

Offset Contracts under Defence Procurement Regulations in India:

Evolution, Challenges and Prospects

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Abstract

The practice of countries demanding discharge of offset obligations as a prerequisite to foreign firms' participation in major civilian or defence contracts is not new, and recent years in particular have seen a number of countries, both developed and developing, apply offsets and industrial participation measures at an ever-growing scale and complexity, as governments worldwide use their purchasing power to develop local capacities and channelize investments and technology to favored domestic sectors. This paper traces the history of offset regulations in defence procurement in India, together with a legal analysis of this evolutionary path over the last four years. It then identifies challenges and areas of concern in the existing regulatory framework, and comes up with suggestions on the way forward to address the identified areas of concern keeping in view two primary objectives of procurement reform, namely, enhancing efficiency and uniformity in the administration of offset contracts in India.

I. INTRODUCTION

India is today among the top ten countries in the world in terms of defence expenditure and the third largest importer of defence hardware¹ with a national defence budget totaling to an amount of USD23.42 billion for the financial year 2007-08. The allocation in financial year 2008-09 has increased to USD26.4 billion (USD12 billion to be spent on capital acquisitions), and it is expected to grow at 7 to 8 percent annually over the next five years.² Over the years, as the Indian private industry has gained in technical capacity and expertise, it has also scaled up its demands for reforming the defence procurement system with an increased role for the indigenous industry, most notably through domestic public-private partnerships and compulsory offset requirements to be

¹ Frontier India Strategic and Defence, CII recommends a Constructive Framework for Implementation of Defence Offset Policy (October 29, 2007), <http://frontierindia.net/cii-recommends-a-constructive-framework-for-implementation-of-defence-offset-policy> (*last visited* December 3, 2008).

² Ernst & Young, India, *Eye on Defence*, Defence Newsletter, at 1 (August 2008), available at [http://www.ey.com/Global/assets.nsf/India/Ernst_&_Young_-_Defence_Newsletter/\\$file/Ernst%20%20Young%20-%20Defence%20Newsletter.pdf](http://www.ey.com/Global/assets.nsf/India/Ernst_&_Young_-_Defence_Newsletter/$file/Ernst%20%20Young%20-%20Defence%20Newsletter.pdf). See also Confederation of Indian Industry, About DAMC (2008), http://www.ciidefence.com/showcasing_defence_acquisition.asp.

met by foreign vendors; and estimates of domestic business currently generated in India as a result of the use of offsets hover around \$2 billion per annum.³

Academic views on mandatory offset liability as a compulsory requirement for participating in defence acquisition programs range from "...the need for relatively advanced domestic industry to exist *a-priori* in order to absorb and capitalize on benefits of offsets...", to the other end of spectrum of views that hold that "...offsets result in increased cost of equipment though with no significant benefits for the purchasing countries...".⁴ Much as there is a large divergence of views on the impact of offsets in achieving their stated goal, the fact remains that offset demands are increasing over time in all regions of the world.⁵

This paper examines the state of regulation of offset contracting in India, looking closely at their evolution over time, and makes suggestions on possible expansion of regulatory guidance on a number of critical and relevant issues aimed at enhancing efficiency and uniformity in administration of offset contracts, particularly in the context of a new set of defence procurement regulations issued as recently as July 2008.

II. BASICS OF OFFSET CONTRACTS

An "offset" is an agreement in which a foreign purchaser, usually a government, requires the contractor to agree to purchase a predetermined level of components from

³ Frontier India, *supra* note 1.

⁴ L. K. Behera, Impressions on International Seminar on Defence Finance and Economics (November 24, 2006), <http://www.idsa.in/publications/stratcomments/LaxmanBehera241106.htm> (last visited December 6, 2008).

⁵ U.S. Department of Commerce, *Impact of Offsets in Defence Trade: An Annual Report to Congress*, Department of Commerce, United States of America: Washington (December 2007), at 4-8, available at <http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/final-12th-offset-report-2007.pdf>.

subcontractors located within the purchasing nation, or to fulfill other portions of the private firm's international purchasing requirements from firms within that nation, or even to assist that nation in selling its unrelated products to third parties.⁶ This definition is similar to the one under the Government Procurement Agreement (GPA) under the World Trade Organization (WTO).⁷

Offsets agreements have emerged in three forms: "direct", "semi-direct", and "indirect" (See Figure 1 on the next page). In a "direct" offset transaction, the seller agrees to coproduce specific components of his products or obtain related services in the buying nation's territory; and the specific components (or it could be services) are thus "directly" related to the supplies envisaged under the principal contract. There are several ways to execute a direct offset, the most common being through coproduction, direct license production and subcontractor production or maintenance agreements. An "indirect" offset is where the supplier agrees to assist the importing country in the development of its export or in investment requirements unrelated to the principal contract.⁸ Some countries recognize a third type as "semi-direct" offsets relative to equipment and/or services very similar to the items covered by the main purchase contract, where technological level of semi-direct offset orders is similar to that of direct participation, but their realization depends on sales to other markets.⁹

⁶ Cedric Guyot, *Countertrade contracts in International Business*, 20 Int'l Law 921, 943 (1986) (citing McVey, *Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas*, 16 L. & Policy Int'l Bus. 2, 12 (1984)).

⁷ Under the GPA, "offsets" are defined under footnote 7 to the GPA as "...measures used to improve local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements...". Full text of the GPA is available on the WTO site at http://www.wto.org/english/docs_e/legal_e/gpr-94_01_e.htm.

⁸ Guyot, *supra* n.6, at 945-46.

⁹ Federal Public Service Economy, Government of Belgium, Policy on Industrial Benefit in the field of Defence Procurements (2008), http://mineco.fgov.be/organization_market/compensations/industrial_offset_en.htm.

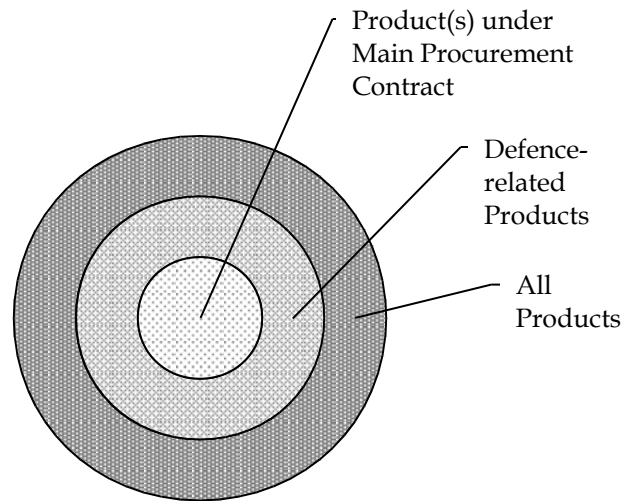


Figure 1: Direct, Semi-Direct and Indirect Offset Categorization

Offsets are sometimes referred to in national policies as “Industrial Participation” (as in Belgium and Turkey), or as “Industrial Compensation/Cooperation” (as in Lithuania, Taiwan and Denmark), but the essential objective remains the same, viz., enhancing local industrial base in defence and commercial high-end technology infrastructure.¹⁰ There is seldom a zero-cost to offset contracting,¹¹ and bidders will inflate their costs by a margin related to the cost of performing the offset obligation, which could be 3 to 5% of the total contract price.¹² It is in this context that the impact on economic returns to the purchasing country accruing out of imposing offset obligations assumes significant

¹⁰ Roger Bulgin, *Background to Offset and Industrial Participation*, at 3, Offsets 2000 Limited: Sussex (August 2006).

¹¹ Bulgin, *supra* n.10, at 7-8.

