REACTION PAPER "ESA APPROACH TO INFLATION – COMMUNICATION TO SPACE INDUSTRY"

April 2023

On December 16th, ESA presented its "Communication to Space Industry", meant to clarify the Agency's approach to address space industry concerns with respect to the inflation impact on ESA contracts.

The European space industry, represented through Eurospace, wishes to convey the following messages and questions to ESA.

1. Introduction

ESA acknowledges that the European Space industry is concerned that this inflation situation may affect the economic operators' profitability.

The document therefore confirms ESA willingness to support industry facing the new situation affecting their economic profitability and financial health. In particular, this is a confirmation of ESA willingness to find solutions to inflation impacting industry and confirmation of legibility of inflation risks.

Eurospace welcomes this acknowledgement to be considered as an important step forward. But beyond endangering industry's economic profitability and financial health, what is at stake in the exceptional inflationary conditions, is the full and effective execution of projects decided by European ministers. This is why a swift and decisive action by ESA is required.

Eurospace recommends, in addition to the inflation parameter, to account for the currency exchange rate factor in the calculation of the hardship model as well as in the calculation of FPV models in order to allow for currency compensation for the companies in countries outside the Euro zone.

Eurospace is at ESA's full disposal to help the Agency pursue their exchange with EC and other Third party to influence these institutions to implement compensation.

The communication only addresses ESA funded programmes. This excludes programmes 100% funded by EU (Galileo, EGNOS), which is an issue for industry.

Question to ESA: *Are Copernicus and Meteo programmes (with EUM) included by the measures?*

2. Guiding principles

For running ESA-funded programmes, "sanctity of contract" is the rule, meaning that there is no change from FFP to FPV in any case.

Eurospace believes that this is in opposition to industry position when ESA are themselves systematically compensated for their Member States subscriptions (for all programmes but mandatory), used for both running and new contracts, allowing more proactive support to industry. Eurospace believes that the practicality of the approach proposed needs to be tested in the short term.

Question to ESA: *ESA is ready to consider Hardship claim under a definition derived from the “principles of European contract law”, which is quite general. Precisions would be very much welcome.*

Question to ESA: *What are to be considered as the “availability of programme financial margins”?*

3. Technology programmes

Eurospace believes that **co-funded Contract shall be eligible to the same approach as per fully financed contracts including FPV eligibility with simplification and digitalisation** i.e., specific ESA consideration including Hardship.

Eurospace believes that for all contracts the **definition of the economic risk should be known well before the ITT release** i.e., at least 6 months in advance.

Eurospace believes that 24 months is considered excessively long in a high-inflation environment and does not provide sufficient protection, this is why Eurospace believes that 8 months maximum needs to be considered for contracts placed under the technology programmes.

> *Nevertheless, the Agency will pay attention to a fair treatment of economic operators facing economic hardship, in particular SMEs and/or companies in Member States and Associated States facing a very high inflation level and/or unavoidable evolution of currency exchange losses.*

Question to ESA: *Is hedging considered as a mitigation/avoidability method? Can ESA cover the currency exchange stability for non-euro contributions?*

> *In the context of all new procurement actions (whether on-going programmes or new ones decided at CM22), tenderers should factor in their FFP their best estimates to cover the economical risk as part of the Proposals to be submitted in response to ESA ITTs/RFQs*

In case this risk is not part of the RFQ, it will induce a discrepancy between the reply and price perimeter evaluation, which will impact TEB evaluation; **the implementation shall therefore be clarified.**

4. Development projects and services

Public authorities' best interest is that projects decided by Ministers are implemented swiftly and completely. This is a matter of allocating the inflation risk where it is the cheapest to bear. **Eurospace is convinced that inflation risk is better hedged by public authorities on a wide range of contracts, than by individual industrialists on single contracts.** Allocating the risk, by using FPV prices, to ESA, results in a more efficient global system.

