Transparency International (UK)

PCOAT project: "Preventing Corruption in the Official Arms Trade"

Defence Integrity Pacts

A tool to combat corruption in defence contracting

July 2004

TRANSPARENCY INTERNATIONAL

1. Introduction

This report describes a constructive new way to prevent and reduce corruption in defence procurement.

It is directed at three audiences:

- ***Importing country governments*** who have a need to procure arms, and who wish to strengthen their regular defence procurement practices. These governments are looking to reduce the influence of corruption in daily life: defence purchasing can be one of the most pervasive areas. Much less frequently, defence procurement will also be for large capital equipment purchases - ships, planes, communications and armoured vehicles - where even countries with strong procurement processes struggle to withstand the pressures for corrupt practices: additional safeguards to the normal practice are required.

- ***Exporting country governments***: these countries have a major impact on the quality of the defence procurement process. They can influence their national defence exporting companies to behave in ways that show a clear commitment to reducing corruption. Officials in the related regulatory and legislative environments – eg export financing, export controls, prosecuting authorities – have a major influence on the integrity of the process. They are responsible for approving the contractor, and investigating them where there is suspicion of wrongdoing.

- ***Defence contractors***: have a great interest in the defence bidding process being free of corruption, both to give them maximum chance of success, and to assist them in complying with the anti-corruption demands of their host governments. Defence Integrity Pacts level the playing field for bidders - providing independent technical scrutiny, giving a common basis for bidder behaviour – as well as showing visible commitment to both the exporting and the importing governments – to work to a high standard of business conduct.

We also hope that a fuller understanding of defence procurement vulnerabilities and the Integrity Pact tool can be used by citizens, academics, NGOs and others in strengthening civil society against defence sector corruption.

Integrity Pacts have a second application: they can be used by companies to establish an *industry-wide* agreement on good anti-corruption business practices. This approach is being developed by the construction and engineering industry globally and a draft of a 'Sector' Integrity Pact for that industry is being developed.[1]

1.1 Where did this initiative originate from?

Constructive proposals for reducing corruption in the defence sector developed over the period 2000 – 2003, driven by an association between Transparency International and the Swedish Ministry for Foreign Affairs, and with the UK Department for International Development. Workshops were held with representatives from the defence industry, NGOs,

[1] Transparency International (UK) 'Anti corruption initiative in the construction and engineering industry, Report 6 'Integrity Pacts' Neill Stansbury, March 2004. www.transparency.org.uk

government, research institutes and academia, and culminated in a set of recommendations[2],[3]. These recommendations were publicised at a press conference in the UK in May 2002 presided over by Clare Short MP, formerly Secretary of State for International Development.

In 2004, TI(UK) started to work with governments, defence companies and NGOs to bring to reality two of those recommendations: the application of Integrity Pacts –a tool applied by TI chapters in other industry sectors– to defence contracting, and the development by defence companies of a common code requiring high standards of business conduct. This work has been supported by funding from the UK Government (Department for International Trade and development (DFID)). The work has been carried out by TI(UK) on behalf of TI globally.

The Integrity Pacts concept was developed by TI chapters in the 1990's, particularly in South America, but has been extended through applications in some dozen countries. The pact approach is also being developed in a separate initiative between Transparency international and the Construction and Engineering Industry, and we have drawn on that work also[4].

In this first phase of the work, TI(UK) has developed the proposals in discussion with representatives from government and civil society in three countries, Colombia, South Korea and South Africa, and with a number of defence companies in Europe and the USA. Whilst the responsibility is all ours for this work, we are grateful to all those who have assisted us for their time and their thoughts on how to make these proposals real, practical and effective.

1.2 **Defence Integrity Pacts**

Most countries need a defence capability. Making this a reality depends on having a good process for deciding what that capability should be, on having a good process for attracting bidders and on reaching a good value conclusion with one of them. For all sorts of reasons described later in this report, it is surprisingly hard to do this in defence without corruption entering into the process: defence procurement is believed to account for about 50% of all bribes paid anywhere in the world[5].

Integrity Pacts work on several levels to support the procurement process:

- They supplement weak laws, by making contractual requirements, for example of greater disclosure of information
- They attract more bidders, by levelling the playing field, providing independent technical scrutiny and giving greater confidence in the probity of government
- They reduce the costs of contracts

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[2] Recommendations arising from the Swedish conference on reducing corruption in the arms trade: see www.transparency.org.uk

[3] Corruption in the official arms trade, February 2002, Appendix 2. Available from www.transparency.org.uk

[4] Anti-Corruption Initiative in the Construction and Engineering Industry: Reports 1 to 6. www.transparency.org.uk

[5] US Department of Commerce. 'Challenging international bribery', Third annual report on the OECD anti-bribery convention, 2001

- They supplement weak or slow enforcement by strengthening the sanctions. They also make them applicable at the time of the tender, rather than after award, which is generally the case in current laws

- They can be developed to provide independent assurance throughout the *execution* phase of the contract as well as the tender phase

- They strengthen public confidence. The defence procurement process often has a poor reputation, is subject to political influence internally and externally. Integrity Pacts provide opportunities for public discussion, transparency to the whole process and independent insight into the whole process.

