

## A Critique of India's Defence Offset Guidelines 2012

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### Summary

The Ministry of Defence (MoD) recently announced its revised Defence Offset Guidelines (DOG), which have come into effect from August 1, 2012. The guidelines have, for the first time, articulated the key objectives of the policy document besides adding some new features and modifying/clarifying some of the earlier provisions. Among others, the DOG has, for the first time, included multipliers up to three to incentivise investment in Micro, Small and Medium Enterprises (MSMEs), and facilitate technology acquisition (from a select list) by the Defence Research and Development Organisation (DRDO). Further incentivisation has also been provided by allowing transfer of technology and equipment as valid mode of offset discharge, extending the banking period to seven years, and expanding the avenues and list eligible product/ services for discharge of offset obligation. A degree of flexibility has also been provided to foreign vendors by extending the period of execution of offset contracts by two years beyond the period of main procurement contract. The monitoring and supervision of offset programmes has been strengthened by establishing a Defence Offset Monitoring Wing (DOMW)-which will replace the existing Defence Offset Facilitation Agency (DOFA) with more powers-and mandating the new organisation to report to the Defence Minister-headed Defence Acquisition Council (DAC) each year about the progress of such programmes.

Despite the above features, the new offset guidelines still suffer from certain key weaknesses including ambiguity in explanation, greater leeway to foreign vendors, little incentive to defence manufacturing, and lack of in-house capacity for monitoring/auditing offset programmes. These weaknesses, if not addressed at the earliest, will come in the way of key objectives of the new guidelines. This Policy Brief recommends the following measures to address the key shortcomings of the new DOG.

- The indigenisation requirement for Indian companies to come under the offset purview should be kept at 30 per cent (as against 50 per cent as stipulated in the revised DOG) so as to allow more Indian companies to compete for the MoD's global contracts. The timeframe to achieve the indigenisation level should also be extended beyond the time of submission of technical bids in order to allow domestic industry to progressively use more and more indigenous components in their final product.
- A uniform value addition principle should be applied for both manufacturing and services sectors, so as to provide equal opportunity to companies in these sectors and avoid potential manipulation by foreign vendors.
- It is high time that the industrial licensing (IL) and foreign direct investment (FDI) regulations were liberalised, so as to allow defence manufacturing to take advantage of the revised offset guidelines.
- The MoD should clarify at what stage the foreign vendors can claim offset credits vis-à-vis transfer of technology and equipment.
- The MoD should unequivocally name all the new entrants which have been made eligible to become Indian Offset Partners (IOP).
- The newly created DOMW should develop its own in-house capacity to discharge the range of responsibilities bestowed upon it by the new DOG.

## Introduction

In a major review of the Defence Procurement Procedures (DPP), the Ministry of Defence (MoD) recently announced the revised Defence Offset Guidelines (DOG). The guidelines, which came into effect on August 1, 2012, include several new provisions besides modifying and clarifying some existing ones. The revised guidelines have also for the first time articulated the objectives of the offset policy which are three-fold: fostering an internationally competitive domestic industry; enhancing the indigenous defence research and development (R&D) capability; and fostering a dual-use industrial base. These ambitious objectives notwithstanding, the guidelines suffer from a range of weaknesses including lack of clarity, unrealistic reasoning, and little incentive to the domestic manufacturing sector, which may prevent the DOG's effectiveness in achieving the stated goals. This Policy Brief provides a critique of the new guidelines. It, however, begins with a brief description of some of the salient features of the revised document.

## Salient Features of DOG

### Clarification of Scope and Quantum of Offsets

Like the previous version, the new guidelines also stipulate a minimum 30 per cent offsets in "Buy (Global)" and "Buy and Make with Transfer of Technology (ToT)" contracts valued at Rs. 300 crore or more (in the latter case, the quantum of offsets of minimum 30 per cent is mandated on the foreign exchange component of the contract). Unlike the previous version, however, the DOG has clarified that an Indian company or its joint venture participating in "Buy (Global)" contracts are exempted from offset obligations, provided the product in question has indigenous content of minimum 50 per cent by value. In case the indigenous content is below 50 per cent, offsets are mandatory but only for the part which involves foreign component.

