produce steel and motorcars and car components of export quality. It was proposed that an existing steel mill should be upgraded at one of South Africa's existing sites namely Yscor. In another proposal it was proposed that technology be transferred to a local producer of crankshafts helping to boost its production for export purposes to 500 000 units a year (Gibson, 1999: 21).

6.4.4 Submarines

The German Submarine Consortium will supply three Type 209/14000MOD submarines to South Africa for a total of R5, 354 billion (Campbell, 2000:16). The submarines will be delivered between 2005 and 2007 (van der Westhuizen, 1999: 4).

The NIP programme for the German Submarine Consortium is centred on a proposed stainless-steel plant, to be built in the Coega industrial development zone in the Eastern Cape (Campbell, 2000: 17). A further proposal is that the South African packaging of

cosmetics does not meet the tough world-class quality requirements and the Consortium proposed that the French company Pechiney transfer technology to South Africa to bring this industry up to international quality standards (Gibson, 1999: 21).

6.5 ADVANTAGES OF THE ARMS PROCUREMENT AND INDUSTRIAL PARTICIPATION DEALS

There is a great deal of time effort and cost associated with the implementation of a countertrade deal. So no enterprise or country would make use of countertrade if there weren't definite advantages associated with the implementation of a countertrade transaction. The following are some of the most common advantages associated with the South African arms procurement and IP deals:

- The demand for raw materials, the spending of incomes earned from employees and spending by government from its tax revenues will all contribute to economic growth and job creation (Stuart *et al*, 1999: 4). The deal will bring in new job opportunities into the South African economy. The countertrade deal is expected to create 65 000 sustainable jobs in an economy that has seen the loss of 1,6 million jobs in the last five years (Stuart *et al*, 1999: 4).
- The deal would focus people's minds on what South Africa has to offer (Stuart *et al*, 1999: 4).
- The deal would draw billions of fixed investment into the country from the successful arms suppliers (Barrell *et al*, 1999: 4), such as the proposed stainless-steel plant that the German Submarine Consortium is planning to build in the Coega industrial development zone in the Eastern Cape (Campbell, 2000: 17)
- Countertrade deals like the arms deal and the South African Airways countertrade deal for the purchase of new aircraft will be an aid in the training of

the South African workforce – through for example technology transfers - thereby increasing their productivity and capabilities (Bailey, 2000: 6).

- Countertrade is also expected to help increase South Africa exports through export promotion programmes. It is expected that the export promotion programme of BAE Systems and Saab will result in nearly R350 million of export orders a year for manufactures of non-defence products (D'Angelo, 2000: 20) It is also expected that some of the components being manufactured locally for inclusion in the defence equipment being purchased such as the tailplanes for the Hawks will be exported to foreign governments such as the 48 other tailplanes being manufactured for the Royal Air Force (Campbell, 2000: 17).

6.6 CRITICISM

There has been a lot of criticism against the arms deal coming from different sources. This criticism can, however, be divided into two separate sections, criticism against IP and the implementation and application of IP, and criticism against the arms deal itself and the way the contracts were allocated. The following criticism originated from the press. The author wishes to state that by including this he does not necessarily agree with it or acknowledge the correctness in any way.

- **Criticism against IP**
 - The Minister of Finance and other economic analysts doubt that much of the offset investment into South Africa promised by the successful bidders would materialise (Barrell *et al*, 1999: 4). In adding to this Sapa (2000:1) reports that international experience has shown that the only function which offsets performance for recipient countries is to provide political legitimisation for the large outlay required on modern defence systems by allowing policy makers to point to apparent, but ultimately non-existing economic benefits. In short offsets are a scam promoted by

the armaments industry, with connivance of politicians, to fleece the taxpayers of both supplier and recipient countries.

- Little has yet been revealed about what offset deals are actually in place, with government representatives claiming the commercial confidentiality agreements could be breached if the public were to be informed. Thus far government has only made public a wish list of possible offset commitments, which weapons sellers mooted (without being tied down to them) during the negotiations aimed at securing the supply contracts (Powell, 2000: 8).

- **Criticism against the arms deal**

- South Africa has lost 1,6 million jobs in the last five years, and could lose even more jobs in the gold mining industry. So the 65 000 sustainable jobs being created by the countertrade deal would hardly make an impact on unemployment in South Africa (Stuart *et al*, 1999: 4).
- There are questions being raised about the real cost of the arms deal and whether the R30 billion being spent on arms can be justified against the R500 million that was slashed of the Gauteng hospital budget in 1999 (Stuart *et al*, 1999: 4).
- There are feelings that the equipment could have been sourced cheaper (Loxton, 1999: 1). It is being said that the price being paid by South Africa for the Gripen fighters, namely \$65 million an aircraft, is wildly inflated, with the benchmark price standing at \$32 million, just under half of the amount (Powell, 2000:8).
- The Ministers of Education, Health, and Welfare want to reduce the size of the arms deal because they fear the deal could reduce their budgets substantially (Barrell *et al*, 1999: 4).

- There has been accusations that the South African Air Force (SAAF) has spent R3, 3 billion on 28 Gripen fighter aircraft it is not in a position to fully utilise. The SAAF currently has fewer than 10 pilots qualified to fly the 30 perfectly serviceable Cheetah C aircraft it currently owns – and none is as yet capable of flying the Gripen. The Cheetah C's were bought, in a batch of 32, from Israel as recently as 1996. Due to a shortage of qualified pilots in the SAAF, more than half of the aircraft are virtually unused. Two of the aircraft have been decommissioned after crashes. The C-class Cheetahs were bought to replace, at the cutting edge of technology, an earlier generation of aircraft, the Cheetah D, which the SAAF still flies. As opposed to the still functioning Cheetah C, analysts noted that the Cheetah D was indeed at the point of obsolescence. The Cheetahs already in possession of the SAAF constituted a force more powerful than any air attack that neighbouring countries in Africa could assemble (Powell, 2000: 8).

- The money spent on arms procurement could have built a million homes (Powell, 2000:8).

- The acquisition of 40 Italian made Agusta utility helicopters as part of the weapons procurement programme was made against the wishes of the SAAF experts. Before the final deal was done, the SAAF had already selected the Bell 427 – the world market leader in the class – going so far as to signal the forthcoming deal by draping the Bell helicopter in South African colours at an exhibition of defence technologies. The deal however went sour after the American company failed to bring Futuristic Business Solutions, a company with close links to the South African military establishment, in on the deal.

