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MP-IDSA
Policy Brief

Refining Draft Defence Offset Guidelines 2020

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Summary

The draft offset guidelines 2020, with revamped features, is a bold attempt by the MoD to attract technology and investment and promote the export of major defence items. However, the guidelines could be further fine-tuned to keep the focus tight on their larger objectives. In particular, the MoD may consider further refining features pertaining to the applicability of offsets to IGA/FMS procurement, quantum and threshold of offsets, specific offsets through the RFP mode, banking provision, negative multiplier, methodology for value addition, the FDI cap and, more importantly, the offset management.

The draft Defence Procurement Procedure 2020 (DPP-2020), released on March 20 for public comments, has made a substantial revision to the offset guidelines.[1] The focus of the new offset guidelines is export of major defence items and investment and technology transfer. Will the new guidelines be a game-changer in the Ministry of Defence's (MoD) efforts at building a strong arms industry, or require further fine-tuning to achieve the aforementioned objectives?

Background to Draft Offset Guidelines 2020

The draft offset guidelines come in the wake of MoD's experience in handling over 50 offset contracts signed until now. These contracts, signed under various DPPs since 2005, are valued nearly $12 billion and likely to be fully executed by 2024. The experience of managing these contracts is likely to have weighed heavily in effecting the change in the draft guidelines. Though the MoD's experience in handling all signed offset contracts is not available in the public domain, some idea could be formed from the key findings of a study undertaken by the Manohar Parrikar Institute for Defence Studies and Analyses (MP-IDSA) on behalf of the Department of Defence Production (DDP).[2] As per the findings of the study, which were conveyed by the MoD to the Parliamentary Standing Committee on Defence, about 87 per cent of the offsets went to 15 Indian Offset Partners (IOPs), who in turn also benefited from repeat orders placed on them by the same offset providers. Moreover, more than 90 per cent of the offset obligations were discharged through the purchase of goods and services, with a few takers for the technology and investment which are considered more beneficial to the local industrial development.[3] Evidently, the previous guidelines neither helped in any meaningful expansion of the defence industrial base nor the industry's technological or infrastructural development. In other words, the previous guidelines were not fully up to the expectations of the MoD. This could be one of the main causes of change in the draft guidelines.

Notable Changes in Draft Offset Guidelines 2020

The draft has made a number of fundamental changes in the offset guidelines, including the objectives which are now much more focused on defence industrial promotion. The development of two synergistic sectors – the civil aerospace and

1 See Appendix D to Chapter II in **"Draft DPP-2020"**, *Ministry of Defence*, Government of India, March 20, 2020.

2 The author was the member and coordinator of the study.

3 See Para 2.18 in **"Demands for Grants (2020-21)"**, Seventh Report, Seventeenth Lok Sabha, Standing Committee on Defence (2019-20), *Lok Sabha Secretariat*, March 2020, p. 38.

internal security, which were part of the offset guidelines since DPP-2011, is no longer a core objective in the new guidelines.

Changes have also been made in the avenues for the discharge of offsets, the eligibility of IOPs to partner with foreign original equipment manufacturers (OEMs) for the fulfilment of latter's obligations, the list of items permitted for the discharge of offsets, and the multiplier applicable in transactions under different avenues (see Annexes 1 and 2 for the key features of the offset guidelines of Draft DPP-2020 and DPP-2016).

In comparison to the existing guidelines, the number of avenues for the discharge of offset has been reduced from six to five. The 'investment in kind', which was introduced in the DPP-2013, no longer remains a valid avenue. The Transfer of Technology (ToT), first permitted as an avenue in the DPP-2013, has been given a renewed focus by permitting the foreign OEMs to obtain direct credit for ToT to the Indian industry to manufacture eligible items, identifying a list of 49 technologies for acquisition by the government entities involved in design and manufacture of defence items, and modifying the list of technologies reserved for acquisition by the Defence Research and Development Organisation (DRDO).

