Indian Offset Policy - Implementation and Challenges Ahead

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India is one of the most promising aerospace and defence markets in the world due to its rapidly increasing demand in capital equipment for the armed forces. Indian defence capital acquisition has increased many folds in the last few years (growing from US$ 4 billion in 2005-06 to almost US$ 10 billion in 2011-12), making India a very attractive defence equipment sellers' market.

Going by the success of the recently concluded AERO India 2013 (Asia's Premier Air Show), it is evident that more and more foreign companies and equipment vendors are keenly interested in and would be involved in the Indian defence market and new joint ventures, collaborations and partnerships are likely to be forged between Indian private and foreign companies.

In order to leverage this extensive capital acquisitions by India to develop and indigenize the Indian defence industry, monetize the local cost advantage related to basic designs and engineering services/components and augment the capacity for research, design and development related to defence products and services, the Ministry of Defence ("MoD") revised its defence offset policy by issuing an updated Defence Offset Guidelines, which came into effect from 1st August, 2012 ("Offset Policy").

n literal terms, offset means "some benefit (such as an amount or claim) that balances or compensates for something else"[1]. The Government of India introduced the concept of offset in the year 2005 in the defence sector as a trade-off for the Indian defence industry against large scale import procurement orders. India is not the only country that seeks offset obligation even though EU law perceives offset as a discriminatory measure that can be imposed only in special circumstances such as national security. Be that as it may, the Government of India seeks to use the Offset Policy as a means of boosting localization of production and enhancement of research and development capability in the defence sector.

Among others, the Offset Policy has, introduced several new concepts and policies for the first time including introduction of transfer of technology and equipment as valid means of offset discharge, extending the offset banking period to seven years, and expanding the avenues and listed eligible product/services for satisfaction of offset obligation. The Offset Policy has also for the first time included the concept of multipliers ranging from 1.5 times up to 3 times to promote investment in Micro, Small and Medium Enterprises ("MSMEs"), and facilitate technology acquisition by the Defence Research and Development Organisation ("DRDO"). To ease the offset satisfaction obligation, foreign equipment vendors and manufacturers ("Vendors") have been provided the flexibility by extending the period of satisfaction of offset obligations by two years beyond the period of main procurement contract. Realizing that the Offset Policy would need effective enforcement, a new monitoring and supervision division [Defence Offset Monitoring Wing ("DOMW")] has been set up to replace the existing Defence Offset Facilitation Agency with substantial monitoring powers. To better understand the role and implications of the Offset Policy in defence procurement, we now briefly analyze the key features of the Offset Policy.

Quantum and Scope of Offsets

Attainment of self reliance in the critical defence sector being the long term objective of the MoD, the Offset Policy applies to all capital acquisitions categorized as 'Buy (Global)', i.e., outright purchase from foreign/Indian vendor, or 'Buy and Make with Transfer of Technology', i.e., purchase from foreign vendor followed by licensed production where the estimated cost of the acquisition proposal is INR 300 crore or more. Simply put, for every qualified defence procurement, thirty percent (30%) of the estimated cost of the acquisition in 'Buy (Global)' category and thirty percent (30%) of the foreign exchange component in 'Buy and Make with ToT' category will be the required value of the offset obligations. Offset obligations may be discharged with reference to eligible products and eligible services as described in the Offset Policy.

In special circumstances, the Defence Acquisition Council may prescribe varying offset obligations above thirty percent (30%) or waive the requirement of offset obligations altogether. The offset condition is an absolute commitment of the Vendor and forms a part of the RFP (request for proposal) and subsequently of the main procurement contract. The offset obligations can be satisfied through any one or a combination of avenues (discussed below) provided in the Offset Policy through Indian enterprises and institutions and establishments engaged in manufacture of eligible products and/or provision of eligible services, including DRDO, (referred to as the Indian Offset Partner "IOP"). A separate offset contract is required to be executed by the Vendor simultaneously with the main procurement contract.

Means for Discharge of Offset Obligations

The Offset Policy provides for the following options for discharge of offset obligations under defence capital acquisitions:

(i) Direct purchase of or executing export orders for, eligible products manufactured by, or services provided by Indian enterprises, i.e. Ordnance Factory Board, Defence Public Sector Undertakings, and private and public sector Indian enterprises.

(ii) Foreign direct investment (equity investment) in joint ventures with Indian enterprises for the manufacture and/or maintenance of eligible products and provision of eligible services. Such investment would be subject to the foreign investment guidelines and licensing requirements stipulated by the Department of Industrial Policy and Promotion ("DIPP").

(iii) Investment in 'kind' in terms of transfer of technology ("ToT") to Indian enterprises for the manufacture and/or maintenance of eligible products and provision of eligible services. This could be through joint ventures or through the non-equity route for co-production, co-development and production or licensed production of eligible products and eligible services. The ToT should be provided without licence fee and there should be no restriction on domestic production, sale or export. The offset credit for ToT will be capped at 10 percent of the value of buyback during the period of the offset contract, to the extent of value addition in India.

(iv) Investment in 'kind' in Indian enterprises in terms of provision of equipment through the non-equity route for the manufacture and/or maintenance of eligible products and provision of eligible services. Additionally, the Vendor will be required to buyback a minimum 40 percent of the eligible product and/or service (by value) within the permissible period for discharge of offset obligations.

