OFFSET OBLIGATIONS IN INDIA: IS THE PATH RIGHT?

Offsets are described in different ways. An "offset" is defined as "*something (such as an amount or claim) that balances or compensates for something* else.[1]" In a commercial sense, the concept of offsets refers to transactions like exports that provide foreign currency inflow to compensate deficits that may arise in the balance of payments made in a foreign currency. In defense procurement, offset is a special form of counter-trade in relation to the sale of defence equipment to the government. The purchasing government can secure economic compensation by exerting leverage over the vendors bidding for major defense procurement projects and provides a choice of areas to be selected by the vendor in fulfilling its offset obligations. In other words, an offset is a trade-off in a formal arrangement where a foreign supplier undertakes specified programs with a view to compensate or assist the buyer in its procurement expenditure and generate benefits for the economy of the buyer's country.

Scope of the offsets

Introduced under the Defense Procurement Policy **("DPP")** 2005, the offsets policy was improvised in DPP 2006. An offset arrangement possesses inherent contractual obligations. The negotiated package consists of the primary contract and the compensatory offsets. Briefly, the DPP 2006 contained three principal features – an offsets clause, no-single vendor purchases and compulsory transfer of technology in all the big transactions. The offsets clause has attracted the biggest attention. This will apply to procurement proposals where 30% of all defense deals above INR 3 billion must be invested in the Indian defense industry and could be in the form of setting up training facilities, sourcing components, technology sharing, or making use of IT services from India-based global service providers. The schemes are categorized as *"Buy (Global)"* involving outright purchase from foreign/Indian vendors and *"Buy and Make with Transfer of Technology"* i.e purchase from a foreign vendor followed by licensed production.

The minimum offset percentage is prescribed with the approval of the Defense Acquisitions Committee (**"DAC")**. The DAC may, after due deliberation, also prescribe varying offset percentages above 30% for different classes of cases or for individual cases depending upon the factors involved such as strategic importance of the acquisition or technology, enhanced ability of Indian defense industry to absorb the offset, export potential generated, etc.

Types of offsets

A. *Direct offsets:* Direct offsets are those obligations which are to be fulfilled by a vendor supplying goods in the same industry, which such goods characterize. These obligations may vary from facilitating export orders for the indigenous industry to the

[1] Black's Law Dictionary, Eighth edition.

investment in such local industries depending upon the offsets policy. The rationale behind such direct offsets is to promote growth and development of local industries with assured revenues. Applying this to DPP 2006, direct offset obligations deal with defence industry only.

B. Indirect offsets: Indirect offsets refer to those obligations to be fulfilled by a vendor supplying goods in industries other than those represented by the goods supplied. The rationale behind indirect offsets is to promote growth and development of not just a specific industry but all other local industries with assured revenues. Indirect offsets give a spectrum of choice to a vendor while accepting its indirect obligations.

It is to be noted that DPP 2006 allows only direct offsets and no indirect offsets are allowed.

Direct offset obligations under DPP 2006

The following offset obligations are to be discharged by a vendor supplying capital goods directly by any combination of the following methods:

(a) Direct purchase of, or executing export orders for, defence products and components manufactured by, or services provided by, Indian defence industries, i.e., Defence Public Sector Undertakings,[2] the Ordinance Factory Board,[3] and any private defence industry manufacturing these products or components under an industrial licence granted for such manufacture. For the purpose of defence offset, "services" will mean maintenance, overhaul, upgradation, life extension, engineering, design, testing, defence related software or quality assurance services.

(b) Direct foreign investment in Indian defence industries for industrial infrastructure for services, co-development, joint ventures and co-production of defence products.

(c) Direct foreign investment in Indian organisations engaged in research in defence R & D as certified by Defence Offset Facilitation Agency **("DOFA")**.