Accepting a long-standing demand from the OEMs, the guidelines have for the first time allowed the fulfilment of offset discharge by entities other than the main offset provider and its Tier-I sub-vendors on a case-to-case basis. This is likely to enable the main offset providers to use their subsidiaries and other sister companies to fulfil offset obligations on their behalf.

The list of eligible products and services permitted for the fulfilment of offset obligations has been sharply pruned to seven major categories of defence items.[4] All the services, except for maintenance and repair and overhaul (MRO) related to aircraft and helicopters, are no longer eligible for discharge of offset obligations. The pruning of the list and confining it to mostly products seems to be driven by the MoD's desire to promote manufacturing, rather than services, in which India has developed a reasonable level of capability.

A noticeable change is the abolition of banking provision from the new guidelines. The provision, an integral part of offsets guidelines since its introduction in 2008, had allowed both pre- and post-banking[5] by permitting vendors to claim credits for certain permitted transactions. Though the reason for scrapping the provision is not known, one plausible factor could be the MoD's difficulty in distinguishing (especially

[4] These categories are arms, ammunition and explosives, armoured vehicles, naval platforms, aircraft, electronics and communication equipment, and other defence products.

[5] Pre-banking provision allows vendors to undertake certain transactions prior to contract signing and obtain credits for the fulfilment of future offset obligations. Post-banking allows vendors to generate excess credits from the ongoing offset programmes, to meet future offset obligations. Banking provision, in theory, allows longer association between foreign and domestic companies.

in post-banking cases), the genuine offset-induced transactions from those undertaken as part of the OEM's routine commercial business. Suffice it to say that since India is a major hub for software, design and engineering services, it is quite possible for the OEMs to have claimed credit for certain transactions which were not necessarily driven by the MoD's offset policy.

From the perspective of the objectives of the draft guidelines and the MoD as a buyer, the key change in the offset guidelines pertains to the multiplier provision.[6] The provision is a direct yet bold attempt to achieve three broad goals: to facilitate technology transfer, attract foreign direct investment, and promote export of major defence items as opposed to parts and components. The higher multipliers (two, three and four) are reserved for investment and technology transfer. For the first time, the guidelines have stipulated a negative multiplier – 0.5 – which is applicable to purchase/export of parts and components.[7] The negative multiplier is clearly intended to discourage OEMs to resort to buying parts and components to fulfil their obligations – a practice found not so effective in furthering the domestic defence industry's core capability.

In addition, the draft guidelines have also made a number of changes, pertaining to offset period of discharge, accountability and transparency. Like in the existing guidelines, the period of discharge is now limited to a maximum of two years beyond the period of the main procurement contract. However, the warranty period, which was earlier part of the procurement period, is delinked, reducing the offset fulfilment period to that extent. Though the reason is not provided, it may be due to the MoD's attempt to enforce quick implementations of offsets. However, from the OEMs' perspective, the delinking of warranty period could be a cause of concern, especially for projects which have a long gestation period.

To improve transparency and accountability, the guidelines have made a provision for online submission of offset discharge claims. This is likely to save not only time in transmitting the bulky documents from the OEMs to the concerned agencies of the MoD, but will also help in a real-time audit of the submitted claims.

For the first time, the offset guidelines have introduced a dispute settlement mechanism in the form of Independent Monitors (IM) to resolve any differences and disputes with the OEMs. The IM is expected to submit its advice in two months. The final decision on the matter, however, rests with the MoD. From the perspective of the OEMs, this provision seems unilateral as it is not in sync with the arbitration

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6 Multiplier is a factor that influences the credit value of any given transactions. For example, a multiplier of 2 will double the credit value of any given value of the actual transaction.

7 The multiplier 0.5 would mean that for a given value of the transaction, the credit value would be half of it.

clause of the main procurement contract, which is also applicable to the offset contract.[8]

Further Refining Draft Offset Guidelines

A Case for Subjecting IGAs/FMS to Offsets

While Chapter I of the draft DPP states that procurement through inter-governmental agreements (IGA), including the foreign military sales (FMS), are exempt from offsets, the detailed offset guidelines are silent about it. The final version of the DPP-2020, when announced, need to clarify the exact provision so as to eliminate the doubt on the applicability of offsets.

