

Exchange Rate Variation in Defence Contracts in India

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Summary

Recent depreciation of the Indian Rupee saw increased advocacy by certain sections of the Indian industry for exchange rate protection in government contracts, and one occasion, for incorporating the same in the Public Procurement Bill that was recently placed by the Government before the Parliament. This Issue Brief analyses industry demands and reviews existing regulations in IT and defence procurement markets, culminating with suggestions on a possible way forward for reforms that can avoid certain adverse implications of industry demands, particularly in view of their potential conflict with important national public policies fostering indigenisation and domestic manufacturing in India.

I. Introduction

The rapid, albeit short-lived, depreciation of the Indian Rupee witnessed recently saw some interesting claims and policy responses unfolding around public procurement in India: certain sections of India's IT industry upped the ante for incorporation of an "Exchange Rate Variation" (ERV) clause in government contracts in India¹; and the Ministry of Finance responded by issuing an office memorandum covering IT procurements² by essentially restating, and potentially further complicating, an already existing provision of the *Manual on Policies and Procedures for Purchase of Goods*.³ These interesting and important developments lend themselves to a quick academic inspection of similar industry claims in the context of defence procurement in India⁴; and this short note accordingly attempts to put forth some suggestions on how government responses could be structured or improved upon, given potential conflicts of such industry demands with important policy interventions for increasing self-reliance and indigenisation outlined under India's *National Manufacturing Policy*⁵, the *Defence Production Policy*⁶ and the *Policy for Providing Preference to Domestically Manufactured Electronic Products (DMEP Policy)*.⁷

¹ MAIT (2012), *IT Industry Voice Concerns Over Public Procurement Bill 2012*, available online <http://www.mait.com/newsdetails.aspx?mpgid=49&pgidtrail=49&nid=11>.

² Ministry of Finance (2013), *Inclusion of Exchange Rate Variation (ERV) Clause in Contracts Relating to Procurement of IT Products*, O.M. No. 26/1/2012-PPD Dated October 01, 2013, available online http://finmin.nic.in/the_ministry/dept_expenditure/ppcell/IncERV01102013.pdf.

³ Ministry of Finance (2006), *Manual on Policies and Procedures for Purchase of Goods*, available online http://finmin.nic.in/the_ministry/dept_expenditure/acts_codes/MPProc4ProGod.pdf.

⁴ ASSOCHAM Requests Defence Ministry to Review Procurement Procedure, *The Economic Times*, august 11, 2013, available online http://articles.economictimes.indiatimes.com/2013-08-11/news/41295691_1_defence-sector-cent-fdi-cap-dpsus.

⁵ Ministry of Commerce (2011), *National Manufacturing Policy*, available online http://commerce.nic.in/whatsnew/National_Manufacturing_Policy2011.pdf. 8.4 of this policy requires minimum local value addition in India for government purchases in certain high-tech sectors. Further, 1.6 of this policy stresses upon the need for acquiring depth of technology in a number of sectors such as defence and telecommunications witnessing high import contents. See, also,

⁶ Ministry of Defence (2011), *Defence Production Policy*, available online <http://ddpmod.gov.in/showfile.php?lid=94>. 5 of this policy requires the Ministry to progressively identify and address issues that impact relative competitiveness of Indian defence industry vis-à-vis their foreign counterparts; and 3 generally require preferential procurement from indigenous sources.

⁷ Ministry of Communications and Information Technology (2012), *Policy for Providing Preference to Domestically Manufactured Electronic Goods*, available online [http://deity.gov.in/sites/upload_files/dit/files/Preference%20to%20Domestically%20Manufactured%20Electronic%20Goods%20Notification%20\(2012\)%20\(10759%20KB\).pdf](http://deity.gov.in/sites/upload_files/dit/files/Preference%20to%20Domestically%20Manufactured%20Electronic%20Goods%20Notification%20(2012)%20(10759%20KB).pdf). 2.3 of this Policy mandates continuous enhancement of domestic value addition by domestic manufacturers supplying covered equipment to Government of India, rising from 25% in the first year to 45% in year 5.

