

Special Address at the Defence Offsets Seminar

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The timing of the seminar is very apt and we are at a stage when we have made some headway and we can actually deliberate on certain issues relating to the subject. The entire exercise of introducing offsets and formulating and promulgating a policy in this regard is aimed at encouraging sound relationship between the defence industries of the advanced countries and those of our own. Fortunately, we have a reasonable depth in our industry and there is a plenty of promise. To set the pace of the seminar it is imperative that I outline the factors that we have considered while formulating the offset policy and towards this end I would like to recall the events that have unfolded in the recent past.

The defence industry was opened for the private participation in 2001. 100 per cent private participation was allowed with 26 per cent FDI and the defence sector was removed from reserved category to the licensed category and the situation is the same till date. Offsets were formerly introduced into the Defence Procurement Procedure for the first time in the DPP 2005. That was a simple enunciation of a concept and was well received by all the stakeholders. Detailed Offset Guidelines were thereafter incorporated in DPP 2006 to provide for the much needed clarity with regard to Offsets, a number of acquisition programs with offsets were initiated in this period and we in the MoD were receiving a number of suggestions for improvement and incorporation from the various seminars and discussions with the stakeholders that were organised in this period.

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DPP 2008 in all earnest has incorporated most of these aspirations of the industry, both domestic and foreign alike, and the policy as it exists today is rather a comprehensive one. There may still be a number of issues that are not addressed and for this I would like to say that from the beginning MoD has done a study of the offset policies of a few countries around the world and the adaptation to the Indian context was considered to be the overriding consideration and hence was the policy evolved accordingly.

One of the important inclusions in the offset policy is the dispensation of the mandated licensing condition as spelt out in DPP-2006. The policy now envisages government regulations as applicable by the extant regulations and the conditions as lay down by the DPP and no fresh condition is laid down. This actually expands the scope of the Indian defence industry from 37 licensed industries to almost 2000 or more industries who otherwise comply with the government regulations on the subject. Thus, the capacity of the Indian industry to absorb offsets has been practically increased manifold. We have also taken a step to include a list of defence products for ease the foreign vendors to make a choice of products and have provided for full freedom to the foreign vendor to choose the Indian partner from the entire list of defence industry without insisting on any type of licensing conditions which otherwise would have made the choice restrictive. The list of defence products has amplified the scope of offset discharge and has enlightened the domestic industry on various types of manufacturing products including component level activities, services including software and knowledge based design services, etc. Thus more number of industries have become eligible for offset absorption and can make necessary investments to gear up to the requirement. This will also increase the capacity to absorb offsets. The policy encourages FDI in industrial infrastructure and also for FDI in R&D establishments engaged in defence products. This will encourage more and more foreign OEMs to set up shop here and help to include the domestic industry into their supply chain which indeed is the focus for more exports.

The banking provisions were introduced to increase the duration of offset discharge by providing a platform for longer gestation periods for various offset projects which might have not been feasible in a co-terminus application. The long term relationships are to be encouraged. The provisions are clearly spelt out in the guidelines and here we intend with clear focus on banking projects to have some tacit relation with future acquisition programs and that is why the foreign vendor is required to indicate the RFP for banking in a span of two and half years or so which is the life period for the bank offset credit. While one may wonder why such a short time span has been accorded for bank offset credits it may highlight that it is in fact much longer. Once the RFP is indicated the foreign OEM can grow with the RFP till its logical culmination into a contract which will provide for a time span of anything between five to seven years. Thus, banking provides more time for fulfilling offset obligations and thus inherently increases the capacity to absorb offsets. We have consciously not included for trading of banking credits as we see no reasonable benefit acquiring to the Indian industry as of now. There are already more than 25 programs operating with offsets and in some, offset contracts have also been concluded. The offset policy of the MoD is here to stay and we will grow with our experience and modify the same as we learn more as we do with our procurement procedure from time to time.

Some of the operational issues as well as policy issues which are critical to the success and growth of offset policy may be mentioned. Coming to the operational issues, the offset guidelines are relatively new and they have been framed in the environment of Indian defence procurements. The objective is to develop our indigenous capability through growth of Indian defence industry. Experiences of other countries were studied but primarily this is our indigenous policy. Learning experience is little; nevertheless DPP 2008 made certain improvements over what was given in DPP 2006. First operational issue proposed to focus is with regards to procedural flexibility. Two examples of how a procedural rigidity can

impact the program adversely may be stated. At present the time limit which is uniformly intimated to all the vendors to submit their offset proposals is normally three months. In case a vendor is not able to finalise his proposal on account of complexity of the whole subject within this time limit, a request for an extension of time is made which is denied as the procedure does not provide for this. Preparing an offset proposal requires intensive interaction with Indian industry, perhaps there is room for some flexibility here. Another example is for accepting a request for change in the offset partner after the contract is signed. Should such a request be allowed through a contract amendment? This may be necessary if an offset partner is not agreeing to provide the product or services of the desirable quality or at agreed price. The other operational issue which may be mentioned is to do with developing an in house system in MoD for registration of proposed offsets programs aiming at creation of credits, account keeping, monitoring of discharge of banking credit and keeping balance of offset credits. Though MoD is aware of this need and a monitoring cell had been created in department of defence production it would remain a live operational issue as the volume of offset program would grow. The third operational issue is with regards to the optimum time period which should be allowed for an offset program, from inception to discharge stage. Any mismatch between the main procurement contract and the offset contract would create enforcement problems. Safeguards would have therefore to be found for such mismatch if allowed.

Here some policy issues may be indicated. The first and foremost is the direct versus indirect offsets. Logic of defence ministry is simple, defence offset program is an offshoot of defence modernisation program and the objective therefore is to develop and grow indigenous defence manufacturing capability. Nevertheless, the capability of the Indian defence industry to absorb a volume of offsets obligations which are likely to be created as defence modernisation program unfolds in future may be a limiting factor. Further, let us agree that the offset program has a cost which

is loaded on the main contract. A question therefore can be reasonably raised as to why the defence budget should meet the cost of offset which are to be discharged in sectors other than defence. The issue leads us to desirability of having a national policy on offset which Ministry of Commerce is already working on. Another important policy issue is to decide as what must constitute the permissible scope of offset activities. A very relevant proposal in this regard is to include transfer of technology within the offset program. There are obvious difficulties in deciding a fool-proof methodology for the evaluation of ToT; also foreign bidders have raised the issue of multiplication factor in the context of discharge of offset obligation through ToT. Then is the issue of necessity and quality of technology which is being offered. We have not yet reached a stage in our experience with offset programs where we can find acceptable solutions to these issues. However without doubt there is need to seek critical and sensitive technologies many of which are otherwise under denial regime. Whether we can leverage the offset program to force the foreign bidders to part with such critical technologies by way of offsets an answer to this question must be found in near future if we aim to raise the qualitative level of indigenous defence production capabilities. Another policy issue is the desirability of allowing transaction in banking credits. The current policy provides for such transaction only between the main vendor and his sub-contractor within the same acquisition program. Desirability of a universal transaction though of questionable merit at this stage, will remain a live policy issue as the offset program grows.

Considering whether the offset route is the most cost effective way to promote indigenous defence industry, the experience of offset till now has shown that offset obligations are being discharged in most mundane areas and not much value addition in terms of learning experience or technology is being achieved. On the other hand, there is a hidden cost of such offsets which are loaded on defence procurements. In some quarters an apprehension as to whether offset has a slow down effect on defence

procurement is also raised. Though guidelines allow FDI under offset may be better results could be achieved by raising the FDI limit from 26 per cent to a higher percentage. These burning policy issues can find answers through immense research and more experience. 