However an analyst has questioned the usefulness of the Agustas in the conditions for which they were bought. The first purchase of Agustas

was made for maritime conditions, but the problem is it cannot take high altitudes, and this reduces its effectiveness (Powell, 2000: 8).

- o CCII Systems has written to the Auditor-General to formally request that a forensic audit be conducted into the removal of CCII as selected contractor to provide the information management system for South Africa's new patrol corvettes. The information system is the vital "brain" of the ship, linking weapons, communications and vessel control systems. The CCII system, which is South African, had been developed in conjunction with Armscor and had been selected by the SA Navy. However, late in the process, the contract was granted instead to French company Detexis. The significance of this is that Detexis is owned by French defence company Thomson-CSF. Thomson also owns the South African company African Defence Systems (ADS) that was appointed to drive South African participation in the "fighting" components of the corvette programme (Sole, 2000:13).

- o Companies with close links to the head of the military weapons procurement committee have been awarded a big section of local contracts in South Africa's R30 billion weapons deal. It has emerged that the head of the defence department's arms procurement committee, Shamin "Chippy" Shaik, has close relations in a company mandated to provide South African partners for the arms deal. A close associate of former defence minister Joe Modise is also a director of the company. The way the weapons procurement programme was structured meant foreign suppliers were required to form partnerships with local players in the defence industry and to guarantee investment in the South African economy, thus creating what cabinet estimated at 65 000 new jobs. There are two companies at the centre of the controversy. Firstly there is African Defence Systems (ADS), which lists Shaik's brother, Shabir, as one of its directors in a seemingly flagrant violation of conflict of interest provisions in legislation governing tender procedures. Chippy Shaik's

wife Zarina works as a senior marketing executive in ADS, which will retain a substantial portion of the R2, 6 billion paid into its account. Also included in the ADS directors as from earlier this year, is another family team former Umkonto we Sizwe member, and retired lieutenant general in the South African National Defence Force (SANDF) Lambert Moloi, and his son-in-law engineer Tsepo Molai.

Moloi is a close associate of Modise (who oversaw the initial phases of the weapons deals before his retirement in 1999) and also a director of the arms manufacturer Denel. Meanwhile both Moloi and Molai are also directors of the other company implicated – Futuristic Business Solutions (FBS). FBS not only was given work on the arms package by ADS, but also subsequently became a shareholder itself. FBS had acquired a 20 percent stake in ADS, and had been associated with ADS since late 1998. The rest of ADS is owned by a French company, Thomson CSF, making a mockery of the company's pretensions to being a black empowering venture.

All in all FBS stood in line to secure around 70 separate contracts in the weapons procurement deal, many of which had been facilitated by ADS as officially designated integrator of various projects. This was despite the fact that FBS lacks any actual infrastructure or manufacturing capacity and merely functions as a logistics co-ordinator (Powell, 2000:4).

- The Auditor-General submitted a report on the arms deal to the Minister of Defence in which it was found that there were problems with the technical evaluation of the bid for the fighter trainer. The fact that a non-cost option was used to determine the successful bidder was a material deviation from the originally adopted value system. This ultimately had the effect that a different bidder, at a significantly higher cost, was eventually chosen on the overall evaluation. The Auditor-General

recommended that a special forensic audit be conducted into the subcontractors which fell out of the original terms of reference of his probe, and which have been the subject of repeated corruption claims (Sapa, 2000: 2).

As can be seen from the criticism the majority of the criticism is against the arms deal itself and the way that the purchase contracts was allocated, while there isn't much criticism against the use and application of countertrade.

6.7 RESPONSE TO THE CRITICISM

For the purpose of completeness it is important to not only look at the criticism against IP and the arms deal, but also at some of the answers to the criticism. The answers to the criticism can also be divided into answers to criticism against IP and answers to criticism against the arms deal.

- **Criticism against IP**

In answer to the criticism that IP is used by the defence industry to silence criticism by politicians and tax payers in the buying country against the huge capital outlay of defence procurements and that the IP obligations always fail to materialise, Barrell *et al* (1999: 4) write that Australia – apparently because of its relatively sophisticated industrial base – managed to ensure that two American guided-missile frigates and ANZAC Class frigates were built in Australia, and that 21 Hawk Lead In Fighter trainers were assembled in Australia. In the course of a major international defence procurement programme in 1996/97, Australia managed to spend more than half of its R10 billion on major and minor capital equipment inside Australia. This proves that IP can work. It just has to be implemented and policed correctly.

In answer to the criticism that little has yet been revealed about what offset deals are actually in place and that the government has only made available a

wish list of possible offset commitments, Van Dyk (2000) says that +/- one third of the NIP are investment projects of approximately R24 billion. The suppliers have presented their business concepts on these investment projects and these concepts have been approved by the DTI, however it takes time – approximately six to nine months which includes the preparation of viability studies - to prepare the final business plan for these NIP obligations. In that time the situation in the market can change and what seemed a viable business concept might not be one any more where the return on investment might not be high enough any more and the process has to start over again determining another viable business concept and plan. It needs to be understood that the contracts are just now coming into operation with the submarine contract only coming into operation at the end of July 2000 and then the supplier has got between 7 and 11 years to make good his obligation. That is the reason why not all the NIP has been finalised yet.

- **Criticism against the arms deal**

One of the criticisms against the arms deal were that there were nepotism in allocating contracts to ADS as well as that ADS wasn't a local supplier and as such the local defence industry wasn't being used in the building of the corvettes. In answer to these allegations Van Dyk (2000) states that one of the criteria of the tender for the corvettes was that whoever won the contract to supply South Africa with the corvettes had to contract at least 60 percent of the value of the contract for the combat suite for the corvettes with the local industry, the local industry being ADS.

The reason for this was that the SANDF and ADS has spent millions of rands over the last ten years to develop technology specifically aimed at the needs of the South African Navy. Had the tender not specified that ADS and its technology be used for the corvette defence systems that portion of the contract might have gone to a German, French or English supplier and the time and money spent on the development of our local defence systems would have been wasted. The defence system makes up approximately two

thirds of the total cost of a corvette. He adds that ADS was originally a local supplier, but in the time that the tender process transpired 60 percent of ADS was sold to the French company Thomson-CSF. It is still however technology developed with South African taxpayers' money that will be fitted into the corvettes.

This was the only case in which there was prescribed to the suppliers with which local suppliers they had to contract, all the other arrangements between suppliers and subcontractors for example between Saab and the fishing community in the Western Cape are purely up to them to decide with whom they want to associate.