### Expanded Avenues for Discharge of Offsets

The avenue for discharge of offset obligations by foreign OEMs has been expanded by: (1) permitting investment in "kind" in Indian industry; (2) allowing Defence Research and Development Organisation (DRDO) to acquire a select list of high technologies; and (3) increasing the number of Indian Offset Partners (IOPs). As per the revised DOG, the investment in "kind" is allowed in the form of transfer of technology (ToT) or transfer of equipment (ToE) for manufacture and/or maintenance of permitted items. Here, a distinction has been made by way of mandating that while the ToT can be either through the equity or non-equity route, the ToE has to be only through the non-equity route.

In case a foreign original equipment manufacturer (OEM) chooses technology transfer as an option for discharge of offsets, the guidelines



mandate that such ToT should be provided without license fee and be comprehensive so as to cover all documentation, training and consultancy required for full ToT. The cost of infrastructure and equipment of civil nature are, however, to be excluded from the calculation of offset obligations. The guidelines also mandate that “there should be no restriction of domestic production, sale or export” resulting from such ToT. To ensure that ToT does not lead to “dumping” of foreign technology, and to guard against undue pricing of technologies, the guidelines have emphasised on stringent buy-back and value addition conditions. As per these conditionalities, foreign companies will get offset credit not for the value of the technologies transferred but for the value addition (in India resulting from such ToT) and their eventual buy-back by foreign companies (see Table 1).



In case of ToE, the conditions are somewhat less stringent. The vendors are permitted to claim credits for the entire value of equipment they transfer to their Indian offset partner. However, this is subject to what seems to be OEM’s minimum buy-back of 40 per cent of permitted items.

Technology acquisition (TA) by the DRDO is permitted in a select list of high-technologies, which will be reviewed and updated periodically. The list, which presently consists of 15 categories, includes fibre laser technology; propulsion, aerodynamics and structures for hypersonic flights; nanotechnology-based sensor and displays; and pulse power network technologies, among others. Valuation of technologies offered by the foreign vendors is to be evaluated by the Technology Acquisition Committee (TAC), which is a multi-disciplinary body comprising of DRDO’s Directorate of Industry Interface and Technology Management (DIITM), the additional financial advisor to DRDO, and members from armed forces headquarters, among others. To ensure a two-way dialogue process between the DRDO and the foreign vendor for better understanding of each other’s position, a window of opportunity is provided to enable detailed discussion.

The list of Indian Offset Partners (IOP) has been expanded by including hitherto excluded government institutions and establishments (including DRDO) that are engaged in manufacture and maintenance of eligible items. The new entrants are allowed to receive both ToT and ToE as offsets for augmenting their “capacity for research, design and development, training and education.” The purchase from and equity investment in these institutions by the foreign OEMs are, however, not allowed.

**Table 1: Aspects of India's Defence Offset Policy 2012**

<b>Discharge of Offset Obligations: Avenue Type</b>	<b>Multiplier</b>	<b>Banking (7 years)</b>	<b>Condition</b>
A. Direct Purchase of permitted goods/services	1.5 if IOP is an MSME	Allowed	Offset credit for value addition to be determined by subtracting value of imported items and any fee/royalty paid to foreign companies.
B. FDI in qualified Indian Industry	1.5 if IOP is an MSME	Allowed	—
C. ToT (both through equity (i.e., JV) or non-equity routes)	1.5 if IOP is an MSME	Allowed	Offset credit is to be estimated at the rate of 10% of value of buy-back of items for which ToT is used. Further, the actual value addition in India will be taken for estimating the value of buy-back.
D. Transfer of equipment (only through non-equity route)	1.5 if IOP is an MSME	Allowed	Offset Credit is subject to 40% buy-back (by value) of eligible items within the period of offset contract.
E. ToT or transfer of equipment to DRDO labs, ABW, BRD and Naval Dockyards	Not allowed	Not Allowed	—
F. Technology acquisition by DRDO	Up to 3.0: 2.0 if the ToT is meant for unrestricted domestic production for armed forces 2.5 if the ToT is meant for unrestricted domestic production for both civil & military use 3.0 if ToT is meant for unrestricted production for domestic (civil & military) and export purposes	Not Allowed	Offset credit for the critical technologies listed in new guidelines. The technology list is to be reviewed periodically