¹² *Ibid*, at 8. Another study, however, places the actual cost of performing offset obligations at 7-10% of the contract price (See Ann Markusen, *The Arms Trade as Illiberal Trade*, at 69, in Paul Dunne and Jurgen Brauer (eds.), *Arms Trade and Economic Development: Theory, Policy and Cases in Arms Trade Offsets*, Routledge: New York (2004), available at <http://www.ecaar.org/Articles/SA%20Papers/Markusen.pdf>).

importance, and the nature of this impact should be an important factor for a purchasing country to decide whether to go in for direct, semi-direct, or indirect offsets, or whether to go in for any offset obligations at all.¹³

III. TREATMENT OF OFFSETS UNDER WTO AGREEMENTS

Government purchases of goods and services for their own use are effectively excluded from the scope of the General Agreement on Tariffs and Trade (GATT).¹⁴ When offsets relate only to work in connection with government contracts, they are measures “governing” procurement by government agencies for the purposes of GATT Article III.8 and are excluded from the national treatment rule.¹⁵ There is another view, however, that holds that while countertrade does not, per se, contravene GATT rules, government measures that require, stimulate, take the form or react to countertrade could be inconsistent with national obligations under GATT policies.¹⁶

The controversy regarding the use of offsets in national defence procurement is now settled under the 1994 plurilateral Government Procurement Agreement (GPA); and its Article XVI provides for a general prohibition on use of offsets in government

¹³ The current defence procurement regulations in India allow the offset percentage to be determined based on a number of factors such as type of acquisition, strategic importance of the acquisition or technology, enhanced ability of Indian defence industry to absorb the offset, and export potential generated.

¹⁴ Jean Heilman Grier, *Government Procurement* (September 2001), <http://www.osec.doc.gov/ogc/occic/gpa.htm> (last visited December 2, 2008).

¹⁵ Sue Arrowsmith, *Government Procurement in the WTO*, Studies in Transnational Economic Law, Volume 16, Kluwer Law International: The Hague (2003), at 53.

¹⁶ Guyot, *supra* n.6, at 924 (citing *Countertrade Outlook*, Vol. 11 No. 16, April 23, 1984)). However, there may not be much weight in this view since Article XXI of the GATT clearly provides a national security exception (in addition to the exclusion of government purchases) by stating that a country cannot be prevented from taking any action that “it considers necessary for the protection of its essential security interests...relating to the traffic in arms, ammunition, and implements of war and such traffic in other goods and materials as is carried out directly for the purpose of supplying a military establishment (or) taken in time of war or other emergency in international relations.”

procurements, with an exception for developing countries for use of offsets for a temporary period.¹⁷ There is a further exception in the GPA to military and other procurements related to national security or national defence.¹⁸ The GPA contains a built-in commitment to negotiations on both the text and coverage of the Agreement, and in December 2006, negotiators reached provisional agreement on a revision of the text of the 1994 plurilateral Agreement; and the “Provisionally Agreed Revised GPA Text” carries forward the existing GPA provisions in terms of general prohibition, exception for developing countries and general exemptions for military/defence/security-related procurements.¹⁹

¹⁷ Article XVI of the GPA provides that:

1. *Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets.*
2. *Nevertheless, having regard to general policy considerations, including those relating to development, a developing country may at the time of accession negotiate conditions for the use of offsets, such as requirements for the incorporation of domestic content. Such requirements shall be used only for qualification to participate in the procurement process and not as criteria for awarding contracts. Conditions shall be objective, clearly defined and non-discriminatory. They shall be set forth in the country's Appendix I and may include precise limitations on the imposition of offsets in any contract subject to this Agreement. The existence of such conditions shall be notified to the Committee and included in the notice of intended procurement and other documentation.*

¹⁸ Article XXIII of the GPA, an *umbrella* article relating to “Exceptions to the Agreement”, states that:

1. *Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information which it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defence purposes.*

¹⁹ Article III: Exceptions to the Agreement

1. *Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information that it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition, or war materials, or to procurement indispensable for national security or for national defence purposes ...*

Article IV: Developing Countries

3. *Based on its development needs, and with the agreement of the Parties, a developing country may adopt or retain one or more of the following transitional measures, during a transition period and in accordance with a schedule, set out in an Annex to its Appendix I, and in a manner that does not discriminate among the Parties:*
 - (b) *an offset, provided that any requirement for, or consideration of, the imposition of the offset is clearly stated in the notice of intended procurement ...*

Thus, while the use of offsets in civilian procurement is conditional subject to temporary phasing-out, the national security exceptions provide an opportunity to all member-states to continue offset policies in defence procurements. The use of offsets in defence procurements is clearly not prohibited under the GPA. In fact, most GPA member-states have strong offset policies applying to defence procurement, notable ones being Canada, United Kingdom, France, Germany, Sweden, Japan, Korea, Israel, Singapore, Switzerland, Italy and Spain,²⁰ and the trend is increasing amongst national across the world to adopt offset policies aimed as industrial base mobilization in matters of national security,²¹ no doubt helped by the fact that the market for military procurement has become essentially a buyer's market allowing customers to extract favorable deals from international suppliers.²²

IV. FRAMEWORK FOR PROCUREMENT REFORM IN OFFSET CONTRACTING

In one of his seminal works on government procurement reform, Schooner has identified a comprehensive range of objectives both for procurement and for procurement reform, the important ones being competition, integrity, transparency, uniformity, efficiency, best value, and customer satisfaction.²³ While most academics

Article V: General Principles

Offsets

6. *With regard to covered procurement, a Party, including its procuring entities, shall not seek, take account of, impose, or enforce offsets.*

²⁰ Names of countries extracted from U.S. Department of Commerce, *supra* n.5, at 2-13.

²¹ Ann Markusen, *The Arms Trade as Illiberal Trade*, at 69, in Paul Dunne and Jurgen Brauer (eds.), *Arms Trade and Economic Development: Theory, Policy and Cases in Arms Trade Offsets*, Routledge: New York (2004), available at <http://www.ecaar.org/Articles/SA%20Papers/Markusen.pdf>.

²² Federation of American Scientists, *Offsets: The Industrial, Employment and Security Costs of Arms Exports* (November 2001), <http://www.fas.org/asmp/campaigns/offset.html>.

²³ See generally Steven L. Schooner, *Desiderata: Objectives for a System of Government Procurement Law*, Working Paper No. 37, The George Washington University Law School (2002); Steven L. Schooner, Daniel

rate competition as a primary desiderata, the fact however remains that almost all countries limit competition and moderate other elements of the procurement system for domestically beneficial purposes, especially so in the case of national security objectives.

For instance, the U.S. Federal Acquisition Regulations contain provisions for “other than full and open competition” for industrial base mobilization²⁴ and for national security reasons. Most other countries, including the European Union, have an entirely separate set of directives for defence procurements, allowing for greater flexibility in decision-making to national governments.²⁵ It is therefore not entirely surprising that the defence procurement procedures in India contain provisions to the effect that defence procurement may need to be conducted on a “limited tender” or a “sole

I. Gordon and Jessica L. Clark, *Public Procurement Systems: Unpacking Stakeholder Aspirations and Expectations*, GWU Law School Public Law Research Paper No. 1133234, The George Washington University Law School (2008), available online for downloading at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133234#.

²⁴ “Industrial Base” is defined as the manufacturing industry that produces consumer products and represents the basic capability in the U.S. in the event of an industrial mobilization during national emergency (Source: Ralph J. Nash, Jr., Steve L. Schooner, Karen R. O’Brien-DeBakey and Vernon. J. Edwards (2007), *The Government Contracts Reference Book*, at 324, Wolters Kluwer: Chicago (2007)). FAR Part 6.302-3 allows procurement methods using other than full and open competition for maintaining facilities, producers, manufacturers and suppliers to achieve industrial mobilization, and also to establish or maintain an essential engineering, research or development capability to be provided by an educational institution or federally funded research and development center. The exception to full and open competition is especially useful in enhancing or maintaining competitive advantages in select areas of domestic capabilities.

²⁵ Article 30 of the European Commission (EC) Treaty allows for prohibitions or restrictions import, export and transit of goods on grounds of public security. Article 296 allows member states to take necessary measures for protection of certain essential interests of its security. The Public Sector Directive 2004/18/EC applies to the field of defence, subject however, to Article 296 and Article 10 of the EC Treaty, thus creating avenues for member-states to make exceptions in the field of defence procurement. In practice, most national authorities make extensive use of exemptions. See Matrin Trybus, *The EC Treaty and Defence Procurement*, <http://www.sigmaxweb.org/dataocd/47/19/40669055.ppt#257,1>, *The EC Treaty and Defence Procurement*; and also Laurence Folliot-Lalliot, *EC Procurement Law Seminar*, presentation made at the George Washington University Law School (November 4, 2008), copy available with the author.

source” basis given the need for confidentiality and /or geo-political security considerations.²⁶

While offset contracts are really subsidiary contracts, and are essentially a part of contract performance rather than the contract formation stage, it is possible to argue that Schooner’s desiderata remain equally relevant and applicable to contract administration as they are to contract formation, barring rather obviously, the objective of enhancing competition. Uniformity, integrity and transparency in contract administration, for instance, have direct relevance to achieving competition and best value in the contract formation stage, since uneven and unpredictable buyer behavior in the latter stage would eventually drive out best suppliers from the market, thereby reducing competition and increasing procurement costs in future acquisitions at the time of contract formation.