II. ERV in Defence Contracts in India

ERV provisions under India's Defence Procurement Procedures (DPP) are not very clearly or unambiguously outlined in the main text, the issue having been relegated to a relatively short and incomplete paragraph under "*Commercial Clauses*" part of the *Standard RFP Document*. Briefly, the applicable RFP provision⁸ reads as follows:

Exchange Rate variation shall be applicable for Rupee contracts with **Indian Vendors, based on RFPs issued under the category 'Buy (Global)'**. ERV, however shall **not be applicable in cases categorized as 'Buy (Indian)'** except for **DPSUs in ab-initio Single Vendor cases or when nominated as Production Agency**. The guidelines on protection of Exchange Rate variation are given at Annexure to this Appendix (emphasis added).

A. Indian Vendors vs. Foreign Bidders in Buy (Global) Cases

The regulatory language in DPP is incomplete, since foreign vendors are already permitted to bid (and *to be paid*) in Dollars, Euros or Pounds⁹ in capital acquisition cases categorised as "Buy (Global)" or "Buy and Make with ToT". Thus, the DPP, *de facto*, provides complete ERV insulation to foreign vendors in these two categories since their payments do not get linked to prevailing exchange rates with Indian Rupee, whereas a plain text reading of the regulatory language could lead a newcomer to believe that ERV is allowed only for Indian vendors in "Buy (Global)" cases.

In contrast to full ERV protection to foreign vendors as outlined above, the DPP presently allows only partial ERV protection to Indian bidders, and that too, only mainly in theory. The *Annexure to Commercial Clauses* part, referred to in 1.4.8 reproduced earlier, read with another part¹⁰ on "*Evaluation Criteria and Price Bid Format*", seems to indicate that payments to Indian vendors are based on exchange rates at the time of import (during the stage of contract performance) vis-à-vis exchange rates at the time of bid comparison¹¹. In a depreciating Rupee scenario, this places an extreme financial burden on Indian bidders, as the present formula ignores the exchange rates prevailing on the last date of submission of bids, making Indian bidders bear the full impact of exchange rate-dependent losses from the period from *last date of bidding* to *date of actual bid comparison/ final contract valuation*,

⁸ Ministry of Defence (2013), 1.4.8, p.131, *Commercial Clauses*, Appendix F, DPP-2013.

⁹ MoD, 1.2.1, p.126, *supra* n.8.

¹⁰ MoD, 1(b)(v), *supra* n.8.

¹¹ The regulatory language is ambiguous on this point. 1(b)(v) speaks of *exchange rates adopted for contract valuation* as the base reference point; whereas 2 states "...the prices *finalised in the contract* are based on the base exchange rates indicated in the contract...". In contrast, 1.2 suggests the use of *exchange rates prevailing on the date of opening of bids* as the base reference point.

which typically could run into a few years¹². This forces Indian defence industry to usually obtain exchange rate insurance to hedge their certain losses, artificially inflating their bid prices in the first instance, thus making them relatively non-competitive at the initial stage itself as compared to their foreign counterparts.

To add to the problem, the language of the DPP is potentially inconsistent: the bid comparison amongst Indian and foreign vendors takes place on the basis of exchange rates prevailing at the time of opening of bids, while payment to an Indian vendor could take place on the basis of exchange rate at the time of transaction vis-à-vis exchange rate at the time of bid comparison or that at the time contract finalisation, as may be interpreted by the MoD acquisition officials given significant inconsistency of the DPP text.¹³

B. Private Indian Vendors vs. OFB/ DPSUs in Single Vendor “Buy (Indian)” Cases

Under DPP, ERV is not applicable in cases categorised as “Buy (Indian)”, except for DPSUs in *ab-initio* “Single Vendor” cases or when nominated as a production agency¹⁴. In all probability, this means that ERV is available only to DPSUs in *ab-initio* single vendor cases or when nominated as production agencies in “Buy and Make with ToT” cases. The logic in extending ERV protection in both cases is clear: it would really make no financial difference to MoD whether such ERV protection is *provided* or *not provided* in single vendor cases. This happens as the single vendor would anyway incorporate foreign exchange risks in the initial bid price in a fixed price contract if ERV protection is not afforded upfront, given the absence of competition and resulting absence of any market forces driving down bid prices.