We believe that Integrity Pacts will work well in improving defence procurement, and are advantageous for all three parties: importing government, exporting government and bidders. This document provides a guide for all three parties on the main elements of Defence Integrity Pacts (DIPs).

Integrity Pacts have to date mostly been applied at the bidding stage of a contracting process. For many contracts they also need to be applied throughout the execution phase as well. If not, there is a danger that the corruption risk is simply driven 'downstream' beyond the point of contract award. Whilst this document focuses on the bidding stage, the main elements are equally applicable to the use of IPs during execution.

1.3 Transparency International

Transparency International (TI) is a global non-governmental organisation (NGO) exclusively devoted to combating corruption. TI works through building coalitions among governments, business and civil society. Through TI's International secretariat, based in Berlin, Germany, and close to 90 chapters around the world, TI works at both the national and international level to curb both the supply of, and demands for, bribery and corruption.

2. Defence procurement

2.1 The process

Procurement is a series of steps, starting from a definition of the need, moving through a detailed specification of the need and the contractual terms, on to inviting bidders to submit proposals to satisfy that need, and then selecting the best one from amongst them. Defence contracting follows the same sequential flow, though it is more complex for the large requirements.

Whilst countries have adopted a huge variety of ways to manage and oversee their defence procurement[6], it consists of a number of largely common phases:

1. Government policy
2. Capability gap definition
3. Requirement definition
4. Support requirements definition
5. Outline project costing
6. Tender
7. Bid assessment and contract award
8. Manufacture and delivery
9. In-service phase
10. Disposal

A fuller description of these phases, and of the various sub phases within them, is given in the document: "The defence procurement process and its vulnerabilities", also available on the TI(UK) website.

2.2 The vulnerabilities

Many vulnerabilities of defence procurement are specific to the defence sector, and these increase the risks of corruption over other 'normal' corruption risks. A brief description of these risks is given below. Some of the risks can be addressed by appropriate laws and by introducing robust procurement processes. Others can be addressed by increasing the transparency of the process. The Defence Integrity pact complements these measures and significantly strengthens the process against many of these vulnerabilities.

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[6] See for example Ravinder Pal Singh, (ed.), 'Arms procurement decision making' Volumes 1 and 2, SIPRI, Oxford University Press 1998 and 2000

- ***Secrecy.*** Some aspects of defence are clearly matters of national security, and thus must be dealt with in a highly confidential way. Confidentiality may be necessary, but any confidentiality requirement increases the risk of corruption

- **Unnecessary secrecy.** Whilst some secrecy may be essential, that need is often exaggerated. This may be for administrative reasons – it is just less effort to be less transparent – or may be for corrupt reasons. Neither is acceptable.

- **The technical requirements are more open to manipulation.** Because of its connection with national security, importing governments can claim security justification for purchasing almost any item at any price. Similarly, those directing technical specification or technical evaluation teams can make specific requirements on the basis of their presumed knowledge of the military needs that are hard for outsiders to refute.

- **Multiple layers of sub contractors.** The larger defence contracts have numerous layers of subcontractors, giving the opportunity both for a lack of knowledge of the prime agreement and its anti-corruption clauses to occur, and for more deliberate hiding of commissions and returned favours through subcontractors. There is anecdotal evidence that the use of subcontractors as a conduit for corrupt payments is increasing in the wake of the 1997 OECD Convention[7].

- **Contract and product complexity.** The complexity and long duration of many contracts mean that corrupt payments can be very hard to detect. The same complexity can be deliberately encouraged to make price comparisons harder to make, and thereby hide corrupt overcharging

- **Use of agents.** The use of agents is almost ubiquitous in defence contracting. Sometimes those agents are visible, more often not. In many cases the existence of agents is regarded as a matter of competitive advantage and their contracts and remuneration not available for examination. Agents also provide a shield behind which the principal company can hide.

- **Military hierarchy and sole decision making**. The military respect for hierarchy carries over in technical aspects of the tenders. Specifications and evaluations may be done by low level officers who will be hard pressed to refuse guidance from their superiors

- **The revolving door syndrome.** This is a well-known risk in defence procurement, whereby defence officials or senior military officers move to defence companies and vice versa. Whilst it promotes transfer of experience, and is sometimes subject to rules for no-contact periods, it is notorious as a way to reward acquiescent government officials

- **National manufacturers.** A dilemma for countries with national defence companies is the extent to which they will go – or need to go – to promote those companies in national defence contracts (and in supporting them for overseas contracts). A cosy climate of mutual support can easily build up, in which undue preference is given to a

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[7] OECD Convention on " Combating bribery of foreign public officials in international business transactions" May 1997

national provider. A strong indicator of this is the number of single source contracts awarded to such companies.

- **External government pressure.** Defence contracts are always for governments. Other governments exert high levels of direct and indirect leverage in support of their national companies. Many contracts are also formally done between governments rather than from supplier to government. The pressure applied is intense, being regularly at Ministerial or President level. Such pressure weakens the integrity of the whole process

- **Enormous post-contract support requirements.** Defence contracts can often be much larger in the support phase than in the capital purchase phase, as much as ten times larger if proper life cycle costing is used. The capital items can thus be treated as loss leaders - just as printers are sold at a loss for the subsequent profits from printer ink. Thus, not only will capital cost evaluation yield the wrong answer, but it offers great scope for corrupt payments for support and maintenance equipment.