While clarifying the doubt, the MoD, however, needs to weigh the cost and benefit of its decision. It is true that offsets make IGAs/FMS deals expensive as vendors are naturally inclined to take advantage of lack of completion and load all the extra cost of offset liability onto the main contract. At the same time, since the IGAs/FMS constitute the bulk of India's arms import, exempting them from the offset purview will reduce offset inflows to a negligible amount. This will particularly impact the micro, small and medium enterprises (MSMEs) for whom offset is not only a key source of revenue but also capacity and capability augmentation. As explained later, there is a case for subjecting IGAs/FMS to offsets, though the quantum may be different from those applicable to contracts under the competition mode.

Offset Quantum and Threshold

Though the revised guidelines are a bold attempt at attracting technology and investment as well as promoting export of major defence items, the guidelines as a whole are not in sync with the quantum and threshold of offsets. As can be seen from Table 1, India's offset quantum at 30 per cent is lowest among the select countries. On the other hand, the threshold at which offsets kick in is the highest. In other words, in comparison to other countries, India foregoes offsets in a large number of arms contracts until the value of the contract reaches $267 million, and whenever offsets apply, the inflows are much smaller. To put differently, for a given value of the contract, India's offset inflows are either nil or much smaller.

8 Amit Cowshish, **"Draft DPP 2020: Legacy Issues in Offset Guidelines"**, *MP-IDSA Comment*, April 30, 2020.

Table 1. Cross-Country Comparison of Defence Offset Quantum and Threshold

Country	Quantum (%)	Threshold ($ Million)#
Canada	100	14
India	30	267
Israel	50	05
Malaysia	100	12
South Korea	10/50*	10
UAE	60	10

Note #: Conversion to US$ based on the prevailing exchange rate; *10 per cent offsets in single-source procurement and 50 per cent in the competitive contract.

Source: Offset policy documents of respective countries.

More significantly, the flow of offset could further decline if the MoD decides to exempt IGA/FMS deals from the offsets. Given that the Indian industry, especially the private sector and the MSMEs, is dependent on offsets for their business viability and technological advancement, it is imperative for the MoD to create an adequate and sustainable bank of offsets. In light of this, the MoD may like to increase the quantum of offsets to, say, 50 per cent and lower the threshold to, say, $10-15 million.

In single-source procurements such as those undertaken through IGA/FMS, the quantum may, however, be different, as is the practice in South Korea, which demands only 10 per cent offsets in uncompetitive bids whereas its offset requirement is 50 per cent in all competitive defence tenders. The lower threshold is intended to partially reduce the offset-related cost loaded to the main procurement.

Specific Offsets Through RFP

With fewer yet more focused avenues for the discharge of offsets in the draft guidelines, it would be ideal if the MoD could demand few specific offsets through the request for proposal (RFP) itself instead of leaving it entirely to the discretion of the OEMs. Leaving it to their discretion does not always help as the vendors are more interested in their business interests rather than the best interests of the Indian industry or the offset policy. To begin with, a few pre-identified offsets in technology areas could be demanded as part of the RFP for the public sector entities. Limiting it to the public sector would avoid the potential allegation of favouritism which is often associated with dealings with the private sector. The specific technologies could be identified based on each procurement and through a consultative process involving the Defence Public Sector Undertakings (DPSUs), the Ordnance Factory Board (OFB) and the DRDO.

Usefulness of Banking Provision

The scrapping of baking provision has created uncertainty over the status of the credits which are either banked or in the audit/submission stage. Suffice it to say that the existing guidelines permit banked credits to remain valid for seven years from the date of acceptance. If the draft guidelines become a rule, all credits which are either banked or in the pipeline for approval would not be eligible for utilisation against any contracts signed under the DPP-2020.[9] This may not find favour with the OEMs who might have contemplated of their future use, regardless of the version of DPP, and subject, of course, to the validity of seven years and other conditions of the DPP.