**Notes:** 1. A minimum 70 per cent of offset obligations are mandated to be discharged by any one or a combination of avenue types from A to D in this table. 2. Discharge of pre-approved banked offset credits, where allowed, cannot exceed 50 per cent of total offset obligations under each procurement contract. Banked offset credits are not transferable except between the main supplier and his Tier-I sub-suppliers.

*Source:* Prepared by author based on information contained in Revised Defence Offset Guidelines 2012.

## Provision of Multiplier

The revised DOG has for the first time included multipliers as a measure to incentivise investment in select areas. The maximum value of multipliers is kept at 3, meaning a foreign company can claim credits upto three times of its actual offset investment. However, multipliers are restricted to two areas: Micro, Medium and Small Enterprises (MSMEs) and technology acquisition by DRDO. In case of MSMEs, a multiplier of 1.5 is allowed when an offset investment takes place in the form of purchase from, FDI in, and investment in “kind”, in these enterprises. Higher multipliers of 2.0, 2.5 and 3.0, are reserved only for technology acquisition by DRDO. The higher the multiplier, the greater is the technology leverage that the DOG intends to achieve. The maximum multiplier of 3.0 is allowed only when a foreign company provides a listed technology without any restriction on its volume of production and sales, including exports.



## Extended Banking Period

The banking of the offset provision, which was first introduced in DPP-2008, has so far drawn a lukewarm response from foreign companies, the primary reason being a limited validity period (a maximum of two-and-a-half years). To overcome this, the revised DOG has extended the banking period to seven years. The banking provision is, however, allowed in case of purchase from, investment in, and technology/equipment transfer to, Indian industry (technology acquisition by the DRDO and government establishments/institutions have been excluded from the banking purview).

Like the previous guidelines, the revised DOG also does not permit offset trading by restricting transfer of banked offset credits to the main supplier and its sub-suppliers within the same acquisition proposal. However, unlike the previous version, the revised document has stipulated that the pre-approved banked credits cannot be used for more than 50 per cent of total offset liabilities arising out of a future procurement contract. This would mean that a foreign company would require at least two procurement contracts to discharge its banked offsets credits. To ensure that the banking proposals of the vendors are considered in a time-bound manner, the DOG has provided an eight-week window to dispose off such cases.

## DOFA to DOMW

One of the critical features of the new DOG is the provision of the Defence Offset Management Wing (DOMW), which will replace the existing Defence Offset Facilitation Organisation (DOFA). The wing, as in the past, will be under the MoD's Department of Defence Production. However unlike DOFA, DOMW is now visualised as a more powerful

organisation in matters related to post-defence offset contract management. The most critical aspect of its power lies in its being one of the repositories of the signed offset contracts, which the DOFA did not have access to. Among others, the DOMW is tasked to formulate offset guidelines; participate in technical and commercial offset negotiations; monitor/audit offset programmes; administer offset penalties in case of default by vendors; implement offset banking; and assist vendor in all offset-related matters.



### **Provision for Supervision at DAC Level**

Apart from DOMW, the monitoring aspect in the revised DOG has been further highlighted by way of supervision at the highest decision-making level in the MoD. The revised policy stipulates that DOMW “will submit an annual report to the DAC in June each year regarding the status of implementation of all ongoing offset contracts during the previous financial year.” This will ensure regularity in supervision and possibly its quality.