It is this author’s premise for the purposes of this analysis, therefore, that a proper and prioritized set of objectives for procurement reform in relation to strategic defence procurement consists only of elements of efficiency, end-user satisfaction, best value, integrity and uniformity, as the other objectives (desiderata) tend to get subsumed by

²⁶ Defence Procurement Procedure-2008 (DPP-08), the regulations applicable to capital acquisitions in the Ministry of Defence (MoD) in India, state in the pertinent parts that:

25. *It is well accepted that the market for state-of-the-art defence equipment and platforms is circumscribed by denial regimes. In addition, national security concerns prevent operational parameters of equipment required by defence services being made public. The procurement of defence equipment on the basis of limited tenders, therefore, becomes imperative.*

73. *In certain acquisition cases, imperatives of strategic partnerships or major diplomatic, political, economic, technological or military benefits deriving from a particular procurement may be the principal factor determining the choice of a specific platform or equipment on a single vendor basis. These considerations may also dictate the selection of particular equipment offered by a vendor not necessarily the lowest bidder.*

A similar set of operational guidelines exempting strategic defence acquisitions was also available in the Defence Procurement Procedure-2002 regulations. Full text of DPP-08 is available for download at MoD site at <http://mod.nic.in/dpm/welcome.html>. A separate set of regulations titled “Defence Procurement Manual” (DPM) deals with other, “non-capital” defence procurements, usually of a recurring nature.

the overriding interests of industrial base mobilization and national security. Keeping in view of limitations of space and the need for maintaining focus, this paper further restricts analysis to two of these objectives of procurement reform, namely, efficiency and uniformity; examines the state of the Law in offset contract formation and administration under defence procurement regulations in India; and makes recommendations in respect of the prescribed regulatory framework so as to enhance these two elements in the contracting process under applicable defence regulations.

V. OFFSET CONTRACTS IN INDIAN DEFENCE PROCUREMENT

A. *Evolution of Offsets*

For almost 45 years after India's Independence, defence contracting was done under the general financial and accounting rules that were primarily aimed at acquisitions for civilian agencies of the government. A separate procedure for defence procurements came into being in India in 1992, and these procedures were revised with the setting up of new defence procurement management structures and systems in 2001 as a part of the implementation of the report of Group of Ministers on reforming the national security system. Continuous efforts have since then been made aimed at procurement reform, which finally culminated in the issue of a consolidated set of regulations termed as Defence Procurement Procedure-2002 (DPP-02) that came into effect from December 30, 2002, but there were no provisions or procedures dealing with offsets in these regulations.²⁷ Figure 2 on the next page shows the organizational setup for approvals culminating in the issue of an RFP.²⁸

²⁷ Full text of DPP-02 (June 2003 Version) is available at <http://www.defenceindia.com/defenceind/dpp.pdf>.

²⁸ This chart is as per the DPP-08, and the structure has remained largely unchanged since DPP-05. Source: Dhiraj Mathur (PWC India), *Offset Obligation in Defence Sector*, Presentation made at USIBC, Washington DC (December 9, 2008).

Offsets were subsequently implemented in the revised “Defence Procurement Procedure-2005” (DPP-05)²⁹ which came into force with effect from July 1, 2005; under which the SCAP Categorization Committee³⁰ was authorized to recommend the inclusion of an offset clause amounting to 30% of the indicative cost in the Request For Proposals (“RFP”) in cases where the indicative cost in the RFP was INR300 crore or more, although changes could be suggested in the offset amount if felt necessary.³¹ Any cost incurred by the vendor in the infusion or providing of any technical or financial assistance was not permitted to form part of the offset offer.³²

²⁹ Full text of DPP-05 is available at MoD site at <http://mod.nic.in/dpm/DPP%202005.pdf>.

³⁰ SCAP stand for “Services Capital Acquisition Plan”. The SCAP Categorization Committee submits proposals to the Defence Acquisitions Council headed by the *Raksha Mantri* (Defence Minister) for approval. See MoD website at <http://mod.nic.in/newadditions/procurement.htm> for some more details on the organizational structure and committees relating to defence acquisitions in India.

³¹ DPP-05, para 18 at 5. The permitted options for discharge of offset obligations were:

- (1) *direct purchase of or providing market access, or creating new markets by generating export orders for products, components or services from any of the covered industries- these being Indian Defence Sector Undertakings (DPSUs) or the Ordnance Factory Board (OFB); and*
- (2) *Foreign Direct Investment in Indian Public Sector Undertakings for defence industrial infrastructure.*

³² Clause 2(f) of “Offset Schedule”, Appendix H to DPP-05, at 69.

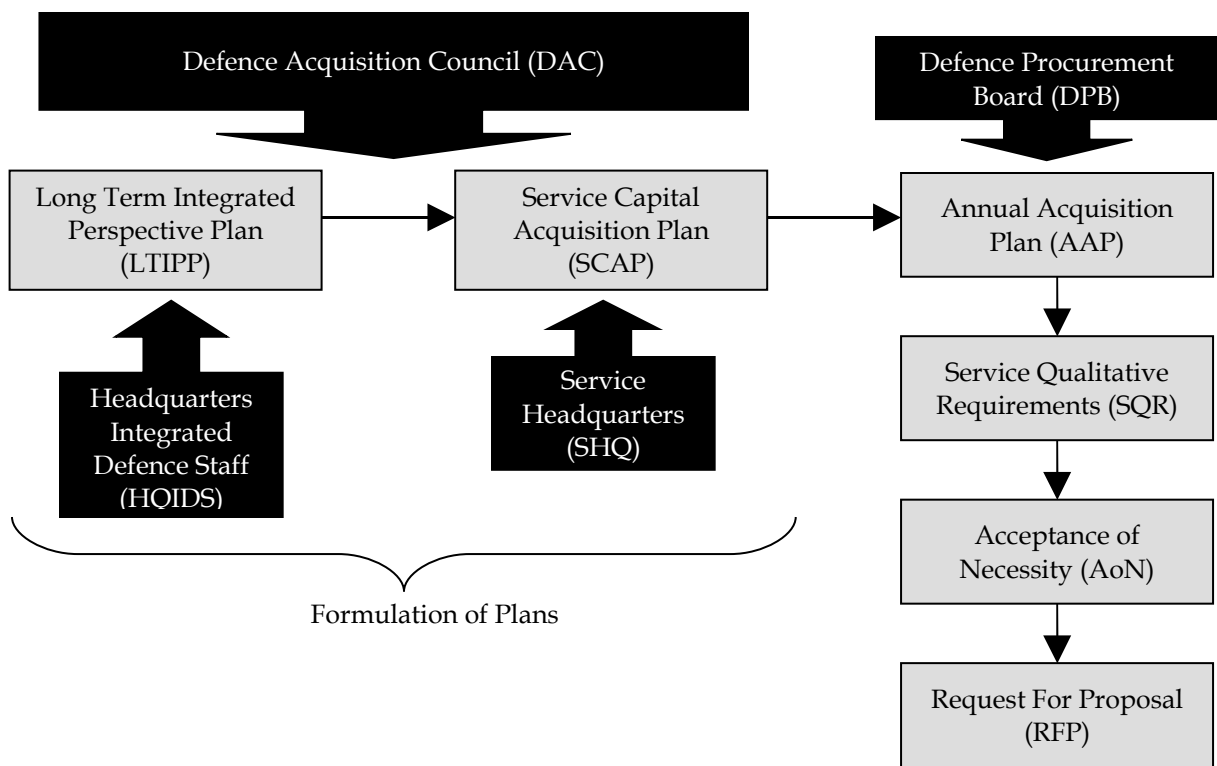


Figure 2: Formulation of Acquisition Plans and Approval of RFPs

categorized as “Buy (Global)”³³ or “Buy and Make with Transfer of Technology”,³⁴ but the range of options for discharge of offset obligations was considerably expanded.³⁵

³³ DPP-06, para 22 at 11. “Buy Global” contracts involve outright purchase from foreign/Indian vendors.

