Offset Investment Inflow Priorities for Ordnance Factories

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Offset agreements are formal arrangements of trade where some sort of leverage is exploited by a buyer to obtain compensatory benefits in the case of high value off-shore purchases by forcing the seller to undertake well-designated activities for enhancing competitiveness, up-gradation of technology for domestic industries, additions to exports, up-gradation in the infrastructure in appropriate domestic sectors, etc. Though these are business deals with built-in reciprocity clauses, it is not a matter of establishing desired equivalence of inflow and outflow resources. For the seller, it provides additional exploitable avenues to further their business interests. Thus, every offset agreement has its related cost.

The end of cold war has transformed the world polity from war of two blocks to increasing battle among splinter groups. The battle field has changed, so have their management paradigms. But increasing numbers of players are being drawn into newer fields making the world a dangerous place to live in. The concept of superiority of numbers of major weapon systems has given way to fire and forget and net-centric environment with rapidly changing newer technology – accompanied with obsolescence of earlier systems. The costs of weapon-systems are increasing in tandem with technological up-gradation putting pressure on advanced countries to search for cost cutting measures. Thus, while the demands for major weapons systems have dropped considerably, the net defence spending has

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gone up squeezing the available resources away from developmental activities – thereby putting pressure on local governments. To pacify hostile local sentiments against increased defence spending and to partially compensate for the procurement expenditure and outflow of resources, the supplier is pressurised to undertake programs to generate benefits for the economy of the buyer country. The supplier in turn takes the advantage of cheap labour and material costs of the buyer country to buy-back, co-produce, sub-contract or gives licence to produce the desired systems or sub-systems or part thereof. Thus, offsets have got a solid footing.

The basic need for vendor selection and source development arises out of the demand for new products or modification in existing products, change of manufacturing process, market conditions, alternate source of supply, reluctance or closure of existing suppliers, emergence of new suppliers, supplier's poor performance, cost-reduction studies, new policies / regulations, political considerations, etc. The cheapest source is always not the best source. Similarly, the source that provides the best quality may not be the best source. A source providing the best quality may not be able to deliver the required quantity. Choosing the right source that can provide the right quantity of right quality at right time at right price is a tenuous task. The buyer can exploit the level of competition among the producers, their desperation to grab the order, and their own negotiating skills to get a good offset agreement. Purposeful selection in consonance with well defined objectives, hard negotiations to extract maximum benefit, detailed planning for its smooth implementation and timely completion and elimination of oversights are the general characteristics of a goof offset agreement.

A genuine offset is required to be free of charge to the customer. But in real terms, most sellers include the offset cost in the contract price. According to reports, it takes up anything from 3 per cent to 10 per cent of the contract cost. Since the sellers recognize the fact that the offset obligations will cost money, they make adequate allowances for it while preparing their commercial bids. They also try other camouflage methods like supplying outdated technology, counting business generated in routine commercial trade against offsets, exploiting existing markets for additional short-term gains; outsource offset requirements to new entities without much experience or commitment to deliver genuine benefits in the targeted area, etc. Countries like Belgium have burnt their fingers in offset deals due to lack of in-depth understanding of the interplay of conflicting interests and prevailing insincere practices forcing them to do away with defence offsets.

As offset contracts are required to be completed during the currency of the main contract, their consequential gains are temporary. Many nations, who failed to foresee the absence of assured continuous orders, have been saddled with manufacturing facilities that are lying idle. The resources wasted in creation of excess production capacity have negated all benefits accruing from offsets. South Africa negotiated a stainless steel plant against offsets in a defence deal, but soon found out that it is not economically viable due to surplus capacity.

Offsets are often based on political considerations as well as economic reflections. Once offset obligations are fulfilled, further orders dry up. One-off orders preclude influx of the latest technology and its continued up-gradation as short-term associations do not get translated into long-term partnerships. With no assurance of future orders, few want to go in for major investments. Thus, offsets always do not generate new business – specifically involving valuable technology transfer. For example, no country will offer technology to their business rivals.