- **Off budget funding**. In perhaps 60 –100 countries[8], the defence budget is not shown, or is not fully shown, to the national parliament or government. On that basis, there is neither public knowledge about what the requirements are, nor of the budget available to procure them. This secrecy is an open invitation to corruption of defence procurement and, more broadly, threatens macroeconomic stability and undermines efforts to eradicate poverty[9]

- **Offsets.** Offsets are additional contracts that the defence contractor enters into on top of the specific bid. They are of two types: direct offsets, in which the contractor agrees to manufacture equipment in the country, or to procure support services in the country; and indirect offsets, in which the manufacturer agrees to establish new businesses in the country. This is the product of a buyers' market, where the importing country believes it can secure additional jobs as part of the defence purchase. They are very common in large defence deals and can be as large as the main deal itself. They offer multiple opportunities for corruption.

These corruption vulnerabilities have been mapped against the procurement process in the document "The defence procurement process and its vulnerabilities".

- These specific features make defence procurement a process that is particularly prone to corruption, even compared with sectors like construction that also involve large long-term contracts.

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[8] Ravindar Singh, Stockholm University personal communication

[9] CSDG Occasional papers "Off-budget military expenditure and revenue: issues and policy perspectives for donors. DFID, January 2002. www.dfid.gov.,uk: publications

3. Experience to date with Integrity Pacts

Integrity Pacts were identified at an early stage in this work as a tool having significant potential to reduce the scope for bribery and corruption in defence contracts. The experience with them in TI dates from their development in the late 1990's in some dozen countries (South Korea, Chile, Argentina, Ecuador, Mexico, Colombia, Italy, etc). They have been used in both 'full' modes, (eg using an independent monitor, with technical expert evaluation) and in more limited variations (eg without independent monitor, without public exposure, without disclosure of agents details). They are believed to be having a significant impact in their full application – which is the version described in this document – but only an 'awareness' impact in the limited form.

This Integrity Pact format has been discussed with various interested institutions, eg World Bank, Asian Development Bank, and the Court of Arbitration at the International Chambers of Commerce.

Detailed information on general Integrity Pact experience can be found on the TI website[10], and a summary of that experience can also be found on the defence industry section of the TI(UK) website.

Learning points on IPs

- Without independent monitoring and technical expertise the Integrity Pact benefit is pretty thin. They do have benefits, in that they state a willingness to tackle corruption, offer opportunities for arbitration and provide for disclosure of agents commissions: however, these are well below the benefits obtainable in a full IP.
- Independent technical review is the aspect of IPs most appreciated by bidders
- Disclosure of agents and of their payment arrangements are regarded as a crucial feature by those involved in parliamentary and judicial oversight
- Arbitration is appreciated by companies as an enforcement mechanism, but is nevertheless not one that they will enter into lightly, as it feels like 'fighting the client'
- Very short procurement processes are antithetical to transparency. Conversely, long and slow procurement processes are also the enemy of transparency: they provide ample opportunities for lobbyists
- Funding and contractual arrangements for the independent monitor needs to be addressed formally and properly before the process starts
- Training of government procurement staff in the mechanics of the IP is important and usually skimped
- Some governments are looking to clean procurement processes, and IPs in particular, as an active way to increase the number and range of interested bidders

[10] www.transparency.org

- Without an IP, there is usually no mechanism for anonymous 'whistleblowing'. Civil society bodies like TI do receive them, but are unable to act, whilst the government control authorities are often unready to investigate

Learning points on cleaner defence procurement

- There are a whole range of reforms that address defence procurement and have great scope to improve transparency. IPs should be an inherent part of this process, but are only a part

- Offsets are regarded both by many bidders and by civil society representatives as a major risk to the integrity of the defence process, and one that is currently not addressed at all in defence procurement measures

- Open competition is the most transparent way to procure

- A surreptitious source of defence corruption is in single sourcing. A surprisingly high percentage of contracts are let single source. Some countries monitor this closely, in others it is not easily available statistic

- Even countries with good defence procurement agencies tend to organise their good practice measures in silos: the DPA, the MoD, etc and are thus vulnerable to corruption issues which flow across the procurement chain, like offsets. IPs address this

Learning points for companies encountering IPs

- Enough IPs have been executed to date to allow some overview of the way that they have been received and experienced by companies. No detailed analysis has been done - this would justify a study in its own right – however some of the initial reactions have been common enough to mention here.

- The bidders are at first concerned that the signing of an IP implies that they are corrupt. This concern is usually addressed from the point of view that even if the bidder is perfectly corruption free, the perception of defence procurement is that it is highly corrupt and the public are not convinced by statements of probity: the process needs to be more explicitly transparent.

- The second concern is over whether it is additional to the law, and if so what is the benefit of doing the IP? This is partly addressed by the clear advantages to the bidder, eg of independent technical evaluation, and partly by the benefits to the bidder of being seen to take a strong anti-corruption position.

- The third concern is whether it deters determined corrupt companies. This cannot be definitively answered, as there have been no completed arbitrations to date. However, the opinion of many is that the process does make the bidders much more aware of the corruption risk, and the risk to them and to others if claims are found to be substantiated. Government officials have commented that they would take action against such companies even if the IP sanctions process was not being followed.