### **Better Clarity in Industrial Licensing and FDI Issues**

From the private sector’s perspective, one of the key hurdles in participation in offsets programmes was the difference in interpretation of industrial licensing requirements and FDI exposure of IOP. The MoD was believed to have taken a stand that IOP, irrespective of its being in defence or non-defence sectors, must have an industrial licence and its FDI exposure must not exceed 26 per cent (the Ministry of Commerce [MoC] guidelines state that an Indian company is subject to IL and FDI restriction if its activities fall only in defence manufacturing). To overcome the above difference, the revised guidelines have made it clear that the provisions in the DOG will be in “harmony and not in derogation of any rules and regulations stipulated” by other agencies. If this is followed true to letter and spirit, it would facilitate participation of non-defence manufacturing companies in offset programmes.

### **Miscellaneous Provisions**

Apart from the above provisions, the revised guidelines have also expanded the list of eligible products/services against which offsets can be discharged; extended the offset discharge period; and put a cap on penalty in case of default. The list of eligible products/services has been mainly expanded in the renamed category of “Products for Inland/Costal Security” (known earlier as “Products for Internal Security”). Four more groups have been added to the category. The “Civil Aerospace Products” and “Service(s)” categories

have been expanded by one group each. In the “Defence Products” category, while the number of groups has remained the same, the group under warship building has been expanded by including four distinct sub-groups for greater clarity. In all, there are now 39 group of products/services in which foreign vendors are allowed to discharge their offset obligations. These groups are apart from the list of high technologies (meant for DRDO), against which foreign vendors are allowed to discharge their offset obligations.

Regarding the offset obligation discharge period, the new guidelines have extended the period by two years from the date of the main procurement contract (the date of the main procurement contract is inclusive of the date of warranty). However, the extension is subject to vendors’ submission of an additional performance-cum-warranty bond equivalent to the value of offset obligations falling beyond the period of the main procurement contract. The submission of a bond is required six months prior to the expiry of the main performance-cum-warranty bond.

While the revised DOG has kept the annual penalty in case of default on the part of vendor at five per cent, it has now mandated that the overall penalties cannot exceed 20 per cent of the total offset obligations during the main procurement contract (there will be no cap on penalty in case of default during the extended period).

## **Critique of the Revised DOG**

### **Unrealistic Indigenous Requirement and Timeframe Under “Buy (Global)”**

While the DPP tacitly defines an Indian defence item as one that has a minimum 30 per cent indigenous content, the offset provisions for Indian companies under the “Buy (Global)” contract try to nullify such a definition. Beyond the definitional issues, what is more important is the potentially damaging impact on the domestic defence industry of the revised DOG’s 50 per cent indigenous requirement and timeframe to achieve that. It is well known that very few Indian companies can offer products with 50 per cent or more indigenous content. This is perhaps the only reason why the indigenous requirement under the “Buy Indian” contracts has been kept at 30 per cent. Given this, it is inconceivable to imagine why the requirement has been suddenly pegged at a significantly higher level. Moreover, even assuming that some Indian companies would like to achieve the stipulated indigenisation level, the time frame provided in the DOG simply does not encourage that. Indian companies are now required, as per the DOG, to prove the indigenous content at the time of submission of technical bids, which means they need to have 50 per cent indigenous content even before the actual production commences! This is not only unrealistic but also dissuasive for any Indian company which wants to compete at the global level.

### **Value Addition: Exclusion of Services**

In a major deviation from the previous policy version, the revised DOG has explicitly excluded “services” from the purpose of estimating value addition in India (the previous

guidelines were silent on this aspect). With the addition of R&D services to the list of “services”, the explicit exclusion of services means far greater leverage to the foreign companies and far less incentive to the eligible Indian manufacturing sector. A simple hypothetical illustration would probably help to understand the gravity of the potential consequence. For example, a foreign company opts for “training” (an eligible service) as a means for discharge of its offset obligations worth Rs 10 crore. Since the foreign company is at complete freedom to choose an IOP, and assuming that there is cut-throat competition within the Indian services sector to participate in offsets programme, it becomes easier for the foreign company to select one IOP which is willing to provide the maximum concession. Let us assume that the IOP agrees to a proposal to accept some surplus trainers from the payroll of the foreign company at the cost of Rs 8.5 crore. Since value addition is not a factor in determining the offset credit, the foreign company is entitled to claim offset credits, including for the amount spent on its own trainers. In this case, the foreign company gets Rs 10 crore worth of offset credits (the amount will increase to Rs 15 crore if IOP is an MSME) against his actual incurred cost of Rs 1.5 crore which the IOP receives for becoming the partner. Had the value addition been a factor in determining offset credit, the foreign company would have got offset credits only for Rs 1.5 crore. Clearly, the loser in this case is the Indian industry (if not the IOP which acts as a mere trading house of services and cannot see beyond its own business interests), which lost Rs. 8.5 crore worth of offset business.