There had also been criticism that the price paid for the Gripen fighter namely \$65 million per aircraft was too high compared to the benchmark price of \$32 million an aircraft. Van Wyk (2000) states that when evaluating a supplier for a contract they looked at three aspects namely technical aspects including costs such as purchasing costs, and life sickle costs, secondly they look at the IP being offered namely NIP and DIP and thirdly they looked at the financing of the contract. So the decision was based on a broad range of aspect that jointly help determine which supplier was going to be awarded the contract.

In response to criticism and fears from the Ministers of Education, Health and Welfare that their budgets might be cut in order to finance the arms deal, the government has said that the arms deal would not cause the state to exceed its budget deficit targets in coming years or raise its interest burden. The government also stated, that it did not expect the deal to cut into the budget allocations of other departments excessively (Barrell *et al*, 1999:4).

Lastly in response to the Auditor-General's report on South Africa's arms deal and the recommendation that a forensic audit be conducted into the subcontracts which fell out of the original terms of reference of his probe.

the Minister of Defence said the government could not be held responsible for any problems at that level, as only the prime contract are their responsibility and that the subcontracts are not their responsibility (Sapa, 2000:).

6.8 CONCLUSION

This South African arms deal consists of two types of countertrade namely national and defence industrial participation. The NIP consists of non-defence IP such as the building of a stainless steel plant in the Coega industrial development zone in the Eastern Cape by the Germans Submarine Consortium and the building of a fish processing plant by Saab in the Western Cape. This NIP is being administered by the DTI.

The DIP or defence IP consists of direct and indirect IP, direct IP being IP projects stemming directly from the arms procurement deal such as the assembly of Hawk trainer aircraft by the local enterprise Denel on behalf of BAE, while indirect IP refers to DIP not directly related to the arms procurement deal such as work that local enterprises will be involved in on the Eurofighter and the BAE Nimrod maritime patrol aircraft. Armscor on behalf of the MoD administers the DIP.

Not all the IP obligations have however been finalise yet, all the business concepts have been approved for the proposed IP but the successful suppliers are still in the process of finalising some of the business plans for the IP obligations.

The arms procurement deal is however not without criticism as was shown, this criticism can be divided into two sections, criticism against IP (countertrade), such as that the IP obligations never materialises and that the IP and its advantages are only used to silence criticism from politicians and tax payers. Secondly there is criticism against the arms deal itself that ranges from the price that was paid for the Gripen fighter was to high, to questions being asked about whether South Africa really needs to

buy new fighters as our old fighters is still more powerful than any air attack that neighbouring countries in Africa could assemble.

But the arms procurement deal also has its advantages in that it is expected to encourage economic growth, create job opportunities, lead to technology transfers and cause an increase in foreign investment.

CHAPTER 7

AN EVALUATION OF THE SOUTH AFRICAN COUNTERTRADE POLICY GUIDELINES

7.1 INTRODUCTION AND EVALUATION METHOD

Chapter five consisted of a literature study in which secondary data was evaluated in order to determine which aspects should be included in a countertrade policy, as well as to determine what a good countertrade strategy should look like. Then in chapter six the current arms procurement deal was written up as a case study including the current South African countertrade policies. The aim of this was to be able to evaluate the current South African countertrade policies against the information collected and documented in chapter five in order to determine how thorough and potentially successful the South African countertrade policies are, and whether South Africa would be able to create and develop local enterprises through the use of countertrade. A survey was also conducted in order to determine the countertrade practitioners' perceptions of the importance of the policy guidelines identified in chapter five before evaluating the South African countertrade policies against these guidelines.

7.2 DETERMINATION OF COUNTERTRADE PRACTITIONERS' PERSPECTIVES

A survey questionnaire was developed to determine the countertrade practitioner's perceptions of the South African countertrade policy guidelines. Secondary data identified and documented in chapter five was used to formulate fourteen statements and one question contained in the questionnaire. The questionnaire consisted of fourteen statements that the respondents had to answer on a five point scale where 1 was not important and 5 very important. The fifteenth and last question was an open-ended

question with respondents being able to answer the question as they saw fit. The questionnaire is included as Appendix A.

Non-probability, judgement sampling was used to determine the respondents as the respondents had to conform to certain criteria namely they all had to be involved in countertrade, in order to be able to answer the countertrade related questionnaire. As a number of the countries and enterprises that use countertrade don't admit freely to doing so it is very difficult to determine the population size and location. To overcome the problem a group of twelve countertrade practitioners from all over the world was selected at the annual Asian Pacific Countertrade Association Conference held at Sun City in South Africa. The questionnaires were sent electronically via e-mail to the respondents and were also received back via e-mail. Twelve questionnaires were sent out and eight received back. **Due to the small size of the sample and the even smaller size of responses the findings were not statistically processed or presented, but only serves to support the literature study.**

7.3 PERSPECTIVES OF THE RESPONDENTS

Table 7.1 gives a breakdown of the responses received to the statements. In the table a rating of 1 is not important and a rating of 5 is very important.

Table 7.1 is presented on the next page.

Table 7.1: Analysis of responses

Statement/Variable	Rating 1.		Rating 2.		Rating 3.		Rating 4.		Rating 5.		Average	Standard Deviation
	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%	<i>n</i>	%		
1. A countertrade policy should contain clear and unambiguous objectives.	0	0	1	12,5	1	12,5	4	50	2	25	3,875	0,991031
2. It should be policy to analyse the motives and policies of potential suppliers.	0	0	1	12,5	2	25	4	50	1	12,5	3,625	0,916125
3. A countertrade policy should state that the country would only negotiate with an enterprise that follows a mutual advantage policy.	0	0	1	12,5	1	12,5	5	62,5	1	12,5	3,75	0,886405
4. A countertrade policy should state that the country would only negotiate with an enterprise that follows a company advantage policy.	2	25	2	25	3	37,5	1	12,5	0	0	2,375	1,06066
5. A countertrade policy should state that not only low value low quality products should be included in the countertrade deal.	1	12,5	2	25	3	37,5	2	25	0	0	2,75	1,035098
6. High value products for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals.	1	12,5	4	50	2	25	0	0	1	12,5	2,5	1,195229

Table 7.1 (continued)