- All bidders, including a significant number of multinational companies, have signed up to IPs. Initial concerns have mostly given way to positive acceptance, as experience has been gained by all parties.

4. Developing a Defence Integrity Pact

For this first phase of this project, TI(UK) has discussed Integrity Pacts with representatives of importing and exporting governments, defence companies and civil society organisations to understand firstly how applicable the DIP is to defence and, secondly, the ways in which a Defence Integrity Pact needs to be different from those used to date. The conclusion on the first question is that DIPs have great potential as a way to reduce opportunities for corruption in defence procurement.

This Chapter addresses the second question; how might a DIP need to be different? Section 4.1 addresses the main elements of Integrity Pacts generally, and the rest of the Chapter is then devoted to how those elements need to be modified for Defence Integrity Pacts.

4.1 Main elements of an integrity Pact

Integrity pacts have the following main components:

i.) Pledge and undertakings by the bidders. The pledge commits the bidder not to offer or accept any bribe or other improper advantage, nor to influence unduly the function of the independent assessor, nor to collude. It commits to applying the pact by its staff, consultants, parent organisation, subcontractors, agents, venture partners and suppliers. It will maintain and enforce a written anti-bribery policy applicable to its business.

ii.) The bidder will disclose to the government procurement department the details of any agent which the bidder or any parent, subsidiary, partner or subcontractor may use, the amount of any payments before and after the award of the contract, and a schedule of the services being provided.

iii.) Pledge and undertakings by the government, their consultants and advisers. The anti bribery part of the pledge is comparable to that signed by the bidder. The second part confirms the way that the government will operate the tender process.

iv.) The appointment of a suitably qualified and experienced independent monitor or monitoring team. Access by the monitor to all meetings and unrestricted access to all material documents and records is agreed by all parties.

v.) Publication of the statement of requirements, the bidding documents, evaluation criteria and all related clarifications. Publication of the bidders' proposals. Publication of the evaluation criteria and the detailed results of the evaluations

vi.) Public hearings for discussions of the bid. Sometimes this is already provided for within the law; if not, it is a key feature of Integrity Pacts that most of the tender documentation is available for public scrutiny and discussion

vii.) Arbitration as an enforcement or conflict resolution mechanism. The arbitration can be national or international

viii.) Sanctions in the case of breach of the pledges. Sanctions may involve exclusion from the bidding process, damages and forfeiture of bonds. Sometimes they prescribe other substantial penalties, eg debarment for a number of years from bidding for contracts with

that government department, or liquidated damages. The sanctions are usually set unilaterally by the government, but are occasionally agreed between bidders at the outset.

ix.) Applicable law. The IP is a contract which gives rise to enforceable rights and obligations. There are a number of different systems of law applicable to contracts around the world. The IP needs to be written in a way that reconciles with these governing laws.

4.2 What does an Integrity Pact not do?

Integrity Pacts are not a panacea. They can be effective, but they can be reduced to a low-impact administrative process, eg where there is no external supervision or technical monitoring. More generally, they will not do the following:

- Result in a certificate of a non-corrupt process
- Eliminate corruption
- Constitute a corruption reform strategy on its own
- Directly address structural issues inside the defence procurement process, eg the 'revolving door syndrome', or legislative oversight issues such as 'off-budget' defence items

4.3 Key issues for Defence Integrity Pacts (DIPs)

A DIP is slightly different from those that have been used to date in other sectors. The following elements need specific consideration:

- The technical complexity of bids
- The selection and competence of the independent monitor team
- Independent consultants
- Disclosure of agents and their payment
- Defence company codes
- Layers of sub-contractors
- Confidentiality and national security
- Offsets
- Bid evaluation mechanisms

4.4 Technical complexity of defence contracts

It is a central feature of defence procurement that the requirements can be technically complex, the bidding documents are usually very technically complex, and the technical part

of the evaluation can be extensive. As a result it is of great importance to both government and bidders that technical experts be used, that they be suitably competent, and that they can be seen to be independent.

4.5 Role, composition and competence of the independent monitor team

The presence of an independent monitor is an essential part of the Integrity Pact. To some, it is the dominant contribution of the IP to cleaner procurement. Yet the nature of that monitor, their roles, competence and engagement is not straightforward and will vary to suit the specific circumstance where the IP is being used.

There are two essential requirements of the monitor, besides the 'sine qua non' of independence. The first is that there be a link in some form to public accountability, either directly in the form of an external civil society organisation, or indirectly, eg that it be a condition of their contract to report regularly to the public and to hear their concerns. The second is that there must be the technical competence. This is not only domain competence, eg in telecommunications or navy vessel procurement, but also in the ways in which statements of requirements, technical specifications, technical evaluations can appear legitimate but contain corrupt requirements that favour one bidder over another: for example in the way in which clarifications are dealt with, in specific areas of the bidding document like the essential qualifications of the bidders or their country of origin.

In addition, corruption risks in the technical material are identified at least as much by the other bidders as by any technical expert.

The requirements for the monitor may not be found within a single person, and/or the procurement may be large enough to require a small team. TI is aware of a variety of experience to date: of single person monitors from civil society, of three person teams made up of a lawyer, an anti-corruption expert and a technical expert, and of single technical experts. Clearly the size and competence of the team will need to be proportionate to the size of the contract and the nature of the need.