The above is probably less in comparison to the negative impact on the permitted manufacturing sector. With the increase in number of categories of the services list, and the cost advantage to the foreign vendor in discharging offset obligations in this sector, the OEMs have virtually no incentive to resort to eligible manufacturing products. In other words, the Indian manufacturing sector is at a tremendous disadvantage vis-à-vis the services sector. This will hamper its prospect of working with foreign companies or becoming a part of the global supply chain.

### **Advantage to Non-Defence IOP**

The revised DOG might have clarified its position vis-à-vis the licensing and FDI regulations as stipulated by other government agencies. At the same time, it has created a unique situation with far reaching implications on the defence and non-defence sectors. For an Indian private company, defence manufacturing is subject to mandatory licensing and a 26 per cent FDI cap. These restrictions are, however, not applicable to companies in the civil aerospace, inland/costal security and services sectors. In other words, companies in these sectors can become IOP without licensing and FDI constraints that their counterparts in defence manufacturing would face. This clearly tilts the playing field in favour of non-defence manufacturing sectors. Foreign companies will be far more inclined to choose a non-defence IOP that does not require a license and in which the foreign equity stake can be more than 26 per cent. On the latter aspect (equity stake), the incentive for the foreign company is even greater. Since there is no restriction on foreign equity stake in an IOP

from the non-defence manufacturing sector, theoretically, a foreign company's wholly-owned subsidiary registered in India can be a front organisation for execution of offset programmes on behalf of its parent company! This may not be the true intent behind the revised DOG, but the MoD should not be surprised if it finds this happening one day.

### **Ambiguity in Date of Reckoning of Offset Transaction with Regard to ToT & ToE**

The new guidelines might be innovative in allowing technologies and equipment as valid methods of discharge of offsets, but it suffers from ambiguity in reckoning the date of completion of transactions arising out of such transfers. The ambiguity is due to the lack of harmony in explanation in two different places in the revised offset guidelines. In the section on Valuation of Offsets (paragraph 5.13), the DOG states that the "date of discharge of offset obligation [with respect to FDI, ToT, ToE and TA by DRDO] shall be reckoned as the date of completion of transaction, based on documentary evidence." Going by this, a foreign vendor can claim offset credits for, say, transferring equipment to an Indian entity after he gets the final payment from the buyer and submits the relevant documentary proof with the MoD. This may be the premise of his claim of offset credit, but MoD may not buy such an argument. Given the sensitivity and oversight concerns, the concerned official in the DOMW can invoke the section on Mandatory Offsets (paragraphs 5.6 & 5.7), which gives it power to reckon such credit only when the foreign company completes buy-back of at least 40 per cent of eligible items from the Indian industry (as in the case of transfer of equipment). Since buy-back involves a comparatively longer period (hence an element of cost also), and also a prospect of penalty in case of default, the vendor may opt for arbitration to prove that his conviction is right.

### **Private Agency to DOMW's Rescue?**

The success of offset policy lies as much in its details as in its effective monitoring provisions. Since the DOFA was first established post the DPP-2006, the organisation was under constant criticism due to its lack of monitoring capacity. The shortage of adequate and dedicated staff, their short tenure, and lack of access to the signed offset contracts for monitoring, had all virtually rendered the organisation non-responsive. Now that the revised DOG has mandated that the DOMW would be responsible for all post-offset contract management, the only practical constraint in its monitoring power appears to be related to manpower. Early reports suggest that these aspects are being addressed by way of augmenting the internal staff strength of DOMW and hiring the services of private firms to undertake a regular audit of the offset programme. While the former is certainly a welcome



step, the latter is not free from challenges. Since private firms mainly cater to industry (both foreign and Indian), there would be a serious conflict of interest if agencies happen to audit the compliance reports of their clients. This aspect needs to be addressed so as to avoid any potential risks in the future.