Time of performance and failure to perform offset obligations

The offset obligations must be coterminous within the period of the main contract. If a vendor fails to fulfill the offset obligation in a particular year, a penalty equivalent to the unperformed offset obligation will be levied. 5% of the value of the unfulfilled portion of the annual offset obligation will be (a) paid as penalty, or (b) recovered from the bank guarantee issued under the main contract, or (c) deducted from the amount payable under

[2] These are public sector undertakings, where management control lies with the government. At present there are eight DPSUs with a turnover of USD 1.4 billion (during financial year 2004-05).
[3] Ordinance Factory Board is the main body governing government ordinance factories in India. The Board has its headquarters in Kolkata.

the main contract and the unfulfilled offset value will be carried forward to the subsequent year.

Submission of offset offers

While submitting its response to a RFP, a vendor is required to give an undertaking to meet the offset obligations laid down in the RFP. A vendor has to submit technical[4] and commercial[5] offset offers with the technical manager on a date specified in the RFP. The technical offset offer will be scrutinized by a committee constituted by the concerned technical manager[6] of the acquisition wing with the prior approval of the Director-General (Acquisition). This committee will examine the technical offset offers and then shortlist the vendors who qualify under the offset obligations. The concerned technical manager will process the report of the committee for approval by the Director General (Acquisition).

Offset offer is examined in two stages by the acquisition wing. In the first stage, the technical offset offer is reviewed to ensure that it fulfills the mandatory offset obligations and is not disqualified otherwise. Upon confirmation, the Contract Negotiation Committee verifies that commercial offset offer meets the stipulated offset obligations. Commercial offset offers will be opened along with the main commercial offers. Finally, on the selection of a vendor an offset contract is to be signed simultaneously with the main contract of goods. The commercial offset offer would have no bearing on the selection of vendor even though offset obligations are conditions precedent for the selection of a vendor.

Defence Offset Facilitation Agency ("DOFA")

MoD has established DOFA as a facilitation agency under the supervision of a Joint Secretary of the Department of Defense Production, and the agency has representatives from defense as well as industry organizations. The DOFA assists potential vendors in interfacing with the Indian defense industry for identifying potential offset products/ projects as well as provide requisite data and information for this purpose. Its functions are to:

- Facilitate implementation of the offsets policy.
- Assist in vetting of offset proposals technically.
- Assist in monitoring the offset provisions.
- Suggest improvements in the policy and procedures.

[4] The technical offset offer must contain details of the products, services and investment proposals indicating relative percentages, proposed Indian partners for offset investment, and other relevant information. The commercial values of the offset proposals are not to be indicated in this technical offset offer.

[5] The Commercial Offset Offer must contain the detailed offer specifying the absolute amount of the offset with a break-up of the details, phasing, Indian partner etc.

[6] Depending upon the nature of capital equipment, concerned official from Army, Air force or Navy is appointed as technical manager.

- Interact with Headquarters Integrated Defence Staff and Service Headquarters.
- Advise, in consultation with the Headquarters Integrated Defence Staff, Services and Defence Research and Development Organisation, areas in which offsets will be preferred.
- Promote exports of defence products and services.
- Provide advisory clarifications on the policy and procedures (in consultation with the Acquisition Wing wherever necessary).

The vendor is required to submit quarterly reports on implementing the offset contract to the acquisition manager concerned. The DOFA will assist the Acquisition Manager concerned in the Acquisition Wing in monitoring the implementation of the offset contract. Where necessary, an audit by a nominated official or agency may be conducted to confirm the actual status of implementation.

Conclusion

By way of offset clauses, the government intends to procure benefits for the local defense industries both in public as well as private sector. This becomes all the more important in the light of the fact that a substantial amount is spent on the import of the defense procurements. As a result, only direct offsets are permitted at present. Many foreign manufacturers perceive the policy and the obligations to be restrictive as the scope of the offsets is fairly narrow. Global defense companies who perceive the present regulations to be narrow have made intense lobbying efforts and have pitched for increased private participation which may need an amendment of the existing regulations. Given its large industrial base the offsets policy will, hopefully, further enhance India's technical and manufacturing potential.