Understanding India's offset policy

India, the world's largest importer of arms, would like to be self-sufficient in defence production. But to realise that ambition, the country needs greater investment and technology from abroad. Karishma Maniar explains new government offsets policies aiming to attract foreign involvement.

The concept of offset, as understood in the defence sector, primarily aims to provide additional benefits to the buyer of a product from a foreign supplier. It can take various forms – from helping domestic industries with additional works contracts, to transferring complicated technology to the domestic industry. Since defence procurements involve a substantial amount of public money, it can be argued that the discharge of offset obligations helps ensure that at least some of this is ploughed back into the local economy. Historically most developing countries have always had some provisions of offset in the procurement process. In the Indian context, the issues surrounding offset are complicated – and there are different implications for players, depending on where they are in the value chain.

India is the world's greatest importer of defence goods – so the potential value of offset is significant. If implemented correctly, the defence policy pertaining to offsets can effectively change the indigenous defence industry and provide a much-needed boost to the R&D sector, although this needs to be fitted into the context of domestic industry and its capacity and capability to absorb such benefits. The current gap between the technology and infrastructure of the domestic players compared to that of the foreign original equipment manufacturers ('OEMs') is quite stark. And as things stand, the massive potential benefits from offset obligations are mostly unrealised – in part because domestic industry, its infrastructure and capacity, is mired in inefficiencies, the impact of which is exaggerated by a lack of a vibrant and massive ecosystem of private players around the defence sector. For a long time now, the sector has been dominated by the defence public sector undertakings ('DPSUs').

Challenges in the offset regime

The offset policy of India has been shrouded in fog and riddled with regulatory and compliance issues since its introduction more than ten years ago. There are many operational challenges that foreign OEMs face in the discharge of their offset obligations – so much so that foreign OEMs have reportedly paid penalties worth US $2.4m in just two programmes[1] which effectively implies that the total offsets not discharged are over US $50m in only these two programmes (given the maximum penalty on offsets can only be 5%). This indicates the quantum of loss of opportunity for the Indian defence industry to learn from foreign OEMs and reflects the failure of India's policies to achieve the country's goals of substantive self-reliance.

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From our interactions with industry stakeholders, we find that a trend emerges:

- Foreign OEMs are very keen to supply defence goods to the Indian government, but the problem of being stuck with an offset obligation which they are unsure how to discharge prevents them from entering the market in the quantum as they would hope.
- Legal bureaucracy and red tape have caused these foreign OEMs to be bound by these obligations for a long period of time. This serves as a great hindrance to doing business.
- Additionally, the responsibility of discharging the offset obligations falls solely on the foreign OEMs and not on the Indian offset partner ('IOP') that they choose[2]. Failure to comply with any provisions, even by the IOP, is the responsibility of the foreign OEMs, which may be penalised for the same.

The purpose of this article is to explore India's offset policy and to evaluate its effectiveness.

India's offset policy – historical evolution and present form

The policy on offsets was first introduced as part of Defence Procurement Procedure in 2005[3] ('DPP 2005') and over the years it has been tweaked[4] to incorporate various demands and changes in the economy. For example:

- At the pre-contract stage, an option has been given to vendors to submit detailed offset proposals at a later stage. The vendor can finalise its IOPs and offset product details one year prior to the intended offset discharge or can even undertake the offset activity and submit claims thereafter. This will facilitate vendors finalising a more realistic offset offer.

- The threshold for the applicability of offsets has been increased from the earlier Rs 300 Crore to Rs 2,000 Crore [a *crore* or *koti* denotes ten million], meaning that only those foreign OEMs which win contracts worth over Rs 2,000 Crore will have to plough back at least 30% of the contract value into Indian enterprises as offsets. Deals with contract values of less than Rs 2,000 Crore will be exempt from the offsets obligation.
- There has been an extension of the offset policy from Buy (Global) purchases to Buy & Make purchases — also extending it to Indian firms or their JVs if their indigenous content is less than the offset value of the contract (typically 30%).
- Value addition norms are being clearly defined to avoid any manipulation of the quantum of offsets being discharged.
- Penalty provisions have been elucidated to ensure the onus of offset discharge is clearly put on the foreign OEMs and their tier-1 vendors.
- Foreign investment in projects of up to 49% is now permitted automatically – up to 100% with government approval.