Given this nuance, even though the DPP explicitly provides for ERV cover only to DPSUs in single vendor “Buy (Indian)” cases, and despite a common misunderstanding that private defence industry in India is somehow *discriminated* vis-à-vis DPSUs, the provision has virtually no adverse effect on the level-playing field.

C. Private Indian Vendors vs. OFB/ DPSUs in competitive “Buy (Indian)” Cases

ERV cover is unavailable to either OFB/ DPSUs or to private Indian vendors in competitive procurement made in competitive “Buy (Indian)” cases¹⁵. This also is quite reasonable at one level, since in such a situation, all competent bidders can be expected to incorporate

¹² The DPP sets a typical time frame of 54-79 weeks (almost one-and-a-half years) for finalisation of contract costs from the last date of receipt of bids; *Broad Time Frame for Procurement Activities*, Appendix C, 15, p.51, *supra* n.8. The actual time taken tends to be quite in excess of the typical time frame under DPP.

¹³ *Supra* n.11.

¹⁴ MoD, 1.4.8, p.131, *supra* n.8.

¹⁵ *Ibid.*

exchange risks in their bid prices, and to hedge their losses by taking exchange risk insurance policies where necessary. Since contract award is based on lowest price, competent participating bidders would negotiate exchange risk insurance policies at the best possible costs to them, and through that process, at the best possible costs to the Government.

Here again, it is fairly easy to see that there is no disruption of the level-playing field in competitive procurement between OFB/ DPSUs and private defence industry. In addition, this lack of an ERV protection also avoids for MoD the serious operational difficulties associated with comparing bids with *different* foreign exchange components, where, if ERV protection were available in competitive cases, a vendor with lower indigenous content would actually be *better off* as compared to another vendor who adopts MoD's indigenisation agenda and incorporates higher indigenous content objectives into his/ her manufacturing strategies.

D. Understanding the Tension between ERV Cover and Increased Indigenisation

The foregoing preliminary analysis brings us to a discussion on the potential trade-offs between providing ERV protection in public procurement vis-à-vis achieving important national policy objectives of increased domestic manufacturing. Indiscriminate use of ERV protection can create a serious disincentive for achieving higher indigenous content, since any smart bidder would like to cover as many losses as possible, and where ERV cover is available, the natural tendency for an Indian supplier would be achieving the *lowest mandatory* indigenous/ domestic content, rather than achieving *higher-than-the-bare-minimum*. Indiscriminate ERV cover would also take away incentives for investing for suppliers to create/ upgrade their manufacturing capacities, for the simple reason that there would be no gains to be made by private/ public players from creating or ramping up of their domestic manufacturing capacities: an outcome that can seriously hamper achievement of more important national objectives of progressively higher domestic manufacturing in the longer run.

In a developing economy context, if no indigenous content requirements are posed, the natural tendency amongst domestic suppliers would therefore be to limit themselves to the role of traders rather than manufacturers, choosing to remain at *zero* indigenous content, given that foreign purchases of components would be fully insured because of ERV protection. In the case of defence procurement in India, for instance, this would imply that providing ERV cover in competitive procurement cases would take down indigenous content to the bare minimum 30% required under the *Defence Production Policy* rather than 70% as voiced by senior officials of MoD recently¹⁶; and for electronic products covered the *DMEP*

¹⁶ Government aims at 70% indigenous procurement for defence industry, Business Standard, November 25, 2013, available online http://www.business-standard.com/article/economy-policy/govt-aims-for-70-indigenous-procurement-for-defence-industry-113112500778_1.html.

Policy, to the bare minimum of 25%. Given lack of incentives and economies of scale, indigenous content in “Buy(Indian)” (or similar) cases would be driven down as aforesaid in these sectors, and would in all likelihood stay tied down to those levels, defeating the objectives of the *National Manufacturing Policy*, the *Defence Production Policy*, as well as the *DMEP Policy*.