The technical expertise requires that there must be some form of competence assessment of the individual. It may be that in defence there are a sufficient number of third party consultancies and systems houses that it will not be hard to find experts. The assurance of independence will need to be considered by the government.

In the longer term, there are many ways of becoming more professional. The development of a professional organisation composed of a cadre of experts who commit to standards of independent conduct is one way of addressing this issue; this is being pursued in other sectors.

<u>Examples of monitor role in DIP:</u>

Public transparency aspect:

- Discussing the DIP and its detailed wording with the Government, with bidders and with the public. Briefing the bidders and government staff on what is expected of them

- Ensuring that most of the bid documentation, apart from what is clearly confidential, is available for public scrutiny, eg via the web.
- Advising on what should reasonably be considered as confidential
- Reporting to the public on the conduct of the tender
- Acting as a focus for whistleblowing or 'tip-offs' by any party: initially to the authorities, and if that doesn't work then to the public.

Technical and procedural aspect:

- Providing an independent technical review of the statement of requirements and the bidding documents to ensure that none of them is unfairly biased.
- Reviewing the bidding documents with the bidders
- Ensuring that the evaluation criteria and the evaluation timescale are reasonable
- Reviewing the results of the technical evaluations
- Attending the major meetings
- Having access to all relevant documents and company records

Fees and Contract

The independent monitor needs to have their costs covered. Given the need for high quality technical input in a DIP, the costs will not be minimal.

There are four possible mechanisms for this to happen: the government pays the cost, the bidders pay the costs, a combination of groups pay the cost, or an independent institution pays the costs. An alternative formula has developed, where the costs are split three ways between the government, the bidders and a beneficial grant given for this purpose by a third party. Alternatively, funding could come from the bidders (eg as an additional costs on top of the cost of the tender documents) or from bilateral or multilateral institutions

Where the government pays, the monitor has a contract with the government. The wording of this contract is very important: it has to allow independence to the monitor and the freedom to walk away from the IP if it is not going cleanly: the government cannot have a veto. It may also be a single source contract if there is no natural alternative group to act as monitor.

Assessing the independent monitor

How do we know if the monitor has done a good job or not? The experience of the IP is too short for there to be any clear answer at this stage.

4.6 Independent consultants

Government often uses independent consultants, eg systems houses, to develop the design, or to construct the pilot, or to carry out the technical evaluations. Sometimes they use them to run the main procurement process as well.

The DIP process should start sufficiently early that it can be directly applied to the process of selecting the government's consultant or technical adviser.

Any consultants used by government need also to be an explicit signatory of the main DIP.

4.7 Disclosure of agents and their payment

The use of agents is extensive in arms procurement, and is well known as a conduit for corrupt payments. The DIP needs to be comprehensive and explicit on the requirements in respect of agents. For example:

- Explicit identification of all agents used,
- Requirements for due diligence
- Details of their service contracts
- Disclosure of all payments to them
- Disclosure of all payments made through them to others
- Payments to be made to the agent and through the agent to others in the case of successful award also to be disclosed.

4.8 Defence company codes

The codes of business conduct of many defence companies, particularly the US ones, are good. Some, for example, require extensive vetting of agents before they are used, and this is done diligently by some companies. However, despite the legal benefits in some countries of having a good code and good compliance systems, research suggests that that many companies still treat them only as public relations add-ons.

The company code of conduct, and the policies and processes that surround it, are an important part of a company's anti-corruption commitment. For the defence IP, the pact should require not only that a written code of conduct be in place, as per normal IP practice, but will also specify additional features that need to be in the code in order for it to be effective in defence procurement.

These features should include:

- Vetting of agents, Disclosure of agents, their services contracts and their remuneration. Keeping information on the flow of the funds onward from the agent
- Company approach to preventing corruption in offset deals

4.9 Layers of subcontractors

Defence contracts often make use of multiple layers of subcontractors and consultants. Whilst the normal wording of an IP specifically mentions all such parties as being bound by the main signature, the companies should provide assurance that the provisions flow down to all material subcontractors, and that the principal associated partners also sign the IP and are similarly bound by the need to make all their staff aware of the pact.

The pact should stipulate that a similar degree of rigour will be put in place for later tenders for the material sub-contractors.

4.10 Confidentiality and national security

It is recognised that some areas of the specification will need to be confidential for reasons of national security. These areas should be kept to a minimum. We suggest that the areas of confidentiality be agreed explicitly with the agreement of the independent monitor, acting under a suitable confidentiality clause.

Parts of the bidders proposals, eg on proprietary technology, would also reasonably be confidential.

In addition, any areas of a bidders proposal that were proprietary knowledge could be kept confidential, with the prior agreement of the independent monitor.

The concern here is not that some parts of documents should be confidential: that is accepted. Rather, it is the historical experience that government or others use the fact that the contract is in the defence sector as a cover for placing excessive levels of confidentiality restrictions on the process, opening it up to a greater risk of corruption. This discredits the overall process.

There have been several cases in recent public contracting where secrecy was invoked in such pacts, only for TI as the independent monitor to demonstrate that all the secret information was already in the public domain.

There are some good practice examples where a government has the right to withhold information on grounds of national security but has chosen not to do so, as a demonstration of commitment to transparency.