In the Defence Procurement Procedure of 2016,[5] the government laid down the various ways in which foreign OEMs can discharge their offset obligations thus:

1. Direct purchase of or execution of export orders for the eligible products and services by Indian enterprises;
2. Foreign direct investment ('FDI') in joint ventures with Indian enterprises;
3. Investment in 'kind' in terms of transfer of technology for eligible goods and services;
4. 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 (excluding transfer of technology, civil infrastructure and second-hand equipment).
5. Provision of equipment and/or transfer of technology to government institutions and establishments engaged in the manufacture and/or maintenance of eligible products and provision of eligible services, including the Defence Research and Development Organisation (as distinct from Indian enterprises)
6. Technology acquisition by the Defence Research and Development Organisation in areas of high technology

Offsets: A word of caution

'Offset' arrangements are generally understood as agreements by which exporters/vendors of defence articles, when entering into procurement contracts with government buyers, undertake further investments or undertakings as a condition of the main contract. The avowed intention of the offset is generally that the procuring country obtains additional benefits in return for its sizeable purchase – thsese could be the creation of employment opportunities and/or access to technology.

Direct offsets are understood as projects which have some connection with the main contract; indirect offsets can be wholly unrelated. They can, for example, help finance the infrastructural or knowledge needs required to realise the opportunities of the main purchase.

But by the very nature of offsets – which are sometimes opaque and complex – they have frequently been linked to graft (for example, bribing individuals to win defence contracts) and lawyers typically advise investors to undertake appropriate due diligence prior to entering into such arrangements.

A Transparency International UK report from 2012 noted: 'Offset transactions carry potentially high risks of corruption, not only due to the high level of secrecy within the defence procurement as a whole, but because they usually lack the scrutiny and monitoring of the corresponding acquisition contract. Additionally, most offset transactions have few, if any, transparency and public accountability requirements.'

That said, a well-articulated and transparent offset policy can create genuine advantages for the procuring nation.

Critical study of India's offset policy

Technology transfer

The main objective of India's offset policy is to make the defence sector self-sufficient and not dependent on imports. The greatest problem Indian industry faces to realising this dream is lack of access to modern technology.

In order to manufacture indigenously, these enterprises must have the capability to manufacture, operate and test such technologies so that they can produce defence equipment that is not outdated and is capable of rivalling that of other developed countries. However, due to lack of know-how, hardly any indigenous companies are able to effectively apply them to their own manufacturing process, as a result of which foreign OEMs are unable to find the right partners for technology transfer by which they can discharge their offset obligations in a cost-effective manner.

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Thus, even though a few large indigenous companies do possess the wherewithal to absorb technologies, due to competitive bidding and price benchmarking, foreign OEMs prefer micro, small and medium enterprises ('MSMEs') to ensure the overall cost of offset discharge is minimal.

MSME sector – a critical stakeholder

To help discharge their offset obligations, MSMEs serve as a great potential IOP. According to industry experts,[6] there has been an increase in competition in the domestic and export markets which has resulted in such MSMEs adopting and implementing the latest technology available to them.

While these MSMEs are unable to absorb the technology on a large scale due to a lack of sufficient funds for research, design and development, and infrastructure, they are characterised by their flexibility, diversity and low-cost input which makes them highly competitive in the defence market for foreign OEMs. Further, the constant availability of knowledge and innovation, coupled with globalisation and networking, has reduced the gap that used to exist between the large companies and these MSMEs. By partnering with such enterprises, a foreign OEM not only gets an enthusiastic partner but will also be able to take advantage of the reduced price of such contracts, which is highly critical for discharge of offset obligations. However, risk of survival and quality assurance can be an issue and thus there is a tug of war in choosing large industry players or MSMEs as IOPs.

FDI limits

The government has relaxed the FDI limits for the defence sector by allowing foreign investment up to 49% under the automatic route and foreign investment beyond 49% and up to 100% through government approval, wherever it is likely to result in access to modern technology or for other reasons to be recorded.[7]

The government also did away with the clause that only 'state-of-the-art' technology would be considered for stakes of more than 49%, thereby giving the government more power to decide on investment proposals by foreign entities.[8]

Foreign OEMs were encouraged to enter the Indian market where they were previously discouraged – with government approval, they would finally be able to hold a majority stake in any Indian company and not have to depend on an IOP whose decisions were binding on them.

However, all of this does not appear to have enticed foreign investors. In July 2018, Minister of State for Defence, Mr Subhash Bhamre informed the Lok Sabha (India's parliament) that while 41 FDI proposals/joint ventures had been approved for manufacturing defence equipment both in public and private sectors, the total FDI received in the defence industry sector from April 2000 to March 2018 was just US$ 5.13m or about Rs 35 crores.

The government has also touted increasing the FDI limit to 74% in niche technology areas in the Draft Defence Production Policy of 2018,[9] which would allow foreign OEMs to hold a majority in any Indian companies or joint ventures in the defence sector. However, the proposal has faced a huge backlash from Indian industry.