³⁴ DPP-06, para 22 at 11. “Buy and Make with Transfer of Technology” contracts involve purchase from foreign vendor followed by licensed production. Both “Buy Global” and “Buy and Make with Transfer of Technology” categories include contracts for warship construction. There are two other categorizations: “Buy (Indian)”, which relates to contracting situations where only Indian vendors are allowed to participate (“Buy (Indian)” must have a minimum 30% indigenous content if systems are being integrated by an Indian vendor), and “Buy & Make” decisions- meaning purchase from a foreign vendor followed by licensed production / indigenous manufacture in the country (See DPP-06, para 4 at 7). Yet another categorization- “Make” categorization- relates to Indigenous Research, Design, Development and Production of systems, which while being favored, need its benefits to be put to careful evaluation, as “Make” categorization leads to denial of offset opportunities to the defence industry (See DPP-06, para 23(b) at 144).

³⁵ Clause 2.1 of “Procedure for Implementing Offset Provisions”, Appendix D to DPP-06, at 35 (see also corresponding current provisions at clause 2.1 of “Procedure for Implementing Offset Provisions”,

Notable changes in DPP-06 related to inclusion of private Indian defence industries as a vehicle for discharge of offset obligations,³⁶ and also in relation to the restatement of an inclusive range of services that were included as options for discharge of offset obligations.³⁷ The most significant development from a contract administration viewpoint, however, was the setting up of “Defence Offsets Facilitation Agency” (DOFA) as a specialized agency under the MoD that was to function as a single window entity in assisting the Ministry in dealing with offset contracts.³⁸ DOFA was to assist

Appendix D to DPP-08, at 43). The range of options for discharge of offset obligations was expanded in DPP-06 over DPP-05 as follows:

- (a) *Direct purchase of, or executing export orders for, defence products and components manufactured by, or services provided by, Indian defence industries, i.e., DPSUs, the OFB, 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; and*
- (c) *Direct foreign investment in Indian organisations engaged in research in Defence R&D as certified by Defence Offset Facilitation Agency (DOFA)*

Note: Under the new DPP-08, DOFA shall not consider civil infrastructure and such technologies that are otherwise easily available in the open market while making certification under item (c) in footnote 19 above. This change was perhaps brought about on account of certification of DOFA under the previous regulation of infrastructure and technologies that were not related to defence and were easily available in the open market.

³⁶ See options 2.1(a) through (c), *supra* n.36.

³⁷ See option 2.1(a), *supra* n.36.

³⁸ DPP-06, para 3 at 36. DOFA’s listed objectives under the DPP-06 were:

- (a) Facilitate implementation of the offsets policy;
- (b) Assist in vetting of offset proposals technically;
- (c) Assist in monitoring the offset provisions;
- (d) Suggest improvements in the policy and procedures;
- (e) Interact with Headquarters Integrated Defence Staff and Service Headquarters;
- (f) Advise, in consultation with the Headquarters Integrated Defence Staff, Services and Defence Research and Development Organisation (DRDO), areas in which offsets will be preferred;
- (g) Promote exports of defence products and services; and

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.³⁹ Figure 3 on the next page shows the process for soliciting offset proposals (as part of bidder/offeror responses to RFPs) and their evaluation.⁴⁰

(h) Provide advisory clarifications on the policy and procedures (in consultation with the Acquisition Wing wherever necessary).

In addition, under DPP-06, DOFA was to assist the Acquisition Manager in the Acquisition Wing of the MoD in the implementation of the offset contract (DPP-06, para 10.1 at 39). This assistance function has now been shifted to an "Offset Monitoring Cell" in the MoD under the new 2008 regulations (DPP-08, para 10.1 at 47), although sub-clause (c) as above continues to remain on board without any modifications. Clause (h) has been completely deleted in the latest revisions to the procurement procedures, indicating perhaps the thinking that policy-based issues are best dealt with in the Ministry itself in a more *formal* environment.

³⁹ DPP-06, para 3.2 at 36. The latest regulations are silent on the composition of DOFA, or whether any changes have been made in a departure from the explicit position under DPP-06.

⁴⁰ Figure as per the DPP-08/DPP-06. *Source*: Dhiraj Mathur (PWC India), *Offset Obligation in Defence Sector*, Presentation made at USIBC, Washington DC (December 9, 2008).

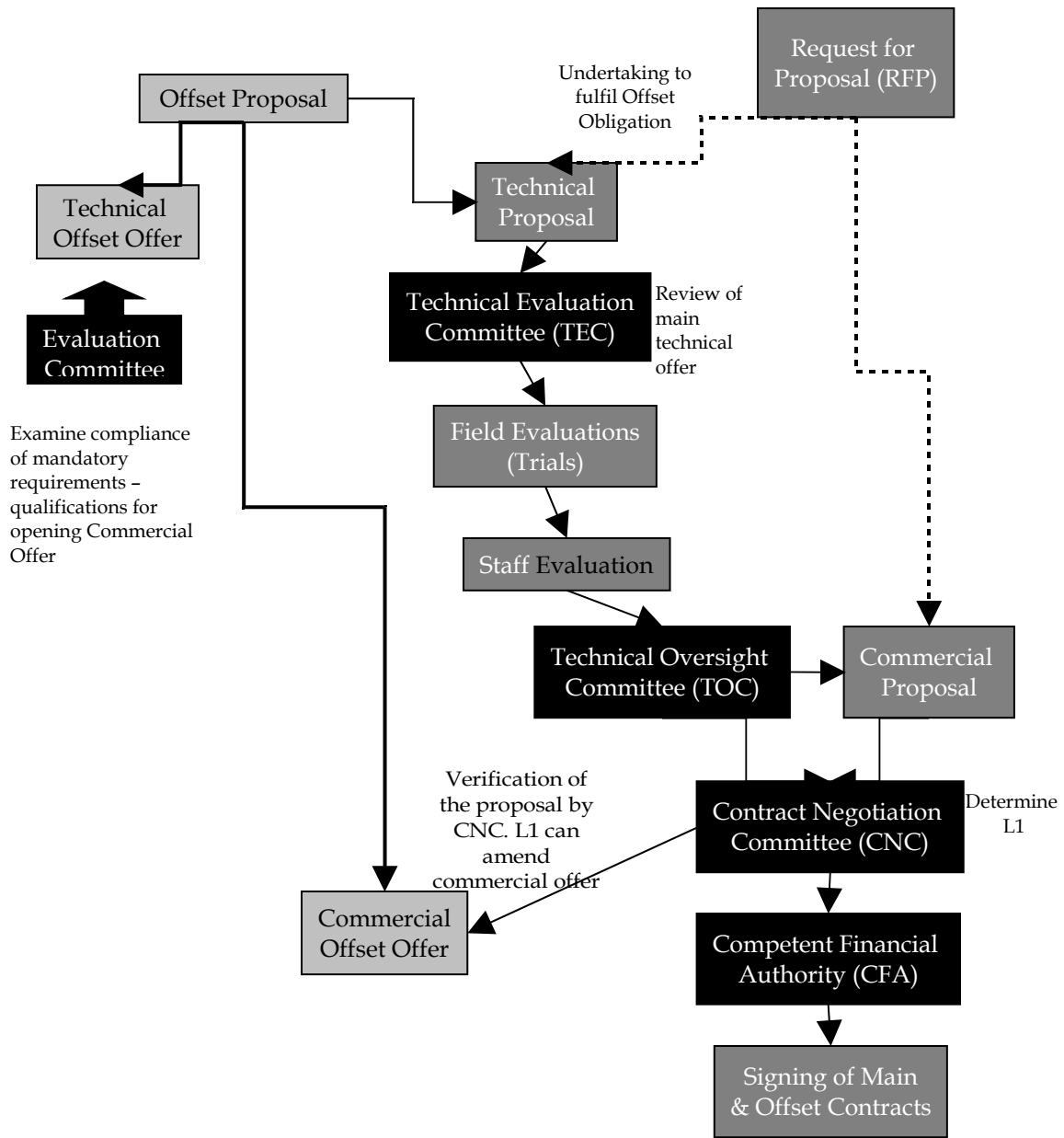


Figure 3: Offset Proposals and their Evaluation Process

B. Applicability and Quantum of Offset Obligations

In DPP-05, offset provisions were to apply to all contracts with an “indicative cost in the RFP” of INR300 crores or more. The application of offsets was restricted in DPP-06 to

capital acquisitions categorized as “Buy (Global)” and “Buy and Make with Transfer of Technology” where the *indicative cost* in the RFP was INR300 crores or more.⁴¹ The language has nominally changed in DPP-08, so as to apply to these two categories of capital acquisitions where the *estimated cost of the acquisition proposal* is INR300 crore or more.⁴²

