Offset Requirements Of Defense Deals Often Have Little To Do With Purchaser
By Daniel Pearl

Could the sale of U.S. weapons in the Persian Gulf help an oil concern unload gasoline stations in Europe? Yes, under the new logic of international arms deals.

For decades, countries that buy weapons have imposed "offset" requirements on their suppliers that keep some of the economic benefits of the deal at home. Now, defense contractors are moving toward more exotic plans to satisfy their growing offset obligations. Many deals have no relationship to the weapons being sold, and a few have only a tenuous connection to the country that is buying. In the Middle East and Asia, entrepreneurs are launching offset investment funds, pooling money from weapons sellers to be invested for offset credit.

Lockheed Martin Corp.'s $6.4 billion sale of F-16 jets to the United Arab Emirates adds fuel to the idea. Lockheed is expected to satisfy its offset by investing $160 million in the petroleum-related "investment portfolio" of the Offsets Group, which administers the program in the UAE. That portfolio includes a natural-gas pipeline passing through the UAE, as well as a United Kingdom start-up called Summit Corporate Services Ltd., which is trying to help the UAE buy into oil tankers and European gasoline stations.

Washington has mixed views about the write-a-check approach. The U.S. officially opposes offsets on the grounds that they distort free trade, and recently said it would launch talks with 21 countries to try to reduce or eliminate them. On the other hand, offsets are a key part of arms negotiations, and the U.S. doesn't want to put its companies at a disadvantage. So the Commerce Department's International Trade Administration issued a 1997 paper suggesting investment funds as a "convenient vehicle" for U.S. companies to satisfy offsets. But the department's Office of Strategic Industries and Economic Security has criticized the idea.

As Congress prepares to review the Lockheed deal, Wisconsin Sen. Russell Feingold, an offset critic, has written to Clinton administration officials asking for information about the offset. One concern his staff and some Commerce Department officials have raised about upfront offset payments generally is that they could be used to channel financial favors to foreign officials.

U.S. law bars that. While nobody accuses the UAE's wealthy rulers of soliciting bribes, the country's family rule does raise some of the red flags lawyers typically cite. The UAE Offsets Group is controlled by the UAE's top arms-deal negotiator, Sheik Mohammed bin Zayed al Nahyan; the board includes him, two close advisers and the head of his personal office. Royal family members have participated in previous offset deals.

But that isn't necessarily a problem, as long as the officials don't get favorable investment terms, U.S. lawyers say. Lockheed says it has cleared its offset plan through "the necessary
steps." The Offsets Group says it allows investments to be administered by a "mutually acceptable leading international law firm."

"We're literally under a microscope," says Keyvan Rahimian of London's Rotch Property Group Ltd., which is trying to bring in Summit Corporate Services as a partner for acquisitions of European gasoline stations. Most immediately, Rotch and Summit have nearly closed the purchase of a 50% stake in a recent $475 million sale-leaseback deal for 180 Shell stations in the U.K. Summit would sell half of its stake to a UAE entity called Hafeet Trading, but Hafeet's composition is unknown. The Offsets Group "cannot get directly involved in commercial activities," Mr. Rahimian says.

For now, Summit's holdings consist of a two-car limousine service and an interest in a 1997 aircraft-leasing offset deal. Still, Summit's founder, a U.S. offsets veteran named R. Grant Rogan, appears to have sold UAE officials on the idea of making major petroleum investments in Europe to hedge the UAE's reliance on Asia as an oil market. "It gives them a mixed portfolio," he says. Now, he needs to convince defense contractors that they really will get offset credit.

So far, investment boutiques have had more luck than big investment banks in breaking into the fragmented offset trade. U.K.-based Chescor Capital Corp. recently launched a $20 million 10-year closed-end investment fund, promising small defense contractors "better than risk-free" returns and UAE offset credits. Devcorp International, a Bahrain company, is managing a $25 million offset equity fund in Saudi Arabia and expects to double that soon.

Defense industry experts say the investment, in the UAE, is less than the cash penalty defense contractors would have to pay if they did no offsets. "Everybody's confused," says one industry consultant. "They think it's great, but they don't understand why they're getting such a good deal."