> *In full respect of the privity of contract principle in relations between Prime and subcontractors: any claims at the supplier chain level shall be handled in the first instance with the direct customer of the supplier, being it an equipment, sub-system or System prime contractor.*

As a general rule, measures should apply to all industry in a consistent way: Primes will not commit to exceptional, non-contractual measures towards their subcontractors, beyond similar measures ESA may grant to Primes.

Industry recommends to implement claims (only on justified/incurred costs – including their impacts on the costs at completion) at key review milestones of the programmes or yearly.

Running projects

FPV can be used only for new contracts and for ESA-funded contracts. **Third parties' contracts are excluded, which is an issue for Navigation contracts.**

> *Case-by-case + Hardship claims are considered for documented unavoidable severe and already materialised risk/impacts. There is no claim on anticipated impact.*

Eurospace believes that **hardship claim should also be considered for FPV contracts**, in case indices significantly departs from the actual inflation.

Question to ESA: *Hardship claim process shall to be clarified, e.g., yearly or only at the end of the contract? What is considered to be "severe"? How to ensure "fairness" and "case-by-case"? What is the funding mechanism?*

Question to ESA: *Beyond "already materialised[1] impacts", could/ should the Agency adopt a more proactive Industrial strategy to avoid negative developments and a risk of weakening the European industrial assets?* **An alternative policy that would allow preventing future hardship situations if impacts can already be predicted with certainty unless a mitigation action is implemented could be needed**.

Eurospace also insists that a swift handling of the claims will allow compensation to be rapid.

> *It is our understanding that subcontractors' claims shall be handled in the first instance by the prime.*

Question to ESA: *ESA is requested to assess the possibility of including known inflation effects in (sub) contracts yet to be signed in running programmes. In view of principles underlying the notion of hardship (unforeseen/not anticipated at contract conclusion) and for corporate governance considerations,* **it is problematic to commit to a (price in a) contract while the negative effects are known at the time of signature.**

> *On the basis of consolidated claims by the Prime, ESA would be ready to consider an exceptional contribution to a hardship situation for specific subcontractors where inflation has already impacted severely the subcontractor's costs beyond their possible control and where no alternative margin could cover the economic hardship.*

This is considered to be an extremely restricted approach if we consider only hardship situations, given the conditions mentioned to declare such state.

> *ESA will closely coordinate with its Prime contractors and pay particular attention to secure that contractual implementation is not blocked or hindered for reasons associated to lack of proper handling of the economic risk.*

Question to ESA: *how will it be assessed in a budget-constrained scenario where limited contingencies have been obtained?*

Eurospace regrets that the compensation of inflation on already awarded contracts is not systematically addressed and understand that the hardship mechanism applies.

[1] *See Annex*

New procurements

> *For ESA "fully funded" projects with duration beyond 24 months, FPV is the norm.*

Question to ESA: Can ESA confirm they will not ask any ITT in FFP even as an option?

In any case, the labour part of the formula should take into account the subcontracting chain reality (inflation levels different between the countries) and therefore should lever in percentage the subcontracting chain country labour rates.

In addition, while Eurospace welcomes the use of FPV pricing, the threshold of 24 months is excessively long. In a high-inflation environment. **Eurospace considers that in the current climate threshold for implementing FPV should be 8 months maximum (with the possibility to increase it in a future review).**

> *There are 3 options: i) "classical" (10% fixed + X% Labor + Y% Material) ii) formula with national indices (e.g., EIU wages/HICP) iii) FFP with adjustment clause.*

Question to ESA: *What could be the protection clause considered by ESA?*

> *In principle, such price type will be based on a "classical" escalation formula as defined in section 2.2 of Annex II of the General Clauses and Conditions (GCC) for ESA contracts, namely with a fixed portion of 10% and apportioned allocation between labor and material indices.*

Eurospace considers that price variation formulas shall adequately reflect the cost structure specificities of the contract, both in terms of split between various material and labour categories and in terms of relevant selection of applicable indices. The recent introduction in section 2.2 of Annex II of the General Clauses and Conditions (GCC) for ESA contracts of a minimum fixed portion of 10% of the contract price in price variation formulas irrespective of actual contract cost structure is in breach with this principle and a major concern in a context of higher inflation rates.