4.11 Offsets

What are offsets?

Offsets, as defined by the WTO[11] are ‘measures to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements’. There are broadly two types of offsets: direct and indirect. Direct offsets stipulate that a certain amount of production or assembly of the goods and services takes place in the importing country. This can include components being produced under license. In the case of indirect offsets, the goods received by the importing country are of an unrelated nature to the goods or

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[11] http://wto.org/english/tratop_e/gproc/over_e.htm

technology being stipulated in the original contract and can include counter trade and foreign investment. As a generality, developed countries seem to prefer direct offsets, while developing countries, unable to take advantage of the advanced technology, prefer indirect offsets with the aim of benefiting the whole economy. The WTO agreement specifically prohibits offsets, but does allow them in defence and in certain circumstances.

They are very widely used in defence contracts, the value of the offsets often exceeding 100% of the price of the original contract. Offsets have become a significant marketing tool for defence companies, although many also dislike them because of the additional administration burden.

Many exporting companies want to see them banned, hence for example current legislation being presented in the USA. Others, who may prefer non-price competition, do not. Importers like them but are vulnerable to sharp salesmanship and non-performance.

Objection to offsets

The fundamental objection to offsets is that offsets confuse the economic and strategic realities of a transaction.

More practically, they are 'promises' that cannot be verified before contract award. The penalty that is often used, of requiring a commitment or bond from companies in case the agreed level of offsets does not materialise is not viewed as effective: it is either built into the contract price, or expected to be reduced on negotiation in later years. There are many anecdotes of companies evading their offset responsibilities.

TI(UK)'s view is that the best way forward is a ban on offsets, as recommended from the earlier conferences[12]. In the meantime the suggestions below are suggestions for a way to bring offsets more into the frame of anti-corruption control.

Possible approaches at the contracting stage

One partial approach is to set up an additional evaluation stream for offsets. The level of offset required and the rules for calculating the value of the offset are specified in the bidding documents. The evaluation of this stream is then made at the same time as the technical and legal evaluations, and is used to bring the list down to a shortlist. After that, the evaluation is again only cost, with no consideration at all of offsets.

A second approach is to allow only related defence offsets and to ban indirect offsets.

A third approach is to require a solid system of company oversight and reporting on offsets in the company code: as described in Section 4.8 above.

Possible approaches in the execution phase

The presence of offsets leads directly to a requirement for some form of DIP to continue into the execution phase. There are other reasons for doing this, as described elsewhere, but where offsets are a major part of the transaction then this is a prima facie reason for requiring one.

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[12] TI "Corruption in the Official Arms Trade" policy paper, April 2002 Pages 7 and 39

Inter alia, this execution DIP would require publication of offset progress on a regular basis after contract award, with a public body responsible for oversight of progress. At present, oversight commitments are taken up within the relevant ministries, often under the supervision of the people involved in approving the contract, and there will usually be no requirement to publish progress.

4.12 Bid evaluation mechanism

The way in which the bids are evaluated has a huge impact on the outcome, and is open to manipulation. Some of the minimum requirements, such as public opening of the bids are now often enshrined in law. The independent monitor plays a key role in ensuring that each phase of the evaluation is done correctly and fairly. For example, the technical evaluation is at risk of being biased by senior military personnel able to command those under them, directly or indirectly, to complete the evaluation in a certain way: independent scrutiny at the technical evaluation phase reduces this risk.

Evaluation can be done on the basis of a two step process: the technical and legal evaluations are done first, leading to a shortlist, after which the evaluation is purely on cost, preferably whole life costs. Doing the technical evaluation in the same calculation as the economic one allows for much more manipulation of the technical performance to influence the result. This is often a better way of doing the evaluation, but sometimes the evaluation mechanics are specified by law, and the law therefore has to prevail.

Whichever mechanism is adopted, the detailed evaluation criteria should be made public, as should the detailed evaluation of the bids against those criteria.

5. Implementation

On the basis of discussions to date with TI chapters experienced in doing Integrity Pacts, with bidding companies and with importing governments, Integrity Pacts seem to be fully applicable to defence sector contracting as to other areas. Indeed they are even more applicable to defence than elsewhere, given the unique vulnerabilities inherent in defence procurement.

Developing a defence integrity pact into practical application consists of three steps:

- Producing a Defence Integrity Pact document that is aligned with the national laws, that can then be directly taken up by the Defence Procurement Agency or Ministry of Defence
- Developing a plan within the government procurement agency for adopting the DIP, both within government, within the Ministry of Defence and its procurement arm
- Locating suitable independent groups or professionals to act as monitor and agreeing their funding

Producing the DIP has to be country specific, as national laws on procurement, defence and freedom of information vary greatly from country to country. Some examples of pacts in use outside of defence can be found on the TI website[13]. In addition, a list of heads and sub-heads of agreement for a DIP are given in Appendix 1 to this document. Advice can also be sought from the national TI chapter.

5.1 Implementation by an importing government

The government is likely to need to nominate a lead government department, such as the Ministry of Defence. There can be other choices depending on the country, such as Foreign Affairs, Industry or Finance.