Since offsets remain outside the purview of the main defence contract, they invite less attention and scrutiny. This makes offset agreements open to corruption. For; firstly, offsets are formulated in general terms and do not lend themselves easily to numerical quantification. Secondly, methods of fulfilment of offset obligations are often left unspecified in the original agreement and are negotiated during the term of the contract. Thirdly, the lack of an effective oversight mechanism and the vendor's reluctance to share data, which may be termed as commercially sensitive, renders the whole program open to manipulation. Extension of the time period to fulfil obligations may be granted for subjective considerations. Pricing of sub-contracted items including Integrated Logistics Support may be flawed. Any or all of these conditions can be manipulated by vested interests to further their selfish agenda.

Offsets are of two types: direct offsets and indirect offsets. In direct offset, the trade arrangement is related to the primary product sold. It does not transcend any other economic or social activities. Thus, the compensatory dispensation remains confined to the main weapon systems, its sub-assemblies and components. It may include buy-back or co-production or licensed production or sub-contracts of the system and its sub-systems. In this arrangement, the seller helps the buyer produce the product or a part thereof and buys it back to use it in his products sold to the same country or elsewhere. Many such arrangements include transfer of technology. The seller does it for his own reasons; such as cutting the cost of production, better and cheaper availability of raw materials in buyer's country, availability of skilled workforce at cheaper rates, to meet targets in time, etc. Thus, the developed countries prefer this mode of transaction. The increasing trend of opening BPO in India is due to the above reasons, though it is not a consequence of direct offsets agreement. Often the arrangements are not publicized to avoid adverse public opinion due to transfer of jobs to the purchasing country.

In indirect offset, the scope is much wider as the agreement is not restricted to the products sold. Since it is more broad based and transcend all economic and social activities, it generally takes the form of compensatory trading. Without using this term, India has been practicing it for a long time in the transactions with the then USSR. The earlier defence purchases of India were done through non-convertible Rupee. Actual defence procurement was done in Roubles, whose exchange value in Rupees was determined by a mutual agreement between the two countries from time to time. The money was kept in the Reserve Bank of India in the account of the Russian export agency. Against this account, the USSR used to import goods from India. After the USSR broke down, the balance at credit of the agency was de-monetized and the Rupee balance was linked to SDR basket rate. During that period, Russia was going through an economic crisis and their imports from India drastically fell. This badly affected some export sectors in India. One of the sectors most badly affected was the export of teas. The impact was felt most in the Nilgiri region hitting the tea growers the hardest.

The above transaction also affected India in a different way. Since the balance at credit was in Rupees as on April 01, 1992 and linked to SDR basket rate on that date, the subsequent devaluation of the Rupee pushed the cost of payment much higher than normally expected. This is one lesson we have to keep in mind while entering into any offset agreement.

In the US, all firms with more than $5 million offset liability are required to report to the Secretary of Commerce. According to reports, offset related defence contracts of the US in 2002 were valued $7.4 billion. The value of attached offsets was $6.1 billion. This is 82.3 per cent of the total value. It is generally estimated that presently the US defence industry has offset obligations of $10 billion. The US Government keeps a close watch on such contracts.

According to reports, the average offset percentage demanded by the 17 EU countries involved in offset activities was 92.6 per cent of the export contract values. Austria obtained 174.2 per cent offsets from the US. The figure for Netherlands, Greece and Sweden varied from 104 per cent to 120 per cent. Austrian radar program had 280 per cent offset value. Czech fighter deal had 150 per cent and South African arms package had 350 per cent offset obligation.

The Indian offset policy is applicable to all purchases where indicative cost is more than Rs.300 crores ($76 million) for "Buy", "Buy and Make with ToT" and shipbuilding contracts. For joint ventures where an Indian firm is bidding, the foreign partner will have to discharge the offset obligation. All proposals which meet the minimum offset requirements, which are placed at 30 per cent, are to be treated at par. No preference is given to extra offsets which are offered. Offset obligation is to be completed coterminous with the main contract. Thus, it is evident that while we treat offsets as holy cow, the Western nations treat it as the milky cow. If we want to play ball with them, there is a need for changes in our attitude towards offsets. While treating the cow as holy, we still can exploit its dung, horns, hide and calf for economic development.