7. The policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase.	0	0	0	0	2	25	2	25	4	50	4,25	0,886405
8. In the case of the use of offsets the policy should state what percentage of the offsets should be direct, and what percentage should be indirect.	0	0	1	12,5	0	0	5	62,5	2	25	4	0,92582
9. The countertrade policy should specify that a detailed description of any countertrade should be given.	0	0	3	37,5	1	12,5	2	25	2	25	3,375	1,30247
10. The policy should state that specific dates should be given for carrying out the programme.	0	0	1	12,5	1	12,5	6	75	0	0	3,625	0,744024
11. Performance penalties should be given for non-performance with the agreed obligations.	1	12,5	2	25	2	25	3	37,5	0	0	2,875	1,125992
12. A countertrade policy should avoid the use of penalties for non-performance and rather use other sanctions such as the increase of the offset volume or extending the time limit.	0	0	1	12,5	1	12,5	3	37,5	3	37,5	4	1,069045
13. The policy should specify that all role players be named for all transactions.	0	0	2	25	3	37,5	3	37,5	0	0	3,125	0,834523
14. The policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations, and to ensure that the penalties or other sanctions are enforced for non-compliance with the countertrade obligations.	0	0	1	12,5	1	12,5	5	62,5	1	12,5	3,75	0,886405

The following can be deduced from the information in table 7.1:

- On the statement that a countertrade policy should contain clear and unambiguous objectives two of the respondents said that clear and unambiguous objectives was very important by indication a five on the five point scale, four gave the statement a four also indicating that the objectives was important, one gave the statement a three and one gave the statement a rating of two thus indicating that objectives isn't that important for inclusion in a countertrade policy. With an average of 3,875 this policy guideline can be considered as important for inclusion in a countertrade policy.
- On the statement that it should be policy to analyse the motives and policies of potential suppliers one respondent gave the statement a rating of five indicating that it is very important to analyse the motives and policies of potential suppliers, four gave the statement a rating of four indicating it is important, two gave the statement a rating of three indicating it is average in importance while only one gave the statement a rating of two. With an average of 3,625 this policy guideline can be considered as important for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that the country would only negotiate with an enterprise that followed a mutual advantage policy, and not with enterprises that followed a company advantage policy (a win-lose policy) one respondent said it is very important giving the statement a five. The majority of respondents responded with a four, namely five respondents. One each marked three and two. With an average of 3,75 this policy guideline can also be considered as important for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that a country should only negotiate with an enterprise that follows a company advantage policy (win-lose), and not with an enterprise that follows a mutual advantage policy only one respondent indicated that this statement is important, three indicated that it was average in importance two that it was less that average in importance and two

said it wasn't important at all giving the statement a rating of one. With an average of 2,375 this policy guideline is less than average in importance for inclusion in a countertrade policy.

- On the statement that a countries countertrade policy should state that not only low value low quality products should be included in the countertrade deals two respondent said that the statement is important marking the four on the questionnaire, three said it was average in importance marking the three, two said it was less than average in importance marking the two and one said it was not important at all choosing the one. When looking at the average of 2,75 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that a countertrade policy should state that products for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals only one respondent felt that it is very important to include such a statement in a countertrade policy. Two respondents felt it was average in importance while four respondents felt the statement was less than average in importance and only one respondent felt the statement was not important at all. Thus with an average of 2,5 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that the countertrade policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase four of the eight respondents said that this statement is very important for inclusion in a countertrade policy. Two said it is important and two said it is average in importance. With an average of 4,25 this policy guideline is important for inclusion in a countertrade policy.
- The following responses were received on the statement that when offsets are used the policy should state what percentage of the offsets should be direct, and what percentage should be indirect. Two of the respondents felt that such a

statement is very important for inclusion in a countertrade policy while five of the eight respondents felt that the statement was important. Only one respondent rated the statement as being less than average in importance by choosing the two. With an average of 4 this is an important policy guideline.

- On the statement that the countertrade policy should state that a detailed description of any countertrade should be given two respondents said it was very important that this statement should be include in a countertrade policy, two respondents said it is important, one said it was average in importance while three said it was less than average in importance. When looking at the average rating of 3,375 this policy guideline is above average in importance for inclusion in a countertrade policy.
- On the statement that the policy should state that specific dates should be given for carrying out the program six of the eight respondents said that this is an important policy issue one said it was average in importance indicating the three while only one respondent said that the policy issue was less than average in importance. With an average of 3,625 this is an important policy guideline for inclusion in a countertrade policy.
- On the statement that performance penalties should be given for non-performance with the agreed obligation three of the respondents said this was an important policy issue while two said it is average in importance, two said it is less than average in importance and only one said it wasn't important. With an average of 2,875 this policy guideline is less than average in importance for inclusion in a countertrade policy.
- On the statement that the policy should try to avoid the use of penalties for non-performance and rather use other sanctions such as the increase of the offset volume, extending the time limit and black listing the enterprise for future sales to the government three of the respondents said the policy issue was very important, three said it was important one said it was average in importance and

only one said it was less than average in importance. Thus with an average of 4 this is an important policy guideline for inclusion in a countertrade policy.

- On the statement that the policy should state that all role players be named for all transactions three respondents said it was important three said it was average in importance and two said it was less than average in importance. Thus with an average of 3,125 this policy guideline is just above average in importance for inclusion in a countertrade policy.
- On the statement that the policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations, and to ensure that the penalties or other sanctions are enforced for non-compliance with the countertrade obligations one respondent said this was a very important policy issue five said it was important one said it was average in importance and one said it was less than average in importance. When looking at the average of 3,75 for this statement this policy guideline can be seen as important for inclusion in a countertrade policy.

The last question was an open-ended question that asked the respondents to state any other variable that they thought was important for inclusion in a countertrade policy.

The following responses were received:

- The objectives to be achieved should lead the policy
- Relatively easy procedures to adapt offset work and schedule should be included but the recipient of offset must be protected to avoid undue supplier switching
- Consistency rather than rules itself are more important
- The policy should maximise the conditions for an initial commitment to be established and then allow for “normal” business relations to be developed between the parties to foster sustainable relations over the long term.
- The faster the offset obligation can be removed as a punitive threat the more innovation and optimisation will occur.

- A visual aid, which geographically identifies where the best benefits can be, achieved e.g. Eastern Cape, Western Cape etc. Also a table which loosely shows where suppliers can easily identify what to do and where to do it.
- Rural development projects, which encompass training, education and job creation identifies opportunities for development in these areas.

7.4 CONCLUSION

In this chapter the policy issues identified in chapter five were evaluated against the opinions of eight countertrade practitioners worldwide. Based on the responses received from them it is now possible to determine which policy guidelines are important for inclusion in a countertrade policy. The South African national countertrade policy and Armscor's countertrade policy can now be evaluated against these policy issues in order to determine their thoroughness and whether they are able to ensure the successful implementation of countertrade in South Africa.

