

Offset Banking in Defence Deals : Need for Caution

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The Government of India introduced offsets in defence procurements in Defence Procurement Procedure - 2005 and detailed guidelines were issued in May 2006. The policy is applicable to all purchases where indicative cost is over Rs 300 crores for 'Buy', 'Buy and Make with Transfer of Technology' and ship-building cases. Offsets higher than 30 percent may be specified for specific cases. For joint ventures where Indian firm is bidding, the foreign partner will have to discharge-offset obligation.

Offset obligation is to be completed coterminous within main contract and can be discharged through any of the following routes:-

- (a) Direct purchase of or executing export orders for, defence products and services provided by Indian defence industries.
- (b) Foreign Direct Investment (FDI) in Indian defence industries.
- (c) FDI in Indian organisations engaged in research in defence R&D.

Generally, offsets are of two types - direct and indirect. In direct offsets, the compensatory dispensation remains confined to the main weapon system, its sub-assemblies and components. On the other hand, indirect offsets have a much wider scope and transcend other economic and social activities. However, India has decided to adopt a semi-direct path and demands offsets related to the defence industry as a whole.

Offset obligations are measured in terms of offset credits. As India does not use offset multipliers, the value of offset credit is equal to the monetary value of the obligation. It implies

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that in case a foreign vendor carries an offset obligation of Rs 100 crore, he has to either purchase goods/services worth Rs 100 crore or invest the amount in Indian defence industry/defence R&D. Of course, he can have a mix but the total value must add up to Rs 100 crore.

A Defence Offset Facilitation Agency (DOFA) has been established as a 'single window' under the Department of Defence Production to facilitate implementation of offset policy, vet offset proposals technically, provide advisory clarifications on policy and procedures (in consultation with the Acquisition Wing, where necessary) and assist vendors in interfacing with industry for identifying potential offset products/projects.

For products, which contain imported components; only the value addition in India will count towards offset obligations. Offset contract will be signed with the main contract. A vendor cannot delay execution of main contract on the plea of inability of Indian offset partner to execute offset contract.

A penalty equivalent to 5 percent of unfulfilled portion of obligation in a year will be imposed on the defaulter. Vendor failing to complete offset obligation during the period of main contract (or during the period extended) will be debarred by Acquisition Wing for future, after giving him opportunity to explain.

The Indian policy has the following major distinctive provisions:

- (a) All proposals that meet minimum offset requirement are to be treated at par. No weightage is allowed for the quality or quantum of offsets. No preference is given for extra offsets offered.
- (b) It is for the vendor to select methodology and Indian partner for the fulfillment of offset obligation.
- (c) No offset multipliers are applicable.
- (d) Offset banking has not been provided for.

The US India Business Council has been spiritedly advocating a number of policy changes. One of their recommendations relates to offset banking. It wants the Government to permit banking of offset credits to enable foreign vendors to accumulate them in advance.

Generation of Bankable Offset Credits

A vendor may generate potential offset credits through programmes undertaken prior to the award of main contract for 'banking' purposes for future use against likely obligations. Many vendors feel that pre-contract offset activities make sound economic sense for the following reasons :-

- (a) Vendors show their earnestness and commitment to the host country and thereby create a favourable impression.
- (b) As most contracts stipulate co-terminus completion of offset programmes, vendors confident of winning main contracts get early-starter advantage.
- (c) Banked credits create an informal pressure on the host country and improve a vendor's chances of bagging the targeted main contract, although pre-contract offset credits do not offer any such guarantee.
- (d) In case a vendor does not get the hoped-for contract, he is at liberty to sell the accumulated offset credits to recover his costs with profit.

Bankable offsets can be created in the following two ways: -

- (a) By excess generation through ongoing offset programmes.
- (b) By executing fresh offset-centric programmes, in anticipation of bagging future defence contracts.

Execution in Excess of Current Obligation

A foreign vendor may decide to continue with an ongoing offset programme even after his obligation has been fully met, provided he is allowed to 'bank' extra credits earned through additional activity. These extensions benefit the host country as well. Such arrangements can materialise under the following circumstances:

- (a) An offset programme may not be financially viable due to lack of economies of scale. A vendor may well decide to scale-up his commitment, provided he is allowed to 'bank' surplus credits earned.

(b) In the case of export of goods and services, a vendor may find the business financially lucrative. After having invested in the development of new markets and having acquired related experience, it may make economic sense to carry on as long as the market conditions remain conducive.