The argument that such a fixed portion would be justified by the existence of fixed depreciation charges reflects a distorted accounting view which does not consider the need for industry to renew its equipment at higher prices and is detrimental to European industry investment and competitiveness. To properly address this topic, equipment supply indices shall also be considered in price variation formulas.

Eurospace therefore encourages ESA to reconsider its position on a general minimum fixed portion rule in price variation formulas in the context of higher inflation rates.

> *In order to streamline administrative efforts across the contractual chain, the parties to a (sub) contract, at any tier, may agree an alternative approach*

The contractual conditions along the subcontracting chain should not be different from the ones between the Prime Contractor and the Agency. **This implies that the escalation formula at Prime level takes into account the subcontracting chain and their nationalities and their respective financial weight**.

> *Rates can be escalated within proposals and will be assessed in the TEB.*

Question to ESA: *how to ensure fairness of the competition if there are no a priori rules in the ITT?*

Question to ESA on rates: *On which basis ESA will estimate rates inflation forecast? Can industry propose a method?*

if ESA uses methodology based on indices, then industry expects that an adaptation is possible upwards or downwards, based on justification.

***Question to ESA on rates**: A clarification would be welcome on the sentence along which "rates agreed prior to 2022 but with a validity in 2022 onwards…". It could be directly considered at a national level when demonstrated inflation is above the initially projected inflation at the time of the initial rate agreement.*

5. Cash

Partial payments and advances can be requested. **This is helpful but does not solve the negative impact of inflation on the financial health of industry.**

Definition of hardship

While appreciating ESA's attempt to define the so-called hardship, a few questions remains.

> *Beyond the typical sphere of control*

Question to ESA: *Does this includes the increase of salaries needed to preserve the purchasing power of the employees?*

> *Fundamental alteration of the equilibrium of the contractual obligation*

Question to ESA: *ESA clearly mentions 2 options to define hardship: i) increase of costs ii) decrease of performance value. What does this mean as a trigger clause?*

On implementation, the bottom up approach all through the contractual chain to contribute to the financial impact recovery is understood. **Eurospace believes that on the basis of the consolidated claims, prime claims shall also be considered by ESA as eligible to the principle of hardship.** In addition, primes need to have a consolidated view on the details of implementation to the whole industrial chain.

In addition, Eurospace wishes to note that inflation always exists, what is unusual is the exceptionally high level of inflation, unprecedented since the creation of eurozone.

Annex – Industry views on already materialised risks/impacts

It is the view of the European space industry that "already materialised Risks/impacts" have to be understood as:

- **Costs increase already incurred** i.e., additional costs resulting from the excess of inflation in a past period and which shall be justified via invoices, agreed rates increase, actual escalation indices etc.;
- **Future costs increase** to be considered <u>only and only if certain</u>, i.e.:
  - **Committed** through a Company liability like signed work orders or subcontracts;
  - **Resulting directly from incurred costs** like the impact on the Cost at completion of the inflation incurred in a past period, typically the cumulative effect of inflation on the hourly rates (see example below)

		Past		Future		CaC
		2021	**2022**	2023	2024	
Before hyperinflation	yearly inflation		2,0%	2,0%	2,0%	
	Hourly Rate	100	102,0	104,0	106,1	
	Workload (kh)		50	75	75	200
	Labour Costs (k€)		5 100	7 803	7 959	**20 862**
After hyperinflation (+3% in 2022)	yearly inflation		**5,0%**	2,0%	2,0%	
	Hourly Rate	100	**105,0**	**107,1**	**109,2**	
	Workload (kh)		50	75	75	200
	Labour Costs (k€)		**5 250**	**8 033**	**8 193**	**21 476**
				Delta CaC (due to past hyperinflation) =		**614**