CHAPTER 8

SUMMARY, CONCLUSION AND RECOMMENDATIONS

8.1 SUMMARY

Countertrade can be seen as an umbrella term used to describe different types of reciprocal purchase agreements. The most common of these different types of countertrade are:

- Barter
- Counterpurchase
- Compensation/Buy-back agreements
- Offset agreements
- Clearing account agreements
- Switch trading

Countertrade isn't a new approach to purchasing as it was already used extensively since the 1920's and barter even before that. The use of countertrade can be attributed to both positive incentives such as the upgrading of manufacturing capacity and expanding markets to negative incentives such as using countertrade because of a lack of ready cash to buy goods and services internationally or using countertrade to rectifying trade imbalances.

The developing countries, of which South Africa is one, makes use of countertrade extensively as 26,1 percent of all reported countertrade between 1987 and 1996 involved the developing countries. Adding to this the majority of developing countries countertrade in this time period (1987 – 1996) was with the former Communist countries or East Block countries, as they are also known. One of the biggest reasons why developing countries make use of countertrade can be attributed to their huge

international debt, which was built up after the international oil crisis in the 1970's. Forcing developing countries to use countertrade to purchase internationally.

When looking at the reported cases of countertrade between 1987 and 1996 a decline in the number of countertrade transactions can be seen from 1993 to 1996. One reason for this can be the WTO's GPA. The WTO does not specifically prohibit the use of countertrade in its agreements but when looking at the meaning of the WTO agreements it can be seen that the use of countertrade is in contradiction with these agreements. So no signatory will be allowed to make the use of countertrade mandatory when trading with their country. However the WTO does not influence nor guide the actions of private enterprises so they are free to use countertrade as they see fit. Government procurement was however specifically excluded from the WTO so governments could use countertrade in their purchases. But since the introduction of the GPA negotiated at the Tokyo Round of the WTO and renegotiated at the Uruguay Round the signatories of this agreement (GPA) has undertaken not to make use of offsets in government procurement. Developing nations acceding to the GPA will however be allowed - if they negotiated it with the other signatories – to require offsets as prerequisite for tendering for government contracts but will not be allowed to use offsets in the determination of the successful suppliers.

It can thus be seen that the WTO prohibits the use of countertrade as they are attempting to free up international trade. Countertrade is therefore seen to restrict international trade, but ironically countertrade in many instances ensure the international trade flow where conventional trade is not possible.

Lastly this paper developed a framework from the literature for a countertrade policy. This framework is summarised below in figure 8.1.

Figure 8.1: Countertrade policy framework

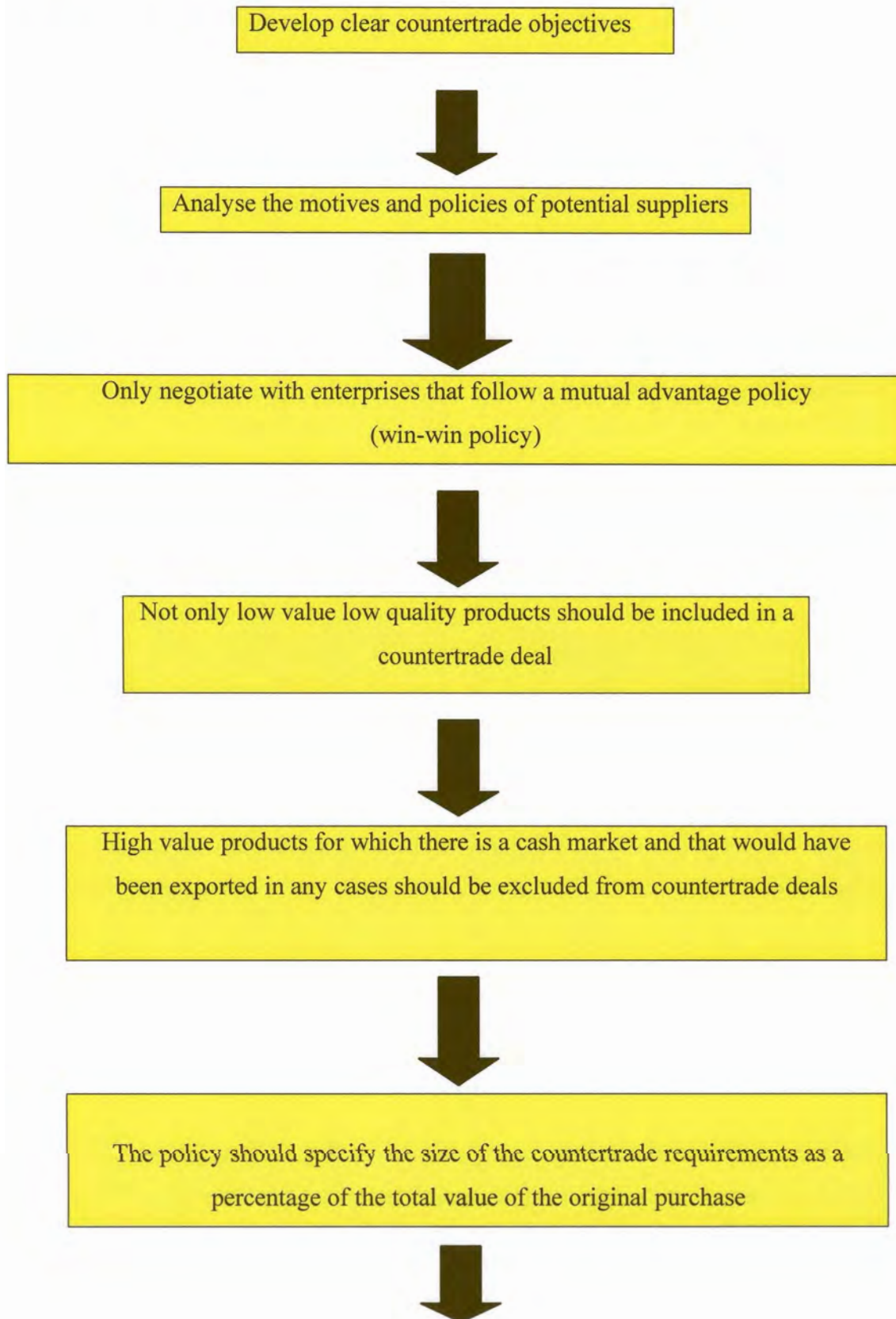
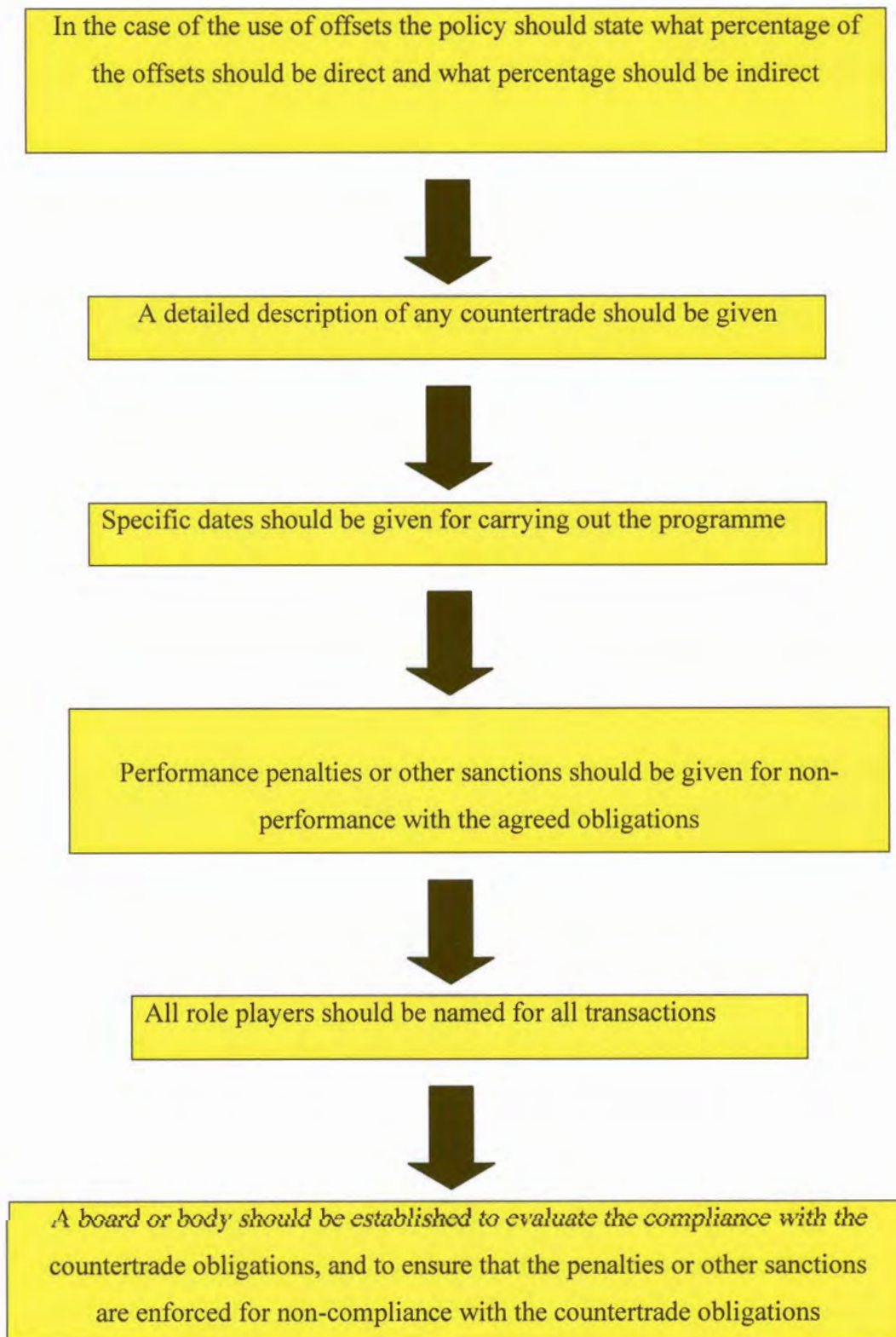