### **Lack of Clarity on Government Institutions/Establishments**

The new DOG does not name the government institutions/establishments which have now become additional eligible entities that can receive offsets in the form of ToT and ToE for their capacity building. The names are, however, mentioned in the MoD's Press Release of August 2, 2012 and include DRDO laboratories, Army Base Workshops, Air Force Base Repair Depots and Naval Dockyards, etc. The list of names in the Press Release is not comprehensive as it uses the term "etc.", meaning some more names could be added to it subsequently. This confusion apart, it is also not clear why the MoD has chosen a press release to identify these entities, instead of the DOG, which, being a part of DPP, is the ultimate reference document. Moreover, it is also not clear why these institutions are kept away from the banking provision, if not the multiplier.

### **Conclusion**

The revised DOG has added certain new features and modified/clarified some of the existing provisions, besides articulating for the first time the objectives that the policy document wants to achieve. The DOG has clarified the offset conditions applicable on Indian companies participating in "Buy (Global)" contracts. It has also expanded the avenues for discharge of offset obligations by: (1) allowing transfer of technology/equipment as valid means of offset discharge; (2) articulating a fresh list of eligible IOPs; and (3) permitting DRDO to acquire a select list of technologies. To incentivise foreign companies to engage India's MSME, and part with some of the high-technologies to the DRDO, the revised guidelines have also for the first time allowed multipliers up to three. Further incentivisation is also provided by way of extending the banking period to seven years. In addition, the DOG has provided a relatively stronger monitoring system by way of creating a DOMW that will replace the existing DOFA with more powers. Clarification of the MoD's position vis-à-vis IL and FDI, supervision of signed offset programmes at the DAC level, expansion of the eligible product/services list, and an overall cap on penalty in case of default are some other provisions in the new guidelines.

The above features notwithstanding, some of the provisions in the DOG do not seem to be well thought out, provide greater leeway to the foreign companies, and have a potentially negative potential on eligible manufacturing sector, particularly defence manufacturing. Mandating offsets on Indian companies – if the products have less than 50 per cent indigenous content – and limiting the timeframe to achieve the required indigenisation level before the production starts, is simply unrealistic. This will dissuade many Indian

defence hardware manufactures from competing against their global peers, even if they are hopeful of achieving progressive indigenisation over a period of time.

The manufacturing sector is further marginalised by two provisions: (1) explicit exclusion of services from the purpose of value addition in India; and (2) clarification of MoD's position on IL and FDI. The first provision means virtually no incentive for foreign companies to choose an IOP of manufacturing background, as choosing an IOP from the services sector will be far more cost-effective. The second provision allows cost-effectiveness to be much more for a foreign vendor if he chooses a non-defence, non-manufacturing IOP that does not require an IL and is not subject to the 26 per cent FDI limit, which is mandated for Indian defence manufacturing enterprises. This means the foreign vendor can set up a 100 per cent-owned subsidiary (specialising in services) in India and choose it as its offset partner. Evidently, this does not at all benefit India's manufacturing sector, let alone defence manufacturing.

The revised offset guidelines might have been innovative in allowing ToT/ToE as valid methods for discharge of offsets, but they are not clear at what stage the vendors are allowed to claim credits for such transfer. The difference in interpretation by vendor and the defence ministry could lead to long-fought arbitration, causing unnecessary wastage of time and money on both sides.

Although provision for a stronger monitoring agency in the form of DOMW is definitely a step in the right direction, what is still unclear is the new organisation's ability to monitor/audit offset programmes, which requires considerable increase in its manpower strength. Given that the efficacy of offsets lies in its effective enforcement and strong monitoring, DOMW should develop a strong in-house capability instead of relying on private help to avoid conflict of interest.