The scrapping of baking provision might seem logical given the difficulty in distinguishing the genuine offset-driven offsets from transactions undertaken under the normal market force, but has vital usefulness, especially in the context of the revised offset guidelines. Unlike the previous guidelines, the avenues of the revised draft guidelines are much more focused, with little incentive for the OEMs to resort to buying services or parts and components to fulfil their offset obligations. The MoD could limit the use of banking to only export of major platforms and/or technology transfers from the pre-identified list. Needless to mention that the banking provision allows a longer and continued association between the foreign OEMs and the domestic industry, which is beneficial in fostering a domestic supply chain.

Impact of Negative Multiplier on Established Supply Chains

If the draft offset guidelines in the current form become the rule, the purchase of parts and components would yield half the credits earned earlier, unless, of course, they are sourced from the MSMEs for which multiplier of 1.5 is retained. The negative multiplier would be viewed as a strong disincentive, especially by those foreign OEMs who have already established some supply chains for sourcing parts, components, assemblies and sub-assemblies from India. Given the disincentive, some OEMs might also contemplate shifting the supply chain from India to greener pastures where such sourcing attracts higher incentive. Though such a move needs to be compensated by fulfilling the offset obligations by making use of other equally tougher avenues, the MoD cannot afford to take it for granted. Given that the future offset inflows could be dramatically reduced if IGA/FMS deals are taken out of offset purview, the OEMs would not have the burden of plenty to stick to the supply chain whose return on investment is reduced by half by a stroke of a policy change. It is, therefore, important for the MoD to undertake a cost-benefit analysis of any policy change in this regard.

Indigenous Content for Determining Value Addition

The draft guidelines have kept unchanged the concept of value addition by providing a credit against the purchase and export of goods. The principle guiding the value

[9] It might be noted that all proposals banked under various DPPs would continue to remain valid and eligible for utilisation as long as they are used in the stipulated timeframe and in a contract that is signed under the relevant DPP under which they are banked.

addition is, however, not in harmony with the revised methodology for Indigenous Content (IC) estimation. Given the advanced and industry-friendly features of the new IC methodology, it would be logical to extend the new methodology for estimating value addition in offsets. As a spin-off benefit, it would push the IOPs to issue IC certificates based on a rationale and practical methodology. Also, the MoD may like to insert a provision of sample audit of IC achieved by the IOPs, so as to encourage them to adhere to the highest standard of accounting.

FDI Cap

Following Prime Minister Narendra Modi's May 12 'Local for Vocal' call through the *Atma Nirbhar Abhiyan* (Self Reliant India Movement), Finance Minister (FM) Nirmala Sitharaman announced a number of defence reforms, including a hike in the FDI cap from 49 per cent to 74 per cent under the automatic route.[10] With the FM's announcement, it is only natural to expect that the new FDI rule is extended to the offset by which the OEM can choose their IOPs with up to 74 per cent foreign equity under the automatic route. A clear provision in the offset guidelines, stating the IOPs' possible equity holding structure, would avoid stakeholders from seeking clarifications on a case-to-case basis.

Strengthening Offset Management

Though the MoD has created a dedicated agency in the form of Defence Offset Management Wing (DOMW), in replacement of the erstwhile Defence Offset Facilitation Agency (DOFA), it is not designed to get the best out of offset guidelines. In its present form, the DOMW is responsible for all matters connected with post-offset contract management. However, for all the matters relating to the pre-contracting stage, it is just one of the many participants, besides the Acquisition Wing, Service Headquarters, and the DRDO. The involvement of so many stakeholders with each having different reporting structures leads to dilution of responsibility and accountability.

In comparison to the DOMW, many other countries have set up a single-window agency for managing the critical aspects of offset functions, ranging from evaluation of proposals to monitoring the progress of projects, auditing of claims and providing credit.[11] The MoD may like to empower the DOMW to undertake the entire range of offset management so as to instill a greater degree of accountability. Any enhanced

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10 For an analytical review of the Finance Minister's May 16, 2020 announcement of defence reforms, see Sujan R. Chinoy and Laxman K. Behera, **"Self Defence is the Best Offence"**, *The Economic Times*, May 18, 2020.