Figure 8.1 (continued)



8.2 CONCLUSION

When considering the application of countertrade in the arms procurement deal it can be seen that two parties are responsible for the formulation of policies and procedures as well as the negotiation and implementation of countertrade, namely, Armscor for the DIP and the DTI for the NIP. When evaluating their policies against the literature study and the responses from the survey the following was found:

- The first policy guideline identified in the literature stated that a countertrade policy should have clear and unambiguous objectives. The respondents in the survey indicated that this was an important issue for inclusion in a countertrade policy. Both the NIP policy and the DIP stated clear and unambiguous objectives as to what it intends to achieve with IP.
- The second policy guideline states that the motives and policies of potential suppliers should be analysed. The respondents in the survey indicated that they thought this was an important policy issue in developing a countertrade policy. When looking at the NIP and DIP policies it is implied through the fact that potential suppliers - as part of the tender process - should submit business concepts and business plans of what they intend doing as part of their IP obligation. Through the evaluation of these preliminary business concepts and final business plans the motives of the potential suppliers can be identified.
- Another policy guideline identified in the literature and viewed as important by the respondents in the survey stated that the policy should state that the country would only negotiate with an enterprise that follows a mutual advantage policy, as apposed to a company advantage policy (a win-lose policy). Both policies state that IP proposals should be profitable for the seller and beneficial for the South African economy. This issue is thus included in the countertrade policies.
- The policy guideline that a countertrade policy should state that not only low value low quality products should be included in the countertrade deal was less

than average in importance based on respondents responses in the survey. Taking this into consideration this issue is neither included in the NIP nor DIP policies. This is however implied by the statement that the IP proposal should be profitable for the seller and beneficial for the South African economy. The Armscor policy also states that the seller must apply sound business principles when contracting with defence related industries in South Africa and that Armscor and the MoD would not accept any responsibility for such contracts. The quality, value and profitability of products included in the IP obligation are thus the responsibility of the suppliers.

The Armscor policy further states that where technology transfer is offered as IP obligation such technology must have an inherent value to South Africa. This means that such technology should increase the efficiency of defence related companies in South Africa or help develop goods not previously manufactured in South Africa.

- A countertrade policy guideline that was identified in the literature but was seen as less than average in importance by the respondents in the survey was that the policy should state that high value items for which there is a cash market and that would have been exported in any case should be excluded from countertrade deals. As was shown above the Armscor policy states that it is the seller's responsibility to contract with local suppliers and determine their IP obligation. The value of the IP is the responsibility of the supplier and even though the South African countertrade policies doesn't specify that high value items for which there is a cash market should be excluded from countertrade deals, the policies do provide other guidelines. The DIP policy for example state that the DTI and Armscor will evaluate the proposed IP obligations set out in the business concepts and final business plans, in order to ensure that the IP objectives are reached. So for example the government has steered clear of linking the IP deals to social development programmes, instead it has gone for a broad range of hard manufacturing industries focused on exports.