An importing government should preferably not be considering an Integrity Pact for defence procurement in isolation from other initiatives. It is best as a part of an overall reform strategy that will encompass staff rotation, centralisation of procurement processes out of the military services into a technically competent civilian unit, revision of the processes and procedures of public defence procurement, strengthening of the relevant laws and oversight organisations, and training of Ministry of defence staff. However, sometimes an IP may be the best place to start.

TI experience has been that an IP is a powerful way to spread the message that a government is serious about anti-corruption and access to information for the public.

[13] http://www.transparency.org/integrity_pact/index.html

5.2 Support for implementation

Practical support by an exporting government

Whilst an exporting country may not be directly involved in the procurement in another country, it can send strong signals of support, which can greatly influence the behaviour of its national companies.

It can propose to lead by example by introducing Defence Integrity Pacts into its own national procurement process.

It can support efforts to give positive mention to no-bribery warranties and Integrity Pacts in the various pieces of arms control and support legislation (eg export credit agency guidelines, arms export control legislation).

It can give a supporting signal for Defence Integrity Pacts in the national or trans-national codes of conduct in which it participates (eg EU Codes of Conduct).

It can show support by prosecuting its own companies when there is evidence of wrongdoing overseas, in line with the OECD Convention.

Most importantly, it can show support by encouraging its national defence companies and others who do business with it, to champion the use of integrity pacts in their business development discussions with governments overseas, and support that message through its own links with the importing government.

Support from Export Credit Agencies (ECAs)

By virtue of its function and the business sectors that its operations support, the ECAs find themselves in a pivotal position in affecting the incidence of corruption in international business. ECA approval of an application will, rightly or wrongly, sometimes be perceived as assuring a measure of propriety and "public" approval. The ECA is uniquely well placed to detect and prevent corruption and positively to influence corporate behaviour to reject bribery in the conduct of foreign business.

Practical support from multilateral institutions

Bilateral and multilateral institutions have a major role to play.

First, they can support the use of Defence Integrity Pacts in countries that they are supporting. They can require them as a condition of anti-corruption support for a defence contract in the country. Where they are involved in financing companies or support ventures (eg offsets) they can support the use of a DIP for the procurement and execution phases.

Second, they could play a role in providing funds, either directly or to match government or bidder funds for operating the DIP.

Finally, there is an increasing realisation of the significance of a responsibly managed defence and security sector in an environment of severely limited resources. As proposed by

the 2002 TI report[14], the security sector and off-budget defence expenditure should be included in the range of public performance issues already considered by agencies and the World Bank in designing loan packages. As part of the good governance agenda, particular attention should be paid to the procurement process rather than purely to levels of expenditure. Some steps have already been taken towards this have already been taken in the US following the 1994 Uruguay round. This requires that the President report to Congress on countries that fail adequately to address corrupt procurement practices.

5.3 Funding of independent monitors

Where a government is proceeding of its own accord to reform defence procurement, it is likely that they will either have to fund the Independent monitor themselves, or to do so in cooperation with the bidders. In this case they need to put aside funds to do so. TI Chapters around the world have developed some experience of the costs of monitoring of procurements, both large and small, and can provide advice and estimates. It varies from periodic involvement at each major step through to full time involvement of perhaps three people (one technical expert, one legal and one civil society expert) for the duration of the procurement, which could be 5 or 6 months.

5.4 Adoption by defence contractors

Importing countries can be greatly supported if the defence companies likely to be involved in the bidding are publicly supportive of the use of anti-corruption measures and DIPs. Some companies in the defence sector are clear already in the benefits that the wide use of DIPs will bring to defence sector contracting. TI calls upon the whole of the defence industry to develop a global position of support for DIPs. In the next phase of this work, TI(UK) will work with the defence industry to help them to achieve this.

Defence companies will also need to review their compliance programmes and the associated policies and processes, to ensure they are in line with the requirements of the Defence Integrity Pact.

5.5 Adoption of an Integrity Pact by the defence sector as a whole?

As mentioned in Chapter 1, this is an alternative/ additional route forward for defence companies, and one which may be attractive to them. By developing the Integrity Pact on an industry basis, they have the opportunity to bind all the major players to one standard.

5.6 Implement for all contracts or just large ones?

It seems to be a particular feature of the defence industry that there is quite a gulf between 'ordinary' sized contracts and the occasional very large contract for capital items.

This results in an important policy question that the importing government must agree for itself; do they wish to apply Defence Integrity Pacts to all defence procurement, or limit it to procurement above a certain size, or to major arms purchases only?

There are some good reasons for applying anti-corruption measures to all defence procurement:

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[14] TI "Corruption in the arms trade", April 2002 Recommendation 12 and page 38. www.transparency.org.uk

- The greatest interest for a developing country intent on eradicating corruption is to remove corruption from the normal rhythm of daily life; in other words, to apply strong measures to all procurements and not just to big ones

- In a country with a significant corruption environment, if there are not strong anti-corruption measures in normal regular procurement, then the culture will be attuned to corruption as a natural phenomena and so the chances of a clean bidding process in a large procurement will be remote

- If the measures prove their worth, probably they will become incorporated in a subsequent update to the relevant procurement laws or freedom of information laws.