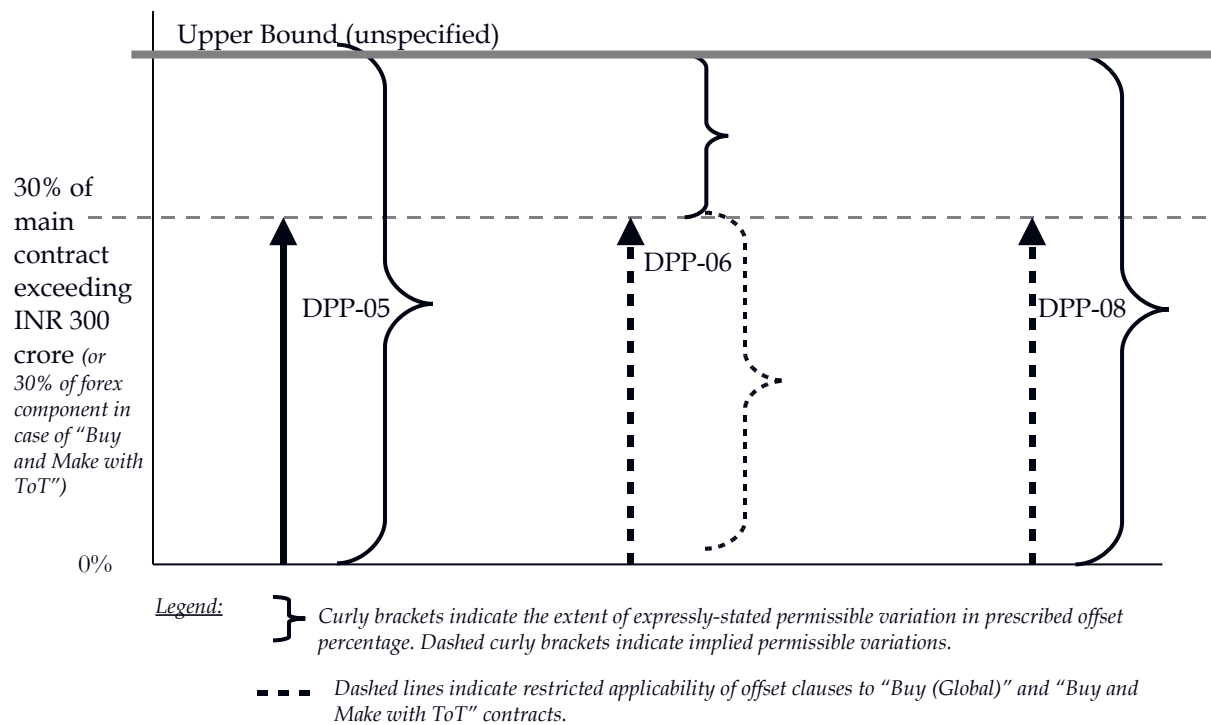
When offsets were first introduced in 2005, the quantum of offset obligation has been fixed at 30% of the contract value. Offset percentages have been retained at 30% of the indicative cost of acquisition in “Buy (Global)” category acquisitions and 30% of the *foreign exchange component* in “Buy and Make with TOT” category acquisitions right since DPP-06. Also, DPP-05 had permitted the SCAP Categorization Committee to recommend higher offset percentages, while DPP-06 allowed the DAC to prescribe varying offset percentages above 30% for individual cases or a class of cases depending upon factors such as the strategic importance of the acquisition or the technology, enhanced ability of Indian defence industry to absorb the offset, export potential generated, etc. Under DPP-08, the DAC is authorised to prescribe higher offset percentages or waive off the requirement in very special cases, depending upon the DPP-06 criteria and/or the type of acquisition.⁴³ Figure 4 on the next page shows the evolution of applicability and quantum aspects of offset obligations in India.

⁴¹ See *supra* n.34 and n.35 for definitions of “Buy (Global)” and “Buy and Make with ToT” contract categorizations, contrasting these with “Buy (Indian)”- where only Indian vendors are allowed to participate (“Buy (Indian)” must have a minimum 30% indigenous content if systems are being integrated by an Indian vendor)- and with “Buy & Make” decisions- meaning purchase from a foreign vendor followed by licensed production / indigenous manufacture in the country (See DPP-06, para 4 at 7; and DPP-08, para 4 at 2 for definitions). As mentioned at *supra* n.46, a fifth categorization- “Make” categorization- relates to Indigenous Research, Design, Development and Production of systems, which while being favored, need its benefits to be put to careful evaluation, as “Make” categorization leads to denial of offset opportunities to the defence industry (See DPP-08, para 23(b) at 150).

⁴² DPP-08 uses the terms “acquisition proposal”, “procurement proposal”, and “capital acquisition project” rather interchangeably, and *apparently in the same sense* as proposals invited under “individual RFPs” and “individual contracts”. However, acquisition proposals and procurement proposals are generally broader agency plans placed before the Defence Acquisition Council/ Defence Procurement Board, and could therefore involve the issue of *one or more* RFPs or individual contracts.

DPP-06 also envisaged that the minimum offset percentage for the following two years would be prescribed based on a review of the experience on implementing these provisions. The defence industry had major concerns with the likely enhancement of offset obligations overall, and this provision has now been dropped in the new DPP-08. However, as stated earlier, the DAC can prescribe higher percentages depending upon a number of relevant factors for individual cases and/or a class or cases.

Figure 4: Evolution of Applicability & Quantum aspects of Offset Obligations in India



⁴³ In some recent defence procurements, the offset percentages have been fixed at 50% of the main contract value. It may however be noted that even at 50%, offset percentages under defence procurement regulations in India compare favorably as compared to standard international practices. At 30% of indicative cost of INR300 crore, the minimum offset obligation in Indian defence contracts would be INR90 crore or USD18 million (USD 45 million in case of a 50% offset). The international average for an offset agreement is USD101 million, starting from a minimum agreement value of USD2 million. Most western countries require an offset obligation of 100% or more vis-à-vis the main procurement contract, including many signatory-states to the Government Purchase Agreement (GPA) under the WTO (Source: U.S. Department of Commerce, *supra* n.5, at 2-13).

The decision of keeping offset percentages at 30% (or at any other figures, for that matter) is necessarily for the purchasing country to make: one that should depend primarily on factors like the negotiating position of the buying country in the world defence market, the perceived need for direct/indirect offsets and the capacities and capabilities of domestic industry to absorb the technology and participate in the quantum mandated for discharge of obligations.⁴⁴ There are no studies pointing out the domestic capacities available in India, though with some of the seemingly indirect permitted offset activities like software and services, there is an immense potential in the country in these sectors.

C. Scope and Partnership Issues

Offsets, as they were first introduced in India in 2005, permitted discharge of obligations by (1) direct purchase of or providing market access, or creating new markets by generating export orders for products, components or services from any of the covered industries (primarily, the DPSUs and the OFB); and (2) Foreign Direct Investment in Indian Public Sector Undertakings for defence industrial infrastructure.