E. Improving MoD’s Operational Guidance

Given the lack of clarity with MoD’s operational guidance, there appears to be a significant need for increased consolidation and internal harmonisation on use and application of the ERV clause under DPP. For instance, the *ERV Clause* may need to be harmonised with the *Bid Evaluation Clause*, so that there is upfront clarity on formulae and base rates for bid comparison. In this context, it may be useful to peg the base rates to those prevailing on the *last date of bid submission*, rather than pegging the base rates to those prevailing on the *date of opening of commercial bids*, given (i) significant time delays between the date of bid submission and date of bid opening; and (ii) lack of certainty in the date of bid opening potentially leading to unnecessary ERV risk insurance-taking by bidders. The payment sub-clause may also need to be tightened: at one point, the ERV Clause talks of annual computation of ERV-impacted cost changes and payments at the end of the financial year¹⁷; whereas there should really be no need for a contractor to wait for the end of the financial year for contract payments (and for MoD to bear higher *in-built* bid costs as a result of delayed payments) when applicable exchange rates are notified by the State Bank of India on an almost daily basis. Finally, MoD officials and bidders could also be benefitted by clearly outlining the ERV mechanism for “Buy and Make with ToT” cases where a subsidiary contract is entered into between the foreign vendor and the Indian production agency.

III. The General Procurement Rule Position in India on ERV

ERV in public contracts in India is governed by the *Manual on Policies and Procedures for Purchase of Goods*, which allows¹⁸ for an ERV clause to be incorporated in contracts with: (i) substantial import content; and (ii) contract performance duration more than one year from the date of signing. In response to tender enquiries for such contracts; bidders are expected to indicate: (i) import content; (ii) foreign currencies used to calculate value of import content in quoted price, the latter being in Indian Rupees; (iii) base exchange rate for each such foreign currency used for converting import content into Indian Rupees; and (iv) extent of foreign exchange variation risk the bidder is willing to bear.

The clause obviously expects procuring officials to be able to measure indigenous content: a capability that may not be as readily available as expected. In addition, the purpose of

¹⁷ MoD, 2, *supra* n.8.

¹⁸ MoF, 9.3.4, *supra* n.3.

requiring the last bit of information to be furnished by bidders is unclear, as the clause does not provide guidance on L1- vendor determination by a procuring official by comparison of bids when *different bidders come up with different willingness to bear foreign exchange variation risks*. The clause also contrasts with a mandate elsewhere that requires *procuring officials to indicate a band of ERV upto which no price benefits would be extended to bidders*. Finally, it is also unclear as to what purpose is served by asking bidders for indicating in their bids the base exchange rate used for foreign currencies, given that elsewhere in the clause, *procuring officials are themselves expected to notify in tender enquiry documents the base date for foreign exchange rates*, including the fact that TT Selling Rates of Exchange as quoted by authorised Exchange Bankers approved by the Reserve Bank of India alone are to be used for calculating price variations admissible to bidders.

While filing claims for payment; the following documents are required to be furnished by the supplier for claiming ERV benefits:

- (a) A bill of ERV claim enclosing working sheet;
- (b) Banker's Certificate/debit advice detailing foreign exchange paid, date of remittance and exchange rate;
- (c) Copies of import order placed on supplier; and
- (d) Invoice of supplier for the relevant import order.

From the above documentation requirements, it appears that ERV claims are to be processed by procuring officials based on the *base date indicated in the tender enquiry documents as incorporated in the contract* and the *exchange rate prevailing on the date of actual payment of foreign exchange by the supplier*. It is however unclear as to how the date of delivery (the only fixed date as per contract) is to be factored into pricing decisions, as in some cases, the date of delivery may precede the date of actual payment of foreign exchange by the supplier – which in a depreciating Indian Rupee scenario would result in a somewhat higher outgo of public funds and consequent questioning of payment actions by oversight authorities.

A. The MoF's Restatement on Exchange Rate Variations

As stated earlier, recent depreciation of the Indian Rupee led to demands from the Indian IT Industry for incorporation of ERV clauses in respect of DGS&D rate contracts¹⁹ where prices remain firm and fixed for roughly six months at a time. The response by the Ministry of Finance (MoF) took the shape of a recent office memorandum extending to well beyond

¹⁹ MAIT, *supra* n.1.