(c) In case a vendor has invested in the indigenous defence industry against partial/full fulfillment of his offset obligation, he may decide to have a more intimate partnership and invest additional funds. Presently, the Government has put a cap of 26 per cent for Foreign Direct Investment (FDI) in the defence industry. There are three scenarios in which investment of additional funds is possible:

(i) In case earlier investment was less than 26 percent, a vendor can increase it to the permissible limit.

(ii) In case the capital base of the Indian company is increased, vendor can pick up additional equity up to the allowed cap.

(iii) The Government may revise its policy and increase/remove FDI ceiling.

(d) Investment in defence R&D has to be flexible as cost and time overruns are fairly common. R&D programmes cannot have rigid financial funding. A foreign vendor has to remain invested and committed till the fructification of the project. At times, he may ~~be~~ get forced to invest additional capital to protect his earlier investment

Execution of Anticipatory Pre-contract Offset Programmers

In some countries, vendors are permitted to undertake approved programmes which would fetch them offset credits, in anticipation of getting major defence contracts. The UAE permits anticipatory offset credits in designated areas, provided it is convinced that the proposed activity would create new economic wealth and will be in the interest of the UAE.

A vendor who is confident of bagging a major defence contract may seek permission of the host country to commence offset programmes in advance. Offset credits thus earned are 'banked' to defray subsequent offset obligations. In case the vendor fails to get the anticipated contract, he is at liberty to trade his offset credits.

Functional Complexities and Need for Caution

Management of offset banking is a highly intricate and complex task. If banking is allowed, trade in offsets has to be accepted. Both are intrinsically and mutually contingent. Experienced vendors know how to exploit ambiguities in policies and lacunae in implementation to their advantage. Unless competently handled the whole exercise can prove in fructuous and even counter-productive.

Given the option, every vendor would choose the easiest and most remunerative alternative. For example, many vendors will find it profitable to outsource defence software from India to earn offset credits. But gains to India may be illusory as India's IT exports are already robust and thriving.

As offset banking may entail economic activities worth thousands of crores of rupees, it is absolutely essential that the Indian Government take a well-considered decision. Offset banking should not be viewed in isolation, but as an important and integral element of long-term national policy. The Government must weigh all issues involved to evolve a comprehensive and explicit policy directive.

Need for Pre-Approval of 'Bankable' Offset Programmers

India allows direct offsets (related to the main system under procurement) and semi direct offsets (connected to defence industry). As all pre-contract activities are anticipatory in nature, they have to relate to semi-indirect offsets. It implies that under pre-contract activities, a vendor can export defence goods/services or invest in the Indian defence sector (including defence R&D) without reference to any specific acquisition proposal of the Indian Government.

As seen above, a vendor may earn offset credits simply by buying any product from Indian defence industry. It becomes

a pure counter-trade arrangement. But, export of goods/services is considered to be the least beneficial form of offsets. As value of an offset programme depends primarily on its appropriate selection, the policy should also indicate the areas in which offsets are preferred and also offer suitable incentives for the same.

To ensure that routine commercial investments and trading activities are not shown as offset programmes to earn credits, it must be ascertained that all pre-contract activities relate to new products/services or new markets or conspicuously enhanced scale of existing operations. DOFA should be the designated authority to approve all proposals against which offset credits ~~would~~ ^{wiley} be permitted. DOFA has to make sure that the additional economic activity generated through offsets is in consonance with national policy imperatives. It will prevent misuse of the facility by knowledgeable vendors.

All countries that allow offset banking have an elaborate procedure in place to estimate anticipated immediate, short term and long-term benefits to their national economy. Expert groups are constituted for different projects and their reports included in the contract document. Therefore, programmes should be selected on the basis of their viability, estimated offset credit value, ease of monitoring and demonstrability of accruing benefits.

Application of Multipliers

As noted earlier, it is not the type of offset but its relevance to own needs that should guide the selection. It is imperative that all pre-contract offset activities be intelligently directed towards programmes involving investment and/or transfer of technology. For this purpose, offsets are commonly assigned 'multiplier value'. It is a factor applied to the actual value of an offset activity to calculate the credit value earned. It is a methodology of assigning differential weightage to various offset programmes to provide vendors with irresistible incentives to offer offsets in targeted area of their choice.

