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Tawazun Economic Program – The Tawazun Economic Council's New Policy Guidelines

LEGAL BRIEFING (29 May 2019)

The Tawazun Economic Council has published a revised version of its policy guidelines for the Tawazun Economic Program on 31 March 2019. The Tawazun Economic Program, formerly known as the UAE Offset Program, aims at creating in-country value from defense spending. For 2019, the UAE has a defense budget of AED 8.6 billion (approx. EUR 2.1 billion). This legal briefing gives an overview of the Tawazun Economic Program and the new policy guidelines.

1. *What is the Tawazun Economic Program?*

The Tawazun Economic Council (TEC) was established in 1992 to ensure the implementation of the Tawazun Economic Program (TEP – formerly known as the UAE Offset Program).[1] The role of the TEC should be viewed as both a regulator and business developer for offset opportunities, as it aims to facilitate investments to the UAE and help defense contractors meet their contractual obligations.

The TEP is an offset program. Offset programs are considered countertrade mechanisms that are generally connected with the sale of defense products and services to foreign governments. They typically require the seller to make a reciprocal investment in the purchasing country (so-called offsets).

The TEP's core focus lies in ensuring that defense related procument results in industrial participation of defense contractors (DCs) in the UAE. The TEP follows similar objectives as other localisation programs in the UAE (e.g. the Abu Dhabi National Oil Company's In-Country Value (ICV) program and the recently launched Abu Dhabi Value (ADV) program).

2. *How does the Tawazun Economic Program work?*

DCs will need to engage in a TEP Agreement (TEPA – which is a framework offset agreement) with the TEC, in case the supply agreement with the relevant government authority is above the threshold value of AED 36.73 million (approx. EUR 9 million). For the purposes of calculating the threshold, the value of the supply contracts will be added up with other existing obligations of the DC and/or its parent company.

In case the threshold value is reached, DCs are required to submit a term sheet. The term sheet includes the DC's respective offset plan. It is a binding plan that contains contractual obligations (comparable with the ICV Improvement Plan).[2] Those specific obligations are not included in the TEPA, but in a supplemental agreement.

The credits must constitute 60% of the total value of the supply contract. For example, if a contractor sells tanks for AED 100

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[1] The word 'Tawazun' means 'balance' in Arabic.

[2] Regarding ICV, please also refer to our separate briefing: <www.schlueter-graf.com/fileadmin/publications/180918_Changing_the_Game_Changer_-_Update_on_ADNOC_s_ICV.pdf>

million, the value of its offset obligations will amount to AED 60 million.

DCs can choose from a range of projects to generate credits which will be calculated and checked by the TEC.

a. What are the Project Categories?

The TEP's guidelines allow DCs to choose from three main project categories:

- Investment;
- Contractual Engagement; and
- Capability Development.

Investments can be carried out in the form of onshore joint ventures with local partners (JVs). Alternatively, the DC can enter into partnerships without equity investment (e.g. toll manufacturing, delivering services, development of new technology in the UAE, etc.).

DCs may also engage in contractual engagement projects (so-called export work packages or local content). Ultimately, such projects (i) provide services and/or manufacture products in the UAE for export purposes; or (ii) create supply opportunities for the local industry to substitute imports.

Alternatively, a DC may opt for capability development (i.e. technology transfer or training of UAE nationals).

It should be noted that the project duration varies from three to seven years.

b. How can Credits be generated by Defense Contractors?

Within the three aforementioned main project categories, the DC has nine options (in order of credit weight) to generate credits from the supply contract with the UAE entity:

- Contribution in equity (cash);
- Contribution in assets (tangible);
- Contribution in assets (intangible);
- Net income;
- Salaries to UAE nationals;
- Value of training & development programs;
- Contract value;
- Export revenues; and
- Value of IP generated.

The credit parameters are based on the entity's audited financial statements and must be documented in the term sheet. Prior to the execution, the TEC may add or remove parameters, depending on their actual value creation within the project.

c. How are the Credits calculated?

The offset credits are calculated in accordance with the credit parameters that are eligible under the respective project category. In most cases, multipliers and/or bonuses can be triggered and included in the calculation. The multiplier can vary from 0.5 to 2 and can, therefore, halve or double the required investment amount/effort.

Bonus multipliers can be awarded through the three following factors:

- Value chain focus (related to the high-end of the value chain, for example system design or final assembly);
- Local content ("made in UAE" according to the guidelines from the Ministry of Economy); and
- High skilled positions for UAE nationals (positions related to engineering, management or leadership roles).

Except for "Value of IP generated", every credit parameter is eligible for at least one bonus. The multiplier figures for the bonuses are not expressly mentioned in the TEP guidelines.

3. What other obligations and rights do Defense Contractors have?

Besides submitting the signed TEPA and supplemental agreement(s) to the TEC, DCs are required to submit a bank guarantee in the amount of 8.5% of their offset obligations (e.g. 60% of the supply agreement amount). The bank guarantee must be valid throughout the entire project.

Within the project execution, the DC may create an excess of credits. In this case, the DC can temporarily "bank" these credits for a period of 5 years (counted from the conclusion of the respective project). During that period, credits can be used in future obligations or traded to either affiliated or third-party companies.

In the event of a shortfall of credits, the DC can (i) pay 8.5% of the shortfall value; (ii) shift the shortage to another supplemental agreement; or (iii) perform a new project (i.e. a new supplemental agreement.).

4. *What remedies does Tawazun Economic Council have against Defense Contractors?*

If the DC is not properly carrying out the project, the TEC is protected via the bank guarantee. The bank guarantee's value will be adjusted in accordance with the level of credits attributed to the DC (pro rata).

If the DC does not comply with its obligations, the TEC will request the contractor to remedy the breach(es) within 180 days. If the situation has not been rectified within such period, the TEC can:

- call on the bank guarantee; and
- notify the relevant government bodies to take further action (e.g. black-listing, terminating the agreement).

It should be noted that the TEC may grant a grace period for specific projects (e.g. building up new manufacturing lines and developing new training programs), thereby altering the start date.

5. *Conclusion*

At present, more than 72 countries make use of offset programs, requiring foreign contractors to reinvest in the economy of the importing country.

Due to a lack of available partners and foreign investment restrictions, contractors have been struggling to generate offset credits in the UAE and meet their obligations towards the UAE government. Under the new guidelines it is expected that offset opportunities will be made more easily available to DCs.

Regardless, DCs will need to monitor their respective obligations under the agreements with the governmental purchasing body, the TEC and the project related parties.

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