11 Laxman Kumar Behera, **"Defence Offsets: International Best Practices and Lessons for India"**, *IDSA Monograph Series*, No. 45, June 2015, pp. 83-85.

role for the DOMW, however, needs to be accompanied by a suitable augmentation of human resource capital, as the present number of officials are grossly inadequate to fulfil a larger mandate.

Summing Up

The draft offset guidelines 2020, with revamped features, is a bold attempt by the MoD to attract technology and investment and promote defence exports. However, to keep the focus tight on the aforementioned objectives, the MoD may consider further refining some of the features, especially those pertaining to the applicability of offsets to IGA/FMS procurement, quantum and threshold of offsets, specific offsets through the RFP mode, banking provision, negative multiplier, methodology for value addition, the FDI cap and, more importantly, the offset management.

Annexes

Annex 1. Key Features of Offset Guidelines, Draft DPP-2020

Offset Discharge Avenue	Eligible IOP	Offset Discharge Subject To	Multiplier#
Purchase / export of eligible defence products & services	Private sector / DPSUs / OFB	List of military items, including MRO related to aircraft and helicopters (civil infrastructure generally excluded)	0.5 for components of eligible items; 1.0 for eligible items; 1.5 if IOP is MSME
Investment for manufacture of eligible defence products*	Private sector / DPSUs / OFB	List of eligible defence products in seven categories (civil infrastructure generally excluded); No restriction on production, sale or export	2.0 if investment is in notified defence industrial corridors; 1.5 in other places
Transfer of technology for manufacture of eligible products	Private sector / DPSUs / OFB	List of eligible defence products in seven categories (civil infrastructure generally excluded).	2.0
Technology acquisition for government institutions*	Government entities such as DRDO / DPSUs / OFB, etc.	Identified list of technologies in 49 areas	3.0
Technology acquisition*	DRDO	List of critical technologies in 32 areas	4.0

Note: *: Offset discharge is permitted by entities other than the main vendor and Tier-I sub-vendor on a case-to-case basis; #: Clubbing of multiplier is not permitted.

Source: Adapted from **"Draft DPP-2020"**, *Ministry of Defence*, Government of India, March 20, 2020.

Annex 2. Key Feature of Defence Offset Guidelines, DPP-2016

Offset Discharge Avenue	Eligible IOP	Offset Discharge Subject To	Multiplier
Purchase / export of eligible defence products & services*	Private sector / DPSUs / OFB	List of eligible defence, inland/coastal security and civil aerospace products and services (civil infrastructure generally excluded)	1.5 if IOP is MSME
FDI for manufacture / maintenance (provision) of eligible products (services)*	Private sector / DPSUs / OFB	List of eligible defence, inland/coastal security and civil aerospace products and services (civil infrastructure generally excluded)	1.5 if IOP is MSME
Transfer of technology through both equity & non-equity route for manufacture / maintenance (provision) of eligible products (services)*	Private sector / DPSUs / OFB	List of eligible defence inland/coastal security and civil aerospace products and services	1.5 if IOP is MSME
Transfer of equipment through non-equity route for manufacture / maintenance (provision) of eligible products (services)*	Private sector / DPSUs / OFB	List of eligible defence inland/coastal security and civil aerospace products and services	1.5 if IOP is MSME
Transfer of technology and equipment to government institutions to augment R&D, training and education	Government entities, including DRDO		
Technology acquisition	DRDO	List of critical technologies in 26 areas	2.0 (for unlimited domestic military use), 2.5 (for unlimited domestic use) and 3.0 (for unlimited use, including for exports)

Note. *: These avenues must constitute minimum 70 per cent of total offset discharge.

Source: Adapted from **"Defence Procurement Procedure 2016 Capital Procurement"**, *Ministry of Defence*, Government of India.

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