India must adopt application of multipliers if it wants to derive full benefits. For example, no vendor is going to invest in India's defence R&D where the risks and uncertainties due to

time and cost overruns are enormous. It is only through the application of multipliers that the foreign vendors can be persuaded to invest in the pre-selected areas.

Efficient Monitoring Mechanism

Inadequately monitored offset activities have always proved wasteful. Monitoring not only helps in achieving the objectives of the programme, but also provides invaluable feedback for data storage and further fine-tuning of the policy.

Monitoring is a multifaceted and complex task for the following reasons: -

- (a) There are no well-developed tools for measurement and evaluation of cost-benefit equation.
- (b) As limited data is made public in respect of defence offset activities, no standard monitoring mechanism has been evolved so far.

Offset banking needs regular and close oversight. Many host nations have found to their dismay that old and routine activities were presented to them under the garb of offset programmes by smart vendors. India must take due precautions before permitting 'banking' and have a properly constituted monitoring system in place to carry out periodic reviews of the process and apply corrections, where necessary. DOFA, duly strengthened by experts, could be assigned this task.

Regulation and Penalties for Default

All nations have in built safeguards in the form of penalty clauses. The Indian policy also has clauses for penalties for default. But these are applicable to offset obligations emerging from defence contracts and not pre-contract activities. In case India decides to introduce offset banking, it has to have systems and procedures in place to ensure that vendors fulfill their commitments diligently.

Vendors should not be permitted to treat pre-contract programmes in a casual and slapdash manner. Though anticipatory in nature, all pre-contract activities consume considerable indigenous resources as well. In case a vendor loses interest (may be due to market dynamics) and wants to

exit before completion, he must be penalised. He should not be permitted to renege on his commitments just because his initial offer was voluntary in nature and not due to any contractual obligations.

Transparency and Close Oversight for Probity

According to Transparency International, offsets are 'very open to corruption' as they remain on periphery and are subjected to less scrutiny. Moreover, they are formulated in broad and unspecific terms. Not all details of offsets are duly published. Security concerns of the host countries and the vendors' reluctance to share data (terming it as commercially sensitive) render the whole programme open to manipulations. The problem of vulnerability gets further aggravated in case of offset banking.

Regular probity check is required in respect of the following aspects:

- (a) Grant of approval to only those programmes, which bring in new economic gains to the country.
- (b) Correct evaluation of credits, especially in cases of transfer of technology.
- (c) Regular monitoring for adherence to agreed terms and conditions.
- (d) Imposition of penalties for default

Concerned functionaries have to ensure that no aspersions are ever caused as regards probity, and this can only be done by maximum transparency and laying down detailed instructions with no discretionary powers. Over-sensitivity to security should be avoided as it breeds unnecessary suspicions.

Conclusion

Offsets have come to stay. More than 130 countries are demanding offsets in one form or the other. The current market for offsets is estimated to be close to USD 50 billion and has given rise to a flourishing worldwide trade in offset credits. These are bought from companies having surplus credits and sold at a profit to defence vendors who need them to fulfill their offset

obligations. It is a highly cost-effective option in cases where a vendor has to execute offsets programmes in areas totally unrelated to his business. Growth of offset banking is a natural corollary of offset trade.

Australia found its Defence Offsets Credit Scheme to be too complicated and unwieldy, and replaced it with Defence Industry Investment Recognition (DIIREC) Scheme in 1995. Instead of granting 'bankable credits', Australia decided to introduce a recognition-centric scheme. DIIREC recognises investments made by overseas companies in Australia's indigenous Defence capability and grants them favourable consideration in new Australian defence contracts.

As regards India, it has just introduced offsets in its defence procurement procedure and is yet to acquire the necessary skills. It has rightly decided to follow a graduated and phased approach. That is the reason why it has kept offset threshold at a high of Rs 300 crores and fixed offset value at a ~~meager~~ ³⁰ ~~meag~~ percent. Provisions will be reviewed as India gains better understanding of dynamics of offsets.

As seen above, offset banking is a highly complex affair needing elaborate organisational setup with a dedicated expert agency. Unless handled with due care and caution, there is a likelihood of the country being taken in by clued-up vendors. Instead of economic gains, India may get saddled with in fructuous and wasteful activities. Besides, it may give rise to unscrupulous dealings with consequent trading of charges. India must, therefore, tread warily and exercise due caution while considering introduction of offset banking.