(v) Provision of equipment and/or ToT to Government institutions and establishments engaged in the manufacture and/or maintenance of eligible products and provision of eligible services, including DRDO.

(vi) Technology acquisition by DRDO in areas of high technology listed in the Offset Policy.

A minimum seventy percent (70%) of the offset obligation is mandatorily required to be discharged by any one or a combination of Paras (i), (ii), (iii) and (iv).

In the discharge of offset obligations under Paras (i), (ii), (iii) and (iv), a multiplier of 1.50 will be permitted (i.e., a foreign company can claim credits upto 1.5 times of its actual offset investment) where MSMEs, having made investments in equipment ranging from Rs. 1 million but not exceeding INR 50 million, are IOPs. In the discharge of offset obligations under Para (vi) relating to technology acquisition by DRDO, a multiplier up to 3 will be permitted.

The Vendor of the equipment under the main procurement contract is responsible for the fulfillment of offset obligations except that the Vendor may allow its tier-1 sub-vendors under the main procurement contract to discharge offset obligations, to the extent of their work share (by value). The Offset Policy provides flexibility to the Vendor to select the IOP for implementing the offset obligation provided the IOP has not been barred from doing business by MoD. For effective implementation, the Offset Policy has extended the period for discharge beyond the period of the main procurement contract by a maximum period of two (2) years. The period of the main contract includes the period of warranty of the equipment being procured under the main contract. In case of extension of the period for discharge of offset obligations, the Vendor is required to furnish an additional performance bond to DOMW in the form of a bank guarantee covering the full value of the un-discharged offset obligations falling beyond the period of the main procurement contract.

Offset Banking

One of the interesting new features of the revised Offset Policy is to allow extended seven (7) years period for offset banking. Only transactions undertaken after signing of the offset contract will be reckoned for discharging offset obligations. However, pre-approved banked offset credits will be considered for discharge of offset obligations subject to a maximum of fifty percent (50%) of the total offset obligation under each procurement contract. The banked offset credits will henceforth remain valid for a period of seven (7) years from the date of acceptance by DOMW.

Penalties for Breach

The Vendor at the stage of submission of the techno-commercial proposal will need to undertake that it will meet the offset obligations laid down in the RFP as per the Offset Policy. The offset obligations are binding on the Vendor and failure on the part of the Vendor to comply with the offset obligations at any stage may result in disqualification of the Vendor from any further participation in the procurement tender/contract for a period up to five years. It may also result in imposition of penalties equivalent to five percent of the unfulfilled offset obligations of the Vendor subject to an overall cap on penalty to twenty percent (20%) of the total offset obligation during the period of the main procurement contract.

Analysis

With the estimated offset obligation pegged at INR 40,000 crores, the success of the Offset Policy lies in its effective enforcement and strong monitoring. According to reports published by MoD, only seventeen (17) offset contracts valued at about US$4.5 billion have been signed by Indian companies with foreign companies since the offset policy came into effect in 2005. The real benefits of these contracts are yet to be seen. To ensure that the objectives of the Offset Policy are fully or even partially achieved, DOMW would need to develop a strong in-house structural and operational capability to monitor and audit the offset programs.

Further, MoD may need to bring level playing field between the IOPs that are engaged in the defence sector as against IOPs engaged in non-defence services sector such as IT and training. Currently, the IOPs in defence sector need to comply with stringent licensing requirements stipulated by DIPP whereas no such licensing requirements are imposed on non-defence sector IOPs. Further, the foreign direct investment ("FDI") in IOPs engaged in the defence sector is limited to twenty six percent (26%) with prior government approval whereas the IOPs in services sector could be hundred percent (100%) subsidiaries of the foreign Vendors. As a consequence, the Offset Policy has (probably unintentionally) tilted the balance in favor of foreign owned IOPs in the services sector and against the defence manufacturing IOPs. Additionally, the Government should re-assess the FDI policy in the defence sector. The current restriction of FDI limited to twenty six percent (26%) in the IOPs engaged in defence sector makes the Indian defence sector unattractive for foreign investment. Substantial or majority control would not only augment foreign capital inflow (which has been a meager US$ 4 million in the last one decade) but would also build confidence for transfer of sensitive and proprietary technologies to IOPs for co-development and production arrangements.

The real test of the Offset Policy lies in its long term benefits for the Indian defence industry which is currently largely government controlled and the role of private sector has so far been minimal. Impetus on equity investment (option ii above) as a means for offset discharge in joint ventures with Indian enterprises for manufacture and/or maintenance of eligible products and provision of services would have long term benefits as against direct purchase of or executing export orders (option i above). The MoD may consider introducing a multiplier system for equity investment and allow foreign companies claim more credits than its actual offset investment to ensure long term investment commitments from the Vendor. Considering that equity investment establishes long term associations and tie-ups, the offset benefit would extend to years far beyond the main procurement contracts.

Modernization of Indian defence forces coupled with effective enforcement of Offset Policy and sustained indigenization of production may reduce India's over dependence on massive defence imports and introduce innovation in and development of ancillary support defence sector.

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