This list of institutions was expanded in 2006 to include (1) Direct purchase of, or executing export orders for, defence products⁴⁵ and components manufactured by, or services provided by, Indian defence industries, i.e., DPSUs, the OFB, and any private defence industry manufacturing these products or components under an industrial licence granted for such manufacture; (2) Direct foreign investment in Indian defence industries for industrial infrastructure for services, co-development, joint ventures and

⁴⁴ DPP-08 allows offset percentages other than 30% to be imposed, applicable for different classes of cases or for individual cases depending upon the factors involved such as type of acquisition, strategic importance of the acquisition or technology, enhanced ability of Indian defence industry to absorb the offset, export potential generated, etc. (DPP-08, para 1.3 at 43).

⁴⁵ For products which contain imported components, only the value addition in India will count towards offset obligations (DPP-08, para 6.4 at 46).

co-production of defence products; and (3) Direct foreign investment in Indian organisations engaged in research in Defence R&D. Transfer of Technology is not recognised as one of the means of discharge of offset obligations.⁴⁶ The clause relating to private defence industry manufacturing these products or components “under an industrial licence granted for such manufacture” stands deleted in the 2008 regulations, with the result that the eligible private industries have substantially expanded in number.⁴⁷

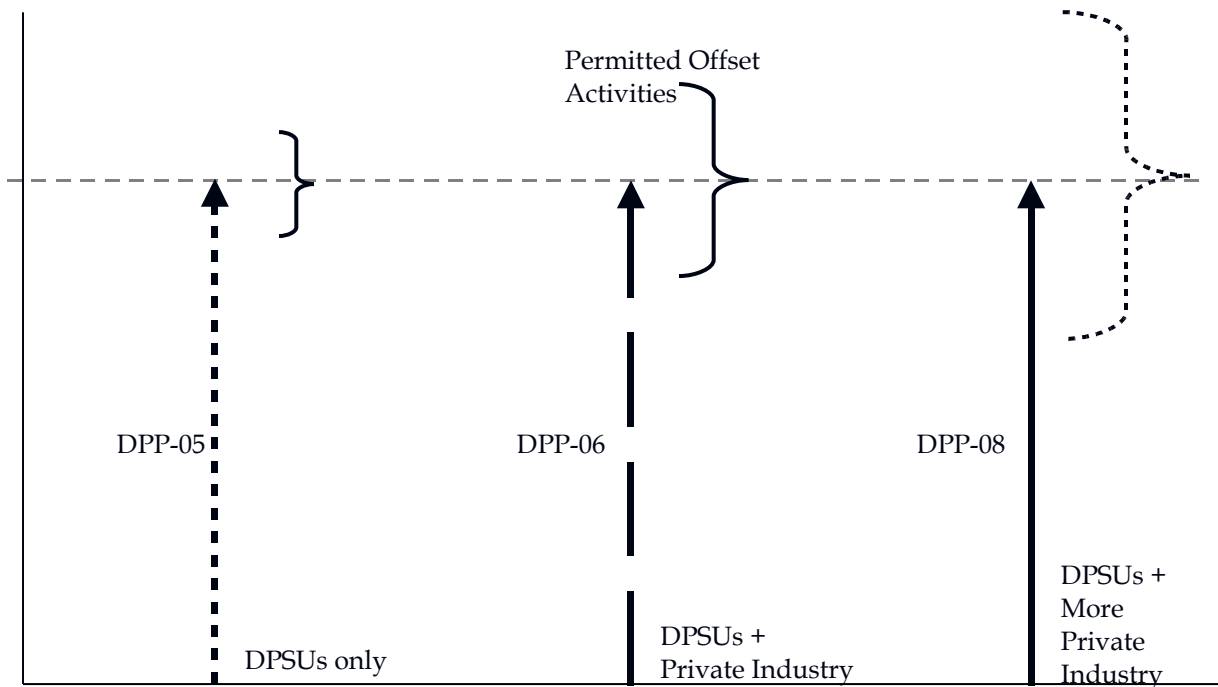


Figure 5: Evolution of Scope & Partnership Issues in Offset Contracts

DPP-06 did not specifically contain a list of eligible products, but it did make available a list of letters of intent/ industrial licenses issued for the manufacture of items under defence industries.⁴⁸ DPP-08 now contains a substantially broad and

⁴⁶ Ernst & Young, *supra* n.2, at 6. See also Clause 2 of “Offset Schedule”, DPP-02, at 69.

⁴⁷ Clause 2.1(a) of “Procedure for Implementing Offset Provisions”, Appendix D to DPP-06, at 35 now stands modified by Clause 2.1(a) of the same Appendix to DPP-08, at 43 where this change has been made.

⁴⁸ See link titled “Firms granted industrial licence for manufacture of defence products” on webpage relating to DOFA at <http://mod.nic.in/DOFA.htm>. This is a list of letters of intent/ industrial licenses

expanded⁴⁹ list of defence products⁵⁰ which are eligible for discharging of offset obligations. See Figure 5 on the previous page for a graphical analysis of scope and partnership issues, where expanding curly brackets show an increasing number of activities being covered as permissible offset activities; the gradually complete lines showing more private industry being brought within the scope of offset partnerships; and the dashed curly bracket shows removal of civil infrastructure being removed from the eligibility criterion for investment activities in India.

It is noteworthy that some analysts view offset obligations in India as “direct”,⁵¹ while some others believe that India has decided to adopt a “semi-direct” path by demanding offsets related to the defence industry as a whole.⁵² It is however important to note that the procurement system permits the product, services or investment eligible for discharge of offset obligations to be completely unrelated to the product(s) being procured under the principal contract, even though they are still military in character- a categorization that has traditionally been treated as “indirect” rather than as “direct”.⁵³ The fact that banking of offsets has now been permitted supports this analysis, as the process of acquiring excess offset credits in one procurement and applying them to an entirely different procurement is an “indirect” offset process rather than a direct one.⁵⁴ It

issued for manufacture of items under defence industries from January 2001 to February 2008. The charter of duties for DOFA on the site is however of 2006 vintage. The page was last visited December 6, 2008.

⁴⁹ Ernst & Young, *supra* n.2, at 3.

⁵⁰ See “List of Defence Products”, Annexure VI to DPP-08, at 54.

⁵¹ See e.g. Priti Suri & Associates, *Offset Obligations in India: Is the path right?* (April 2008), <http://www.psalegal.com/pdf/OFFSET%20OBLIGATIONS%20IN%20INDIA.pdf> (last visited December 11, 2008); and Ernst & Young, *supra* n.2, at 6.

⁵² Mrinal Suman, *Offset Banking in Defence Deals: Need for Caution* (2007), http://www.usiofindia.org/article_Jul_Sep07_10.htm (last visited December 9, 2008).

⁵³ Susan Willett and Ian Anthony, *Countertrade and Offsets Policies and Practices in the Arms Trade*, Copenhagen Peace Research Institute Working Paper No. 20/98, at 2 (1998).

⁵⁴ Raghu, *India: New Policy on Defence Offsets Contracts* (February 28, 2008), available online at <http://www.politicalaffairs.net/article/view/6539/1/317/>.

is believed that indirect (or “semi-direct”) offsets tend to be generally inefficient in achieving objectives of offset contracting,⁵⁵ and that a country like India with a sufficiently strong industrial base in general and basic defence production, for instance, could perhaps be better served by a direct offset system, or at least a multiplier-based indirect offset system that enhances its capabilities in the specific areas where such enhancement is especially required and desirable.⁵⁶

The decision to expand the list of eligible domestic companies to those involved in manufacture of defence items in the private sector was motivated by a desire to encourage foreign vendors to enter into meaningful, long-term relationships with private domestic industries with a considerable degree of maturity and expertise,⁵⁷ and also perhaps in view of perceived limited capacity of DPSUs to deliver the needed quantum of discharging offset obligations.⁵⁸ This move will certainly have the result of further enhancing domestic capabilities in high-end defence technologies, using the flexibility offered through partnerships with an increasingly aggressive and enigmatic private Indian industry. The decision to disallow civil infrastructure investments from eligible offset activities, on the other hand, appears to be motivated by the easy availability of these technologies in the domestic market anyway, and this decision reinforces the premise that offset contracting should selectively be used for encouraging technology-upgradation and investments in specific gaps in strategic domestic

⁵⁵ Jurgen Brauer and J. Paul Dunne, *Arms Trade Offsets and Development* (January 2005), <http://www.bristolcaat.org.uk/information/Offsetsanddevel.pdf> (last visited December 6, 2008).