As per the provision of Defence Procurement Procedure-2008, the mandatory requirement of Industrial Licence to partake in offset programs has been removed. Requirement of Industrial licence for defence goods is to be governed by the DPP guide-lines on licensing. Transfer of Technology is not a part of the offset proposal as at present. However, for the purpose of defence offsets, "Services" includes up-gradation, life extension, maintenance, overhaul which can be taken as offsets. It is the onus of the Services Head Quarters to identify the key areas in which the offsets will be preferred covering a time span of 3 to 5 years.

A Committee on Defence Offsets Facilitation Agency (DOFA) has been constituted to act as a single window agency to:

- Facilitate implementation of the offset policy.

- Assist in vetting offset proposals technically.
- Assist in monitoring the offset provisions.
- Suggest improvements in the policy and procedures.
- Interact with Headquarters Integrated Defence Services, the Services Headquarters.
- Advise in consultation with the Headquarters Integrated Defence Services, the Services and the Defence Research and Development Organization areas in which offsets will be preferred.
- Promote exports of defence products and services.
- Provide advisory clarification on the policy and procedures (in consultation with the acquisition wing wherever necessary).

The DOFA is an Agency under Department of Defence Production. The Agency is functioning under the supervision of a Joint Secretary (Exports) of the DDP. Nodal Officers in the core group for the same are Director (P&C), who is the Member Secretary, assisted by PO (CAP) and DPO (CAP) respectively and representatives from the Services Headquarters, Headquarters Integrated Defence Staff, DRDO, OFB, BEL, BEML, HAL as well as representatives from CII and FICCI.

DOFA assists potential vendors in interfacing with the Indian defence industry for identifying potential offset products / projects as well as provide requisite data and information for this purpose. DOFA may set up committees and sub-groups as considered necessary or based on the inputs received from DRDO.

The total annual turnover of Ordnance Factories is in the range of Rs.7000 crores. Our net import content is about 5 per cent, which may go up to 7 per cent under special circumstances. Thus, most of our contracts have values less than the threshold value for offset agreements. Yet, we should move in the direction of offset in a bigger way due to the following reasons:

- It introduces a quid-pro-quo element in defence procurement.
- Indian defence industry benefits immensely, since orders are assured because of our cheap and talented workforce, skilled in specifically devoted areas.
- There is a possibility of technology absorption and capacity utilization.
- This will also invite inflow of FDI.
- It will complement the intended goal of self-reliance in defence technology.
- It creates employment opportunities and growth in the defence manufacturing sector.
- It opens opportunities for Indian defence industry to provide Integrated Logistics Support for maintenance of imported goods and thereby lead to understanding of the technology involved.

However, because of the reasons explained above and because of our past experience in "Buy and Make with ToT", Ordnance Factories prefer to go for co-production / co-development in the following areas:

- 5.56 mm Rifle.
- 5.56 mm Light Machine Guns.
- 5.56 mm Carbine.
- 105 mm Light Field Gun.
- MBT Arjun.
- Low Temperature Plastic Explosive (LTPE).
- Mine Protected Vehicles.
- Armoured Ambulance.
- Water Bowser.
- Ammunition for AK-47.
- Rocket PINAKA.
- 155 mm High Explosive Extended Range (HEER) Ammunition.
- 155 mm Cargo Ammunition.
- 130 mm Cargo Ammunition.

- 125 mm Fin Stabilized Armour Piercing Discarding Sabot (FSAPDS) Ammunition.
- Protective clothing for extreme cold climates.

Already we are partnering with many foreign vendors for offsets services as follows:

- CQB Carbine and its ammunition.
- 155 mm Artillery Gun Program – towed, SP Wheeled, tracked, etc.
- Future Air Defence Gun.
- Naval Gun and Chaff launcher for fleet tanker.

Offset program will help the OFB in easier absorption of technology for indigenization upon contract finalization. The benefits will flow to the Indian Industry in general as OFB will like to be lead integrator with the help of the Indian public / private sector. This would provide technology to the local industry, enlarge the local content share in the defence sector and simultaneously provide economic benefits. Such a long term relationship would also act as an incentive for the foreign seller to deal with India in a mutually beneficial manner and this calls for using offset credit as an instrument. This would enable passing on the offset benefits across the three services irrespective of the product purchased. The most important factor to be ensured is that the technology gap should not be permitted to widen which can only happen if the offset equation is researched by both parties ensuring mutual advantages in the long run. With a good offset agreement, we can reap the maximum benefits.