Rigid contractual terms

Currently, the offset structure is very rigid. As per our discussions with industry officials, once a foreign OEM finds an IOP, they can only change that partner with the approval of the Secretary of Defence Production. Any change to an offset contract or partner takes roughly one-and-a-half to two years to be implemented.

Further, a contract amendment can take an additional one or two years to be approved. As a result, any decision made regarding a firm's offset partner is effectively final.

Many firms prepare to discharge their offsets only to find that their offset partner does not have the capability to absorb the technology they are providing at a reasonable cost.

All these factors serve to discourage foreign OEMs from entering India.

Draft amendments to the offset policy: 'Out-of-the-box' thinking by the government of India

The government has provided for numerous ways in which foreign OEMs can discharge their offset obligations, and have also gone one step further to provide multipliers for such discharge, meaning that foreign OEMs will be able to incur a much lesser amount as offsets than a contract might stipulate.

In May 2018, the government introduced a draft amendment to its offset guidelines which provides further additional ways in which foreign OEMs can discharge their obligations and at even higher multipliers. This amendment also provides for 'defence industry corridors', which will enable the setting up of defence production facilities, as well as SEBI (Securities and Exchange Board of India)-regulated funds which can be used for the discharge of offset obligations at a high multiplier.

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Equity investments in defence companies

The policy proposes to open up any investment in equity in the defence sector

Comparison with other countries

Other countries, including Saudi Arabia, Japan, Brazil and Israel, have already started reaping the benefits of their respective offset policies and have moved ahead of India in leaps and bounds.[10] The reason for the progress of these countries requires analysis of their offset policies. Some, such as Saudi Arabia, have recognised that they must not only be able to use the technology but also carry it forward before it becomes obsolete. For this reason, their offset programme has progressively stressed the transfer of medium, commercial exploitable technology, rather than 'high' technology, promoting the growth of commercial and dual-use products with wider markets.

Israel has spent large sums promoting research and development (roughly 3% of its GDP) which is at par with the most advanced economies of the world. This, coupled with a highly skilled workforce, has helped Israel to advance its defence sector. Its offset arrangements have resulted in additional investment, new jobs and technology transfer, which the Israeli economy was in a very good position to absorb.

Japan obtained its technology via technology transfer from western countries and subsequently overtook them by constantly striving for self-sufficiency and undertaking licensed production of high-tech military equipment to build up a sizeable military industrial complex of its own. By observing these countries' success with their offset policy, a number of lessons can be learned. Indian companies must look to not just acquire modern technology but to develop a way of retaining and advancing such technology themselves.

Further, the amount spent on R&D needs to be increased so that India can be in touch with other developed countries and not just rely on transferred technology. Without any R&D of its own, the defence sector will constantly remain outdated no matter how much technology it receives. Additionally, it must be noted that India ranks very poorly on the Ease of Doing Business and Corruption Perception Index of the world[11] which makes it an unattractive destination for investment (despite projections that it would have the second-highest offsets in the world from 2016-2021, only behind Saudi Arabia).

Steps must be taken to ensure complete transparency in operations involving offsets as well as a more convenient way in which foreign OEMs can carry out their business.

by a foreign OEM as an avenue for the discharge of offset obligations. While entering into joint ventures has been one of the favourite ways for foreign OEMs to invest in technology transfer and creation of capacity in the country, a recent data point quoted by the Minister of State for Defence noted that since 2000, only US$ 5.13m worth of FDI has been received under 41 proposals for FDI/JVs that are approved.[12] This clearly reflects the preference foreign OEMs have to form JVs, but the actual investment under the JVs is paltry, implying no technology transfer or capability creation. The opportunity to take an equity investment as a way to discharge offsets should act as an added incentive to increase the actual inflow of FDI, provided other operational requirements can be ironed out. If the government proposal of increasing the FDI limits for defence to 74% is indeed approved, this will be the most attractive avenue for discharge of offsets in a long-term perspective.

Defence corridor

This amendment is still pending final approval but it shows the intention (some say 'desperation') of the government to encourage investment by foreign OEMs into India by effectively reducing their offset obligation or giving them a lenient opportunity to discharge their offset obligations. Also, as per the Draft Defence Production Policy of 2018, defence industry corridors will be set up in collaboration with states to provide state-of-the-art infrastructure and facilities for setting up defence production facilities. These defence corridors will enjoy a higher multiplier as compared to other areas with regard to the discharge of offsets.

