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Defence Offset Guidelines - A Languorous Journey So Far

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Summary

The Defence Offset Guidelines complete one year of being in force on August 1, 2013. Looking back, the journey so far has been quite impassive with the Ministry of Defence (MoD) remaining indifferent to the numerous demands made on it to modify the guidelines and to clarify some of the provisions. In fact, the only development since the promulgation of the guidelines has been temporary suspension of the 'services', including software development, as a valid avenue for discharge of the offset obligations.

Several issues have been raised in the last one year. Some of these issues would warrant tweaking of the policy underlying the guidelines. One such issue concerns the need for amending the policy to enable the MoD to demand offsets in specific area(s) rather than being driven by the vendors. This is necessary to channelize the offsets into manufacturing and such other areas as might be critical to promotion of indigenous capabilities in research, design and development. Another important policy issue concerns introduction of the provision for offset trading, which could complement the already existing provision for offset banking. The MoD can resolve these, and other similar issues, entirely on its own. It is inexplicable why it did not do so in the past one year.

A greater cause for concern is the fact that there are many other policy issues that cannot be resolved by the MoD by itself. These issues relate to industrial licensing, taxation, foreign direct investment, formation of joint ventures, incentives for indigenous production, permission to export, etc. It is true that these issues did not arise suddenly after the promulgation of the offset guidelines last year. Nor are these related exclusively to discharge of the offset obligations. However, these issues are crucial for the Indian defence companies, whether acting as the prime vendors or as the Indian Offset Partners (IOPs). The clamour for resolving these issues has been gaining momentum with renewed vigour since the announcement of the offset guidelines last year.

A year's time was perhaps not enough to resolve these issues but it was certainly sufficient to set the ball rolling. Some steps have indeed been taken, such as notification of the list of the defence items by the Department of Industrial Policy and Promotion (DIPP). The issues regarding deemed export status for certain defence projects and rationalization of tax and duty structures have also been taken up by the MoD with the Ministry of Finance. This was announced by the MoD through its Press Release of April 20, 2013. However, these sporadic steps do not cover the entire gamut of issues that must necessarily be resolved to create the kind of eco-system required by the domestic defence industry to flourish.

While the lack of any visible progress on these issues is somewhat disappointing, it would be unfair to pillory the MoD for it. Resolution of the policy issues, regardless of whether they are within the remit of the MoD or they require consultation with other ministries and departments, does take a long time. The MoD has at least taken some initiative in this regard. What is dismaying, however, is that in the past one year, MoD has not taken the simplest step of offering clarification on any of the several issues relating to existing policy that are being raised at various forums. The MoD could have marked the first anniversary of the 2012 guidelines by providing those clarifications. Be that as it may, it is never too late to do that. What are these issues?

The first set of issues relates to industrial licensing. The prime movers in the business of offsets are the foreign vendors, along with their sub-vendors who are also now permitted to discharge a part of the offset obligation. They need to tie up with the Indian companies,

either in anticipation of getting a contract or in the context of a specific acquisition programme. The guidelines provide that any Indian enterprise, institution or establishment engaged in manufacture of eligible products and/or provision of eligible services (presently held in abeyance), including the Defence Research & Development Organization (DRDO), could be an IOP. A foreign vendor is free to select any IOP as long as the latter is not barred from doing business by the MoD. By and large, this part of the guidelines is quite clear, though it would have added to the clarity in the policy had the terms 'enterprise', 'institution' and 'establishment' been defined in the guidelines.

The problem, however, arises from the stipulation that, besides any other regulations in force, the IOP should also comply with the guidelines/licensing requirements stipulated by the Department of Industrial Policy and Promotion (DIPP). This would clearly imply that an Indian company with more than 26 per cent foreign direct investment (the present cap on investment in the defence sector), including a wholly-owned subsidiary (WOS), which might be operating in the sectors where more than 26 per cent FDI is permitted, such as the civil aerospace and software development (presently the latter is under abeyance), can act as an IOP. It may be recalled that the existing policy permits discharge of the offset obligation through these sectors. But there are widespread misgivings about acceptability of this interpretation by the MoD.

The question whether industrial license is required by the companies manufacturing dual-use items has also been hanging fire. The MoD is of the view that this is not required and has conveyed it to the DIPP but this decision is yet to be notified by the latter, which is the final authority on matters related to licensing. The MoD needs not only to persuade the DIPP to notify this decision but also clearly define what is meant by dual-use items. A simple definition could be that all those items which do not figure in the list of defence products notified by the DIPP would fall in the category of dual-use items if such items, being manufactured for civil use, are also used for any defence product. A related issue is whether service providers operating in non-defence sector would similarly be exempted from obtaining a license if they have to provide a service in relation to a defence acquisition or an offset programme.

The second set of issues relates to the avenues for discharge of the offset obligations. These issues are important not just for the vendors but for the MoD itself if it has to achieve the objectives of the offset policy without falling into pitfalls resulting from varying interpretation of the same provisions. Some of these issues are as follows.

First, one of the avenue for discharge of the offset obligation is 'direct purchase' of, or 'executing export orders' for, eligible products manufactured by, or services rendered by (presently held in abeyance) by the Indian enterprises. The question is: what is meant by these two terms? Does 'direct purchase' imply purchase by the foreign vendor from an Indian company with the former being the consignee? If so, how is this different from 'execution of export order', unless this term implies sale by the Indian company to a

foreign company other than the prime foreign vendor (who has to discharge the offset obligation) through the intervention of the latter? If that is the case, it would also need to be clarified what kind of intervention would be necessary for the foreign vendor to earn the offset credit.