DGS&D rate contracts, drawing attention to, and reiterating, clause 9.3.4 of the *Manual*. On a closer reading, the OM contains two significant departures from the general conditions of the underlying clause: (i) the new OM limits itself to procurement of IT products, whereas the original clause applied to procurement of non-IT products as well; and (ii) the new OM seems to mandate that actual payments under contract be linked to *exchange rate prevailing at the time of the scheduled delivery date*, in contrast to the original clause which suggested that actual payments by government be linked to the *exchange rate at the time of actual procurement of imported elements by the supplier*. Reasons for either of two deviations are not stated in the OM.

An important operational ambiguity with the OM is on whether the ERV clause is to be provided for foreign exchange component *beyond the maximum 75% (55% by Year 5) that is a statutory minimum for covered IT procurements under the DMEP Policy*, or whether the ERV clause is to be applied to *all foreign content*. As a result, if procuring officials end up providing ERV for the full foreign content under the authority of the OM, its implementation is likely to result in derogation of not only the immediate requirements of the *DMEP Policy*, but also long-term strategic objectives of that policy. An easy way to prevent such implementation problems would perhaps be for MoF to reword the OM by explicitly mentioning additional perspectives and requirements of the *DPEP Policy* and limiting ERV to foreign content *beyond* the statutory minimum.

Another area for improvement in the MoF OM is regarding the base (reference) points for computing ERV-impacted payments. The original clause 9.3.4 in the *Manual*, for instance, requires procuring officials to set reference points as *the TT Selling Rates of Exchange as quoted by authorised Exchange Bankers approved by the Reserve Bank of India*, whereas the new OM talks very broadly of “...*indices published by Governments periodically...*”, leaving it unclear as to: (i) *which indices* are to be used; (ii) *the specific government authorities* whose indices need to be looked up, since neither the Central Government nor State Governments apparently publish such indices. Some of these problems with the OM could perhaps be resolved by: (i) laying down clear methodologies for comparison of bids where bidders indicate *different foreign contents and different currencies of payment* to their foreign sub-suppliers; (ii) clearer methodologies for computing payments due to suppliers at the stage of delivery/ filing of claims containing the formula for payment, indices to be used, and required documentation.

IV. Summing Up

Providing ERV protection to bidders in government contracts is a complex policy decision with important implications for domestic manufacturing, both immediate and long-term effects. Procurement guidance must therefore necessarily factor objectives and intents of applicable national manufacturing policies in relevant sectors. In more operational terms, a well-designed ERV clause should be able to provide the fullest possible clarity to procuring

officials on bid-comparison amongst bidders with varying foreign content and on payments at the stage of contract performance. It should also provide an equal amount of clarity to bidders on applicable procedures, documentation and timelines, in order that cost to procuring organisations is not unnecessarily inflated and avoidable disputes do not get generated in the contract award or contract performance phases. An important issue for government consideration may be making the Procuring Policy Division the only government office with authority to issue policy and regulatory directions on public procurement: the new MoF OM for instance fails to fully account for the *DMEP Policy* that was issued by the Ministry of Communications and Information Technology or the *National Manufacturing Policy* that was issued by the Ministry of Commerce.

For the MOD, to the extent that the new MoF OM may not perhaps be the best role model, MoD's policy options may lie in addressing, on priority, the non-level playing field between Indian and foreign bidders in "Buy (Global)" cases that presently exists because of a poorly-designed ERV clause in DPP that applies to domestic bidders, as compared to full ERV protection that is *ab-initio* available to foreign bidders. The redesign of the ERV clause in such cases should provide adequate clarity on bid comparison aspects, as well as settlement of claims upon product delivery.

Insofar as providing ERV cover in competitive "Buy (Indian)" cases, MoD's decision-makers may find it particularly useful to consider potentially adverse implications of such protection on the objectives of enhanced indigenisation outlined in the *Defence Production Policy*, as well as potential adverse effects on negotiating capabilities of Indian bidders with their back-end foreign component suppliers. In addition, the redesign process in these two categories may need to take into account the 30% indigenous content requirements in "Buy (Indian)" cases and 50% in "Buy and Make (Indian)" cases, and may need to provide adequate disincentives for suppliers who could end up driving down indigenous content to the bare minimum, and take India further away from achieving important policy mandates of fostering indigenous manufacturing in the defence sector.