⁵⁶ Suman, *supra* n.57.

⁵⁷ Statement of Union Minister of Defence, Government of India as contained in “Foreword” to DPP-08. See also K. Ganesh Raj, *DPP 2008 banking on defence offset to power indigenous industry*, *The Economic Times* (August 5, 2008), available online at <http://economictimes.indiatimes.com/articleshow/msid-3326472,prtpage-1.cms>.

⁵⁸ Ajai Shukla, *Aggressive MoD gets clear on Offsets*, *Business Standard* (April 7, 2007), available online at <http://ajaiashukla.blogspot.com/2007/04/aggressive-mod-gets-clear-on-offsets.html>.

capability, and that offsets should, therefore, perhaps be more direct than semi-direct or indirect.

D. Offset Contract Administration

Both DPP-06 and DPP-08 envisage an important role for Defence Offsets Facilitation Agency (DOFA) in assisting the MoD in the formation and monitoring of offset contracts. The roles and responsibilities of DOFA as mandated by DPP-06 were:

- (a) Facilitate implementation of the offsets policy;
- (b) Assist in vetting of offset proposals technically;
- (c) Assist in monitoring the offset provisions;
- (d) Suggest improvements in the policy and procedures;
- (e) Interact with Headquarters Integrated Defence Staff and Service Headquarters;
- (f) Advise, in consultation with the Headquarters Integrated Defence Staff, Services and Defence Research and Development Organisation (DRDO), areas in which offsets will be preferred;
- (g) Promote exports of defence products and services; and
- (h) Provide advisory clarifications on the policy and procedures (in consultation with the Acquisition Wing wherever necessary).^{59,60}

⁵⁹ In addition, under DPP-06, DOFA was to assist the Acquisition Manager in the Acquisition Wing of the MoD in the implementation of the offset contract (DPP-06, para 10.1 at 39). This assistance function has now been shifted to an "Offset Monitoring Cell" in the MoD under the new 2008 regulations (DPP-08, para 10.1 at 47), although sub-clause (c) as above continues to remain on board without any modifications.

⁶⁰ Clause (h) has been completely deleted in the latest revisions to the procurement procedures made in DPP-08, indicating perhaps the thinking that policy-based issues are best dealt with in the Ministry itself in a more *formal* environment.

However, DPP-06 suffered, to some extent, from a lack of clarity about the role of DOFA. For instance, DPP-06 assigned this agency, inter alia, with the task of providing advisory clarifications on the policy and procedures (in consultation with the Acquisition Wing wherever necessary).⁶¹ DOFA was also to assist potential vendors in interfacing with the Indian Industry in identifying potential offset products/ projects.⁶² One of DOFA's mandates was, and remains so even today, to assist the technical committee in evaluating offset proposals,⁶³ and to advise the high-powered "Contract Negotiation Committee" whenever required.⁶⁴ DOFA was also to assist the concerning Acquisition Manager in monitoring the implementation of the offset contract.⁶⁵ Taken together, these provisions would appear to place DOFA in an extremely important role in assisting the parent MoD in the evaluation of offset proposals and in the monitoring of offset contracts.

Interestingly, however, DOFA was not associated under DPP-06 with any re-phrasing of offset obligations within or outside the time-period of the main contract under *normal* or "*force majeure*" conditions. This limited association of DOFA (only with technical evaluation and monitoring the discharge of offset obligations) tends to support the hypothesis that DPP-06 did not adequately define DOFA's role in the offset contract formation or performance periods. Figure 6 on the next page shows the changing role of DOFA from DPP-05 to DPP-08 during various stages of the main procurement contract (MoD has had a role throughout the currency of the offset contract, right from DPP-05 upto the current regulations (DPP-08).

⁶¹ DPP-06, para 3.1(h) at 36. This role has now been removed from DOFA's charter of responsibilities under the new DPP-08. See more details at *supra* n.39 and n.40.

⁶² DPP-06, para 3.2 at 36.

⁶³ See DPP-06, para 3.1(b) at 36; DPP-08, para 3.1(c) at 44.

⁶⁴ See DPP-06, para 8.2 at 38; DPP-08, para 8.2 at 46.

⁶⁵ DPP-06, para 10.1 at 39. See also *supra* n.39.

Under the new DPP-08, DOFA now has no specified role in assisting the concerned Acquisition Manager in monitoring the implementation⁶⁶ of the offset contract, which responsibility has now been taken over by the “Offset Monitoring Cell” in the MoD. However, DOFA now has a specifically assigned role in assisting the Acquisition Wing in re-phasing of the offset obligations within and outside the period of the main contract under both normal⁶⁷ and “force majeure” conditions.⁶⁸

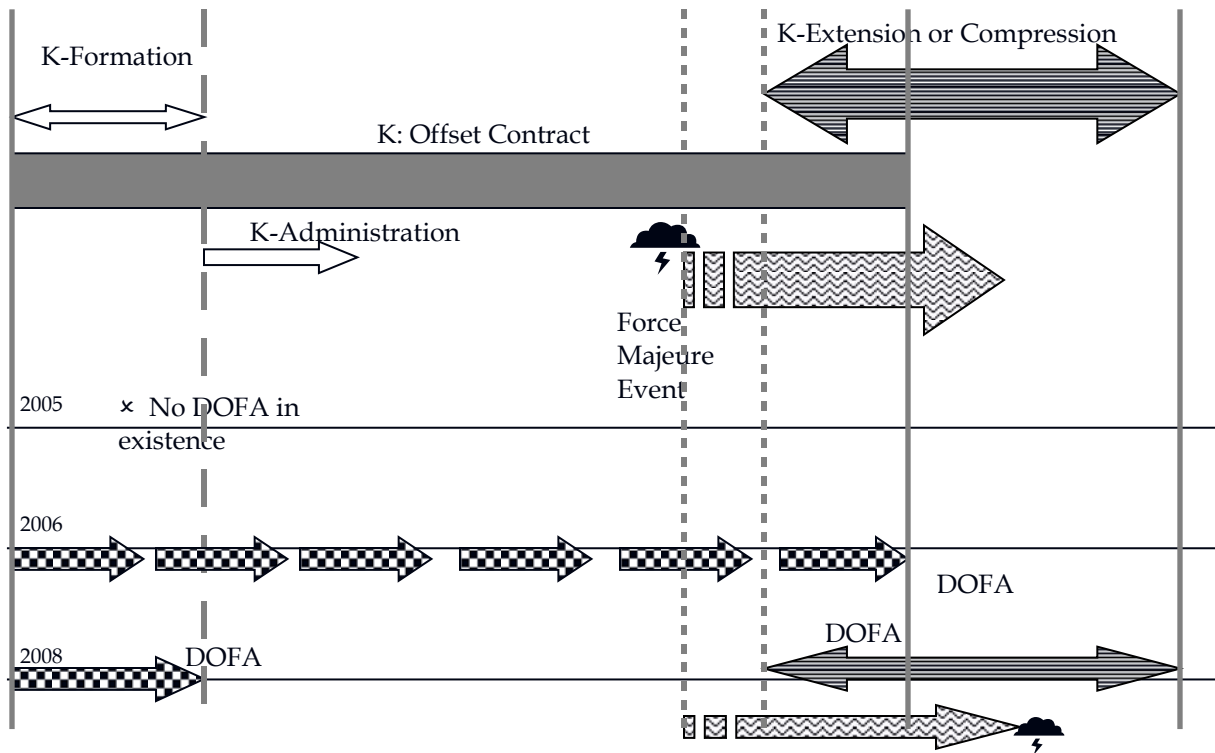


Figure 6: Changing Role of DOFA during various stages of the main procurement contract

⁶⁶ See DPP-08, para 10.1 at 47.

⁶⁷ DPP-08, para 10.2 at 47.

⁶⁸ DPP-08, para 10.3 at 47.