Second, investment in kind in terms of transfer of technology (ToT) to Indian enterprises is a permissible avenue for discharge of the offset obligation, subject to exclusion of the cost of the civil infrastructure and the equipment. In such cases, the offset credit for the transferred technology will be restricted to 10 per cent of the value of the buyback during the period of the offset contract, to the extent of value addition in India. Does this imply that if in a $50m project undertaken for discharging a part of the offset obligation in a $300m contract, and the value addition in India is, say $30m, the prime vendor will have to buy back products worth $300m to be able to get credit up to $30m (10 per cent of the buyback) on account of transfer of technology?

If this understanding is correct, it would make no sense to discharge even a part of the offset obligation through this route. The foreign vendor might as well make direct purchase of, or execute export orders for, defence products worth US $ 30m and get full credit for that. If, on the other hand, this understanding is not correct, what will be the correct interpretation of the relevant provision in the guidelines?

Third, investment in kind is also permissible in terms of provision of equipment through the non-equity route, subject to exclusion of the cost of the ToT, civil infrastructure and the second hand equipment. The guidelines provide that in such cases, the vendor will be required to buyback a minimum of 40 per cent of the eligible products (by value) within the permissible time for discharge of the offset obligation. Does this imply that if the vendor buys back 40 per cent of the products (by value), credit will be given for the entire investment made for provision of the equipment, excluding the cost of ToT, etc.? If this is so, how will the cost of the equipment (which will be the value of the investment) be worked out? Again, if this understanding is not correct, what will be the correct interpretation of the relevant provision in the guidelines?

Fourth, there is no stipulation of the credit being limited to 10 per cent of the buyback in the case of investment in kind in terms of ToT or the vendor having to buyback 40 per cent of the product (by value) in the case of investment in terms of provision of equipment, if the recipient of the ToT or the equipment is a government institution or establishment, including the DRDO. That being the case, how would the value of the ToT or the equipment be assessed? The issue regarding costing assumes a great significance as this route for discharging the offset obligation includes such intangibles as augmentation of the capacity for research, design and development, as also training and education.

Fifth, technology acquisition by the DRDO in the areas of high technology specified by the MoD is yet another valid route for discharge of the offset obligation. There is, however, no clarity regarding the method to be adopted for assessing the value of such technologies.

The third set of issues concerns offset banking. The offset guidelines provide that banked offsets shall remain valid for a period of seven years from the date of acceptance by the Defence Offset Management Wing (DOMW). The question is whether the banked offsets can be utilized in relation to a contract that is signed within seven years of the date of acceptance of the credit for banking by DOMW or in relation to a contract that is signed beyond seven years also, provided the response to the Request for Proposal (RFP) had been submitted within the period of seven years? What is the correct interpretation of the stipulation regarding validity of the banked offsets?

The guidelines also provide that the banked offset credits are not transferrable, except between the main vendor and his tier-1 sub-vendor within the same procurement contract. The issue to be clarified is whether a holding company, which might also be involved in manufacturing or servicing, can be a tier-1 sub-vendor of a subsidiary company if the latter happens to bag a contract which involves the offset obligation.

The fourth issue concerns discharge of the offset obligation by an Indian vendor. The guidelines provide that if the indigenous content in the product offered by an Indian company in Buy (Global) category of procurements is less than 50 per cent, the bidding company has to submit an undertaking along with the main technical bid that it will fulfil the offset obligation. How will this obligation be discharged? The existing avenues are direct purchase of, or executing export orders for, eligible defence products manufactured by the Indian enterprises, investment in kind through transfer of technology or equipment to Indian enterprises or government institutions and transfer of critical technologies to the DRDO. These avenues are meant for the foreign companies. The Indian companies cannot discharge the offset obligation in a Buy (Global) case through these routes.

These are only some of the issues that keep getting mentioned at different forums. In all probability, everyone will have quick answers to these issues. But it is equally probable that different persons would have different answers. The authentic answers can come only from the MoD which would have received many more queries and representations. The question is who will offer the clarifications.

The offset guidelines say that any clarification relating to the offset proposals at the pre-contract stage will be provided by the Acquisition Wing in consultation with DOMW and clarifications required at the post-contract stage will be provided by DOMW in consultation with the Acquisition Wing! But, what about clarifications required simply for a better and a more accurate understanding of the offset provisions? Greater clarity about what various provisions of the guidelines mean would result in offset proposals being prepared correctly, saving a lot of time that might otherwise get consumed in clinching an offset contract.

Formulation of defence offset guidelines is one of the functions assigned to the DOMW. By implication, it would also be responsible for offering clarifications. It is certain that the MoD would have received a number of queries and representations regarding the offset

guidelines. It would also have received feedback from the industry associations and the think-tanks. It is, therefore, inexplicable why no clarification has been issued in the last one year on any issue. The 2012 guidelines could have been revised to incorporate all the clarifications before the guidelines were made a part of the Defence Procurement Procedure 2013, promulgated with effect from June 1, 2013.

That opportunity was lost but it is never too late to take up all these issues and put all the clarifications on the FAQ page of DOMW's website. In fact, the norm should be to take up an issue as soon as it is brought to the notice of the MoD and post the clarification on the website immediately. It does not help if the issues are left unattended.

The question, however, is whether the DOMW, which is the most likely entity in the MoD to take up this task, has the wherewithal to handle it and whether it is sufficiently empowered to proactively resolve the policy issues. This question holds the key to the future of the offsets.