- Both the literature and the survey found that it is important that the policy should specify the size of the countertrade requirements as a percentage of the total value of the original purchase. On this policy guideline the NIP policy states that the sum total of all commercial/industrial activity (subject to crediting criteria) must equal or exceed 30 percent of the imported content. The DIP policy on the other hand states that DIP obligations for defence contracts between \$ 2 million and \$10 million can be up to 50 percent while DIP obligations for defence contracts of \$10 million and above will be at least 50 percent. For the current arms procurement deal there is a NIP obligation of 100 percent and a DIP obligation of 100 percent. So this policy guideline is covered in the two South African countertrade policies.
- A policy guideline that was also seen as being important by both the literature and the respondents in the survey was that a policy should state what percentage of offsets - if offset are going to be used – should be direct and what percentage should be indirect. Even though offset was used in the current arms procurement deal neither of the policies has stated what percentage of the offsets should be direct and what percentage indirect.
- The respondents in the survey perceived the policy guideline that the countertrade policy should specify that a detailed description of any countertrade should be given as being above average in importance. Both the NIP and DIP policies state that the potential suppliers must firstly supply a business concept – stating what IP they are proposing – to the IPS and the IPCC, after this concept is approved a final business plan - stating what the final IP obligations will be – must be submitted to the IPS and IPCC. These concepts and plans must be received and approved before any contract can be signed with the supplies. Thus through the business concepts and business plans the IP will be described.
- The next policy guideline stated that the policy should state that specific dates should be given for carrying out the programme. This guideline was rated by respondents as important for inclusion in a countertrade policy. According to the

NIP policy the suppliers have seven years from the effective date of the IP agreement to fulfil their IP obligation. The DIP policy also states that a maximum of seven years is allowed for the seller to discharge his DIP obligation. For contracts with a value of less than \$10 million, a shorter period may however be prescribed; the DIP policy further states that the potential suppliers have to indicate in their business plan what the agreed discharge milestones are within that seven-year period. For this arms procurement deal however the discharge period ranges between seven and eleven years.

- A policy guideline that was identified in the literature but was perceived by respondents, as less than average in importance is that the policy should give performance penalties for non-performance with the agreed IP obligations. Both the NIP as well as the DIP policies has included performance penalties. The NIP stated that a five percent performance guarantee will be required from suppliers, while the DIP policy states that:
 - A penalty for non-performance will be levied or liquidated damages can be claimed, in terms of the DIP agreement.
 - Penalties could be as low as five percent and could take the form of a non-performance penalty linked to specific milestones, or liquidated damages.
 - The format and type of guarantee is normally specified in the RFP, and could refer to either a bank, corporate or sovereign type of guarantee. An acceptable guarantee will be required when the DIP agreement is signed, or prior to the signing thereof.
- Another policy guideline identified in the literature that is related to the policy guideline above states that a countertrade policy should avoid the use of penalties for non-performance and rather use other sanctions such as the increase of offset volumes and black listing suppliers for future purchases. The respondents in the survey rated this policy guideline as important. As was seen above the NIP and DIP has given specific performance penalties for non-

performance with the agreed IP obligations. It is however being investigated for future inclusion in a countertrade policy by Armscor and is currently being applied as an unwritten policy to black list suppliers for future contracts if they don't honour their IP obligations.

- A policy guideline that was rated by respondents in the survey, as just above average in importance for inclusion in a countertrade policy, is that a policy should specify that all role players be named for all transactions. Both the NIP as well as the DIP policies state that the final business plans should be finalised and accepted before there can be contracted with a supplier, the parties to the different IP obligations must be set out in these business plans. So this policy guideline is included in both countertrade policies.
- The last policy guideline identified from the literature states that a countertrade policy should require the establishment of a board or body to evaluate the compliance with the countertrade obligations. The respondents rated this policy guideline as being important for inclusion in a countertrade policy during the survey. Both the NIP and DIP policies identify three bodies that have been formed for this purpose. For the compliance with the NIP obligations the IPS and IPCC was formed. The IPS administers and audits the performance of all NIP projects, prepares status/performance reports for the IPCC that support the allocation of credits or penalties and submits an annual report containing information concerning all the activities of the Secretariat and progress with all IP obligations/agreements to the IPCC. The IPCC on the other hand is responsible for evaluating the performance reports, as supplied by the IPS and award credits or penalties where justified and ensures that all relevant IP agreements are monitored and audited by the IPS on a regular basis. The DIP on the other hand is monitored by the DIP Committee. This DIP Committee will be constituted by the Armscor DIP Division (the chair), Armscor's audit and legal experts, the Chief Acquisition of the Defence Secretariat (MoD acting as co-chair) as permanent members. Other members of the MoD, the organised defence industry and the Armscor programme Manager will be co-opted in

certain cases. It is the DIP Committee's responsibility amongst other things to approve all DIP credit claims and the imposition of penalties.

It can thus be said that compared to the countertrade policy guidelines identified in a literature study and evaluated against the responses of countertrade practitioners worldwide that South Africa has got two very thorough countertrade policies. Both the NIP and the DIP policy and procedure manuals contain all the policy guidelines identified in the literature except for the fact that they don't specify what portion of offsets must be direct and what portion indirect. This can be seen as a shortcoming of the policies, and needs to be considered for inclusion in these policies in future. Except for this one omission from the policies, it can be said that South Africa has got clear policy guidelines for the implementation of countertrade (IP).

Adding to the above section on performance penalties and the monitoring of performance. It was written above that the IPS and IPCC was appointed to monitor the attainment of the NIP obligations while the DIP Committee was appointed to monitor the attainment of the DIP obligations. To ensure the attainment of the IP obligations for this arms procurement deal the performance guarantees was increased from five percent as stated in the NIP and DIP policies to ten percent. So every time a performance milestone was missed the suppliers will be penalised. On the DIP side there are also penalties for late delivery of equipment, meaning that if the supplier is late honouring his DIP obligation he is penalised but it will also mean that if he is late on his direct DIP obligation he will probably be late delivering his equipment as well and will thus be penalised there as well. Even though the South African countertrade policy sets specific penalty guidelines and do not officially use alternative sanctions such as black listing suppliers for future contracts for not honouring their IP obligations, Armscor will also unofficially black list these suppliers for future purchase contracts. Thus forcing suppliers to deliver on their IP obligations (Van Dyk, 2000). So far the deal has since April generated new business and exports for local companies worth some R248, 9 million with the remainder of the obligations being delivered on over the next twelve years (Swart, 2000: 10) Thus South Africa has put in place a comprehensive structure

consisting of three committees as well as official and unofficial penalties to ensure that the supplier honours their IP obligations.