Introduction of defence funds

The government has introduced SEBI-regulated funds for defence, aerospace and internal security. By investing in such funds, a firm's offset obligation not only ends there but is also considerably reduced, thanks to the proposed multiplier of 3. Further, discharge of offsets through such a route means that the foreign OEM does not have to carry out a meticulous search for an IOP. Such SEBI-regulated funds, which are expected to be run by industry professionals and veterans, are to be used to encourage the development of technology through R&D along with giving impetus to the defence sector of India. It is observed that usually offset obligations have only been written off and have not been fulfilled as expected.

With the introduction of such a fund, the government can keep proper tabs on the amount of money the foreign OEM has invested in India and there is complete transparency in operations.

In addition to providing a multiplier of 3 on investment, these funds are a much more convenient and practical way of discharging offsets and serve as the way forward in the defence industry, at least in the short term. The Indian government is already facing flak from some industry sections for effectively reducing offset obligations of foreign OEMs through these means. Whether or not these 'out-of-the-box' ideas will be implemented or not, is yet to be seen.

Conclusion

The sheer volume of defence imports by India provides the country with a huge kitty of offset which has enormous potential to be used for the development of the defence sector in India. However, due to certain historical and structural issues, the domestic industry is not always in a position to properly utilise the opportunities. Indian OEMs are incapable of manufacturing the requisite quality and quantity of defence goods that are being demanded. They lack the requisite know-how and are unable to absorb the technology that is transferred to them in the most cost-effective manner. In such an environment, foreign OEMs are relied upon more than ever to not only meet the country's defence requirements but to also assist the indigenous sector so that India can be more self-sufficient.

At the same time, legal and regulatory requirements have caused a chilling effect for foreign players, especially newcomers, looking to operate in India. While expert advice can mitigate much of the risk, foreign OEMs also require support and assurance from the government policies.

In this respect, the amendment proposed by the government of India in 2018 should go a long way. The amendment proposes major game-changing ideas and concepts. The effective use of multipliers to incentivise the defence corridors would benefit while the concept of a defence fund to discharge offset obligations would mitigate some of the risks that come with dealing with a domestic player directly.

While some sections of the industry are opposing these ideas (and in the long term, rightfully so), in the short-term, India needs immediate access to technologies, funds and professionals to deploy these funds in the right manner to help become a self-sustaining military power house.

All of these objectives can be met with this proposed amendment to offset policy, without prejudice to India's rights to revisit its policies in the coming times. ■

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Links and notes

1 http://pib.nic.in/newsite/PrintRelease.aspx?relid=144966

2 Foreign OEMs do have a contractual protection in law to ensure the Indian offset partner delivers; however, it's their reputation and overall contract (which is much bigger) that is on the line. Offset policy puts no cap on penalties if the offsets are not discharged in the main contract of the MoD with the foreign OEM so the stakes are much higher for the foreign OEM than for Indian offset partners.

3 Available at: http://cdarndhyd.gov.in/manuals/DPP2005CA.pdf

4 Indian Defence Review of Offset Policy. Available at: http://www.indiandefencereview.com/news/the-offset-policy-a-decade-in-retrospect/

5 Defence Procurement Procedure 2016. Available at: https://mod.gov.in/sites/default/files/dppm.pdf_0.pdf

6 Enhancing Role of SMEs in Indian Defence Industry, available at: http://www.cii.in/webcms/Upload/Enhancing%20role%20of%20SMEs%20in%20Indian%20defence%20industry1.pdf

7 Press Note on FDI in Defence Sector, available at: http://pib.nic.in/newsite/PrintRelease.aspx?relid=160287

8 *Economic Times* article, available at: https://economictimes.indiatimes.com/news/defence/no-change-in-defence-fdi-limits-but-state-of-art-technology-not-needed-for-investments-over-49/articleshow/52843171.cms

9 Draft Defence Production Policy 2018 - https://ddpmod.gov.in/sites/default/files/Draft%20Defence%20Production%20Policy%202018%20-%20for%20website.pdf

10 Successful Offset Experiences Worldwide, available at https://idsa.in/jds/3_1_2009_ASurveyofSuccessfulOffsetExperiencesWorldwide_AMitra

11 OECD Global Anti-Corruption and Integrity Forum report, available at: https://www.oecd.org/cleangovbiz/Integrity-Forum-2017-Beraldi-Broecker-offsets-public-procurement.pdf

12 https://economictimes.indiatimes.com/news/defence/total-fdi-in-the-defence-sector-from-2000-18-is-rs-35-crore/articleshow/65038196.cms and
FDI in Defence, available at: https://idsa.in/idsacomments/making_fdi_count_in_defence_lkbehera_220616