However, there are also good reasons for limiting Integrity pacts to only the larger defence procurements:

- An IP with independent monitoring costs money, and this is only likely to be made available for the larger procurements

- An IP runs the risk of becoming a routine event, almost an administrative procedure, if employed too often. Current situations where the IP is used in all procurements have clearly suffered from this. Applying an IP to the larger events sends a signal that special precautions are being adopted. This is appropriate given the ferocity of the competition for the large contracts

In due course we anticipate the use of DIPs on all contracts, but with differences in the weight of requirement appropriate to the size or risk level of the contract. Rather like annual financial audits, the smallest ones may be exempt from audit, modest sized companies have only a limited audit requirement, and larger companies have a full audit requirement.

5.7 Execution phase DIP as well as Tender phase DIP

As discussed at the beginning of this document, the execution phase is important: both in general, and as a specific response to the question of how to address offsets.

6. Next steps

The application of DIPs was discussed at the Arundel conference by members of importing and exporting governments, defence companies and civil society. They supported the approach described in this document.

We hope that importing country governments will take up the use of DIPs in their defence contracting, and that exporting country governments will encourage their industries to support and propose DIPs in their bid discussions. We hope that the defence industry will develop a forum for global issues such as these to be taken up and adopted.

TI(UK) and national chapters as appropriate will support all three groups as requested. In addition, TI(UK) in the second phase of this work will be advancing specific parts of this agenda.

7. Project team

The team developing this first phase of the project comprises Mark Pyman (team leader), Admiral Hugh Edleston, Carolyn Hodder and Dominic Scott. In addition, significant contributions were made by Patrick Brown and Professor Ravinder Pal Singh. The project was built on the foundations laid by the great work done by national TI chapters in Colombia, South Korea and other countries.

The project's strategy was overseen by the PCOAT strategy group, comprising David Murray (Deputy Chairman, (TI(UK)); Laurence Cockcroft (Chairman, (TI(UK)); Anne Charlotte Wetterwik, (Ministry for Foreign Affairs, Sweden); Alan Waldron (Air Commodore ret'd); Lord Garden (Professor of Defence Studies, King's College); Dominique Lamoureux (Thales); Anthony Sampson; Jeremy Carver(Clifford Chance); Jeff Kaye (Trading Nation); Roy Isbister (Saferworld) and Joe Roeber.

8. Acknowledgements and enquiries

The project team has had very positive support from numerous individuals in governments, in civil society, in defence companies and in other TI chapters. They all share our same objective - reducing and preventing corruption in defence contracting - and were often ready to be public about the need to do something, in advance of their own organisation expressing an official position.

Please address all enquiries about this document and Defence Integrity Pacts to the TI(UK) chapter[15] or to Mark Pyman or Carolyn Hodder[16].

[15] Email to info@transparency.org.uk

[16] Email to mark.pyman@transparency.org.uk or Carolyn.hodder@transparency.org.uk

Appendix 1

Suggested Heads of Agreement for a Defence Integrity Pact at the pre-qualification and tender phase of a contract

1. **Undertakings by all Parties**

1.1 Not to offer any bribes, favours or other improper advantage, directly or indirectly
1.2 Not to demand or accept the same
1.3 Not to make any improper payment
1.4 Not to influence the Independent Monitor
1.5 Agreement to arbitration

2. **Undertakings by the Government**

2.1 Not to affect the process so as to favour any party
2.2 Fair, objective and arms-length criteria.
2.3 Sealed bids
2.4 Public access to all documentation except that which is designated confidential
2.5 Public access to the evaluation criteria
2.6 Public hearings at stages through the process
2.7 Confidentiality
2.8 Action to disqualify non-performing bidders
2.9 Setting up government office for oversight
2.10 Commitment to publish and share information externally on breaches

3. **Government Advisory consultant Undertakings**

Comparable undertakings to Sections 2. and 4.

4. **Contractor's Undertakings**

4.1 Anti –collusion undertaking

4.2 Disclosure of agents' details

i. Name and address of all agents

ii. Amount paid, or intended to be paid to each agent, and the currency of such payment; both before contract award and upon contract award

iii. Summary of the services which each agent has provided, or is intended to provide.

iv. Further details as requested

4.3 Confirmation at contract award of no bribery by senior official

5. Obligation to Ensure Compliance

5.1 Sub-contractors: Applicability to all material sub-contractors, partners and others

5.2 Anti-bribery Code of Conduct and related business processes in place

5.3 Offset compliance: Written policies and processes to ensure compliance

5.4 Single point of overall responsibility for compliance

6. Independent Monitor

6.1 Appointment by Government

6.2 Stated reasons for independence

6.3 Unrestricted access to all material documents

6.4 Attendance at material meetings.

6.5 Unrestricted access to all relevant books and records

6.6 Regular Reporting to the public and on the internet

6.7 Rights to withdraw

6.8 Action in the case of suspected breach

6.9 Action in the case of legal proceedings

6.10 Funding of the Independent Monitor and Payment of costs

6.11 Removal from role

7. Breaches of this Agreement

7.1 By the Government

7.2 By the contractor

7.3 Sanctions and damages

7.4 Actions to be taken on suspicion of breach by any party

7.5 Actions to be taken within the organisation of the party on suspicion of breach

8. **Duration of Agreement**

9. **Governing Law and Dispute Resolution**

9.1 Governing law

9.2 Arbitration details

9.3 Joint and several liability in the case of consortia and joint ventures

10. **Signatures**