The final research question requires that the study should determine which countertrade (IP) obligation was negotiated with the suppliers. In doing so it can be determined whether countertrade will be able to develop and grow local enterprises. When looking at the IP obligations that was negotiated the following should be kept in mind to understand the light in which these obligations were negotiated. The National Industrial Participation policy's mission statement makes it clear that the South African government wants to use countertrade as a technique to develop South African industry. Adding to this the DIP policy states that one of the DIP programme's intentions is to further the initiative of capacitating and empowerment of Black enterprises and business into the defence related industry. With this in mind the following IP obligations was negotiated:

- The weapons pylons for the Gripen's will be manufactured by Denel a South Africa enterprise, these pylons will not just be manufactured for the local market, but also for the export market. Denel has on its tern subcontracted the manufacturing to a Port Elizabeth based enterprise Camau.
- Saab has installed an aircraft design centre at Denel, using 3D computer modelling.
- Denel will be assembling 23 of the 24 Hawk aeroplanes for the SAAF here in South Africa.
- Denel will also manufacture 23 tailplane sets for the South African Hawks, as well as 48 for the Royal Air Force.
- The South African enterprise AMS has been appointed to produce the health and usage management system (Hums) for the South African, Australian and

Canadian Hawks. Further the AMS Hums is now offered as standard on all BAE Hawks and as an option on all other BAE aircraft.

- ATE is developing the avionics suite for the SAAF Hawks, and this suite will be offered as an export variant for other countries.
- Denel's tooling manufacturing capacity is being looked at to make production jigs for the Eurofighter.
- Denel will further supply rudders, ailerons and other structural components for the Avro RJ regional airliner manufactured by BAE. Denel will also manufacture structural components, rudders and ailerons for the new Avro RJ-X, a new aircraft launched in March 2000.
- Grintek will supply the communications management system for the Gripen fighter aircraft.
- Saab suggested the expansion of the Swedish firm Electrolux's plants in Bronkhorstspuit and Cape Town to produce products for the world market.
- The Swedish producer of fish Swedefish will according to a proposal by Saab go into partnership with the South African fishing community for the development of a fish processing plant. Saab will supply the financing for the plant and also help with the training of the employees.
- In a proposal aimed at the disadvantaged sections of the South African community Saab and BAE will help with the development and manufacturing of a sun heating system and devices for determining electricity consumption.
- Saab will also help with the upgrading of existing sawmills, help market South African furniture in the international market, and help with the development of new furniture manufacturers in South Africa.

- BAE will invest in the South African industry with the acquisition of a 20 percent stake in Denel Aviation for a sum of R 6,5 billion.
- Augusta is planning to build a mini steel mill as part of their NIP obligations.
- Augusta is also planning the manufacture of high value mohair products in South Africa.
- Augusta is planning to manufacture gold chains in conjunction with Filk Gold the world's third largest gold jewellery manufacturer.
- Denel will be involved with August through the manufacture of the commercial Koala helicopter, which Denel will market with them.
- Augusta also proposed the establishment of an ostrich leather tannery on an ostrich farm in the Potgietersrus area.
- The local enterprise ADS will be responsible for the manufacturing of the combat suits for the corvettes and prospects for securing exports of elements of the South African combat suit to other Meko customers are reported to be good.
- A mini-steel mill that will be manufacturing galvanised steel or more specifically plate steel for the motor industry, helping produce steel, motorcars and car components of export quality.
- Technology will be transferred by the German Frigate Consortium to a local supplier of crankshafts helping to boost its production for export purposes to 500 000 units a year.
- A stainless steel plant is proposed for the Coega industrial development zone.

- Lastly the German Submarine Consortium proposed the transfer of technology by Pechiney to South Africa to bring the cosmetics industry in South Africa as far as packaging of cosmetics goes up to international quality standards, enabling South African firms to export cosmetics internationally.

Not all the IP obligations are known yet as some of the suppliers are still busy finalising their business plans. This is however a departure from the NIP and DIP policies as these policies states that potential supplier's should submit business concepts to the IPS and IPCC. When this concept has been approved a final business plans - stating what IP they are going to be involved in – should be submitted to the IPS and IPCC and only after approving this final business plan can the purchase contracts be awarded.

In conclusion the research proved that South Africa has got proper policies in place to ensure the successful implementation of countertrade. It has also been shown that there are proper policies, procedures and committees in place to monitor the compliance with the agreed IP obligations, one of the biggest reasons for the failure of many foreign countertrade deals.

From the IP obligations already determined it can be seen that IP (countertrade) will increase the demand for South African products through production and exports, arms related and non-arms related, making these enterprises grow through increased production. There are also a couple of theses IP obligations focussed on the development of new enterprises such as the Saab project to develop new furniture manufacturers in South Africa. It is however still early days as a couple of IP obligations still has to be announced and the suppliers has got between seven and eleven years to honour their IP obligations. But as was stated above since April 2000 R248, 9 million worth of IP has already taken place. So countertrade relate to this arms procurement deal is capable of leading to the development and growth of South African enterprises.

8.3 RECOMMENDATIONS AND FUTURE RESEARCH

This research was finalised as the Auditor-Generals report on the arms procurement deal was released. In this report it was found amongst other things that there were problems with the technical evaluation of the bid for fighter trainers. The report also recommended that a special forensic audit be conducted into the subcontracts, which fell out of the original terms of reference of his probe (Sapa, 2000: 2). After this report was released the National Assembly's standing committee on public accounts found that the arms procurement deal could cost R14, 5 billion more than initially thought because of bank fees and other transaction costs not taken into account (Loxton and Bloomberg, 2000: 1). The procurement of arms and the allocation of contracts fell outside the scope of this study as it was just focussed on countertrade's ability to develop and grow South African enterprises. However the findings and results of the National Assembly's standing committee's probe as well as the Auditor Generals forensic investigation into the subcontracts creates room for additional research into the allocation of contracts for this arms procurement deal.

Lastly the arms deal and its countertrade obligations are only in its infancy stage as a result one will only be able to determine the success or failure of this deal over the medium to long-term, as the IP obligations will only materialise over the next seven to eleven years. The proof of the pudding is in its eating, and it will require ongoing research and monitoring as well as a situational analysis at certain predetermined check points to determine the success or failure of this deal. Future research can thus be conducted into whether the IP obligations actually materialised and to what extent.