On balance, it is easy to see that DOFA is currently, under the new regulations, expected to discharge these new responsibilities *without* being involved with *regular* monitoring of implementation of the offset contract. The situation has thus now moved to a relatively weakened role for DOFA, which appears to be not entirely in conformity with its stated purpose and objectives of facilitating formation of industrial alliances and improvement of offset contract administration.⁶⁹ While the disassociation of DOFA with providing advisory clarifications on the policy and procedures could be justified on grounds of avoiding possible conflicts of interest since DOFA has membership from private industry associations,⁷⁰ the lack of continuity of DOFA's association with the offset contract administration could have policy reasons other than a mere conflict-of-interest concern. The present situation would suggest that there is definitely a need to clearly and unambiguously specify its role, since it heightens ambiguity concerns beyond the levels that already existed under the previous DPP-06 regime.

E. Banking of Offset Credits

DPP-06 provided that only contracts for export of defence products or services or investment made after the signing of the main contract would be reckoned for discharging offset obligations.⁷¹ This was perceived by the industry to be unduly restrictive, and there had been an important demand for bringing in provisions to allow for banking of offset credits to allow for greater flexibility in planning for discharge of

⁶⁹ See *supra* n.39 for a list and history of DOFA's objectives.

⁷⁰ "DOFA will function under the supervision of a designated Joint Secretary of the Dept of Defence Production, and will have representatives from the Service HQrs, HQ IDS, DRDO, DPSUs, and OFB as well as from CIL, FICCI and ASSOCHAM and other agencies as deemed necessary" (DPP-06, para 3.2 at 36). This paragraph about the composition of DOFA, or anything similar, no longer exists under the revised DPP-08. Apparently, however, DOFA's composition has not undergone any changes.

⁷¹ DPP-06, para 6.4 at 38.

offset obligations by vendors.⁷² The origin of these demands lay in the fact that it is possible for a vendor to end up discharging offset obligations in excess of the legally required minimum. Further, once having established business relationships in the procuring country, a vendor may even voluntarily want to continue exports or investments beyond the particular procurement contract to capitalize on economies of scale or to make use of attractive market opportunities;⁷³ and vendors may even want to generate potential offset credits through programmes undertaken prior to the award of the main contract to get an early-mover advantage.⁷⁴

DPP-06 did not initially contain any provisions allowing for banking of offset credits, perhaps on account of the fact that permitting such banking tends to allow vendors to pass off regular business transactions as “offset” entitlements, when they would have in any case undertaken those transactions as routine commercial investments and trade activities. The provisions have now been modified and DPP-08 allows foreign vendors to create offset programmes in anticipation of future obligations.⁷⁵ Offset credits so acquired can be banked and discharged against future contracts, but they are not transferable except between the main contractor and his sub-contractors within the

⁷² See e.g. U.S.-India Business Council, Objectives for 2007-08, <http://www.usibc.com/usibc/advocacy/objectives.htm> (last visited December 6, 2008); and India Defence Review, Interview with Lt. Gen. S. S. Mehta, Director General CII (March 24, 2008, Vol. 23.1), <http://www.indiandefencereview.com/?p=222> (last visited December 6, 2008)

⁷³ Suman, *supra* n.57.

⁷⁴ *Ibid.*

⁷⁵ DPP-08, para 2.1(d) at 44 allows creation of offset programmes in anticipation of future obligations only in the main text of the regulations. However, clauses 1 to 5 of the part titled “Banking of Offset Credits” (Annexure VII to Appendix D of DPP-08, at 55) contain provisions to the effect that a vendor could also create extra credits by exceeding his obligations under the main procurement contract. Thus, even though the main text of the regulations speak of a limited scenario of creation of offset credits in anticipation of obtaining a future contract, a full reading of the regulations reveals that there are provisions for both anticipatory credits in the context of future contracting, as well as for excess credits in the context of current contract performance.

same acquisition programme.⁷⁶ A vendor will be able to discharge the banked offset credits for the RFPs which are issued within the two financial years of the date of approval of the banked offset credits.⁷⁷

This regulatory guidance is however limited. It is easy to see that banking of offset credits brings with it immediately a number of issues like the “competent authority” for certification, “valuation” and “timing” of certification, handling of disputes regarding certified amount or date, tradeability,⁷⁸ and verifiability of a certified offset credit.⁷⁹ In a claim for certification of an offset prior to obtaining a future procurement contract, the relevant “time” could be the date on which the offset was discharged,⁸⁰ or alternatively

⁷⁶ DPP-08, para 2.1(d) at 44; Clause 3 of “Banking of Offset Credits”, Annexure VII to Appendix D of DPP-08, at 55.

⁷⁷ Clauses 4 and 5 of “Banking of Offset Credits”, Annexure VII to Appendix D of DPP-08, at 55. The cut off date would be 1st April and 1st October of the financial year. As an illustration, offset credits which have been banked on or after 1st April 2009 would be valid for discharge against RFPs issued up to 30th September 2011. Similarly offset credits banked on or after 1st October 2009 would be valid for discharge against RFPs issued up to 31st March 2012. Further, if a vendor is able to create more offsets than his obligations under a particular contract, the surplus offset credits can be banked and would remain valid for the period of two financial years after conclusion of the said contract. The surplus offset credits would be valid for discharge against the new RFPs which would be floated within this period. Wherever the offset banking/discharge is done by way of investment in Indian defence industry and R&D, the related foreign investment needs to remain valid and active throughout the duration of the MoD contract in relation to the RFP.

⁷⁸ Suman, *supra* n.57. See also Thomas Mathew, *Getting the Defence Offset Policy Right*, The Economic Times (December 5, 2008), available online at <http://economictimes.indiatimes.com/articleshow/3794199.cms>.

⁷⁹ Only the first of these issues, viz., “competent authority for certification” has been resolved at present. A senior official in the MoD in the rank of Joint Secretary to Government of India has been notified as the competent authority to certify under Public Notice No. 1/OMC/08 (F.No.14 (1)/2008/D(S-III)/OMC) dated September 17, 2008. The same communication also notifies a senior officer in the rank of Director in the Department of Defence Production, MoD as the officer-in-charge of the Offset Monitoring Cell. The notice can be viewed by first clicking on the link “New Additions”, and then subsequently on the link “Offset Banking Procedure” at MoD’s site at <http://mod.nic.in/>.

⁸⁰ For instance, an offset obligation could be treated as discharged on the date(s) on the investment was made, or when the goods or supplies were actually exported.

the date on which the claim was presented for certification, or on the date on which the claim was finally certified or approved.⁸¹

A similar problem in regard to the timing and valuation could arise in the case of discharge of excess obligations of offsets under ongoing procurement contracts. The certification of banked offsets, in the context of an ongoing procurement, may have to wait for the conclusion of the main contract and finalization of valuation thereof, in order that the exact quantum of excess, if any, may be certified. This would then also raise issues regarding timing of valuation of the excess credit, especially in relation to transactions where foreign exchange fluctuations have an impact, since the obligation may have been discharged at a previous point of time and the certification thereof takes place much later. It is a fact that contracts tend to become disputed between parties, and that therefore such disputes may result in legal proceedings not necessarily limited to arbitration. It is also possible to envisage a situation where a vendor may “withdraw” such excess offset activities from the claims/ certification process, and use them instead for future anticipated RFPs, but the incentive of immediate tradeability, even though limited to sub-contractors, would be absent in the latter case.

DPP-08 presently grants recognition to offsets at the time of approval. Recognition at the time of approval as against recognition at the time of offset activity may not only create an incentive to a vendor to file a claim as late as possible, but even an incentive for the vendor to file an incomplete claim in order that the resolution thereof takes a considerable amount of time so as to enable him to get a date of approval of offset that

⁸¹ Clauses 4 and 5 of “Banking of Offset Credits”, Annexure VII to Appendix D of DPP-08, at 55. *See also* Ernst & Young, *supra* n.3, at 4. DPP-08 specifically mentions a time of two years from the “date of approval” of the banked offset credits, which would mean that the third alternative out of those mentioned in this discussion is available under the current Indian defence procurement regulations. Further timeframes, for instance, those relating to period between discharge of obligation and filing of claim for offset credits, or the period between filing of claims and approval (certification) of offset credits have not been indicated in the regulations.

is as late as possible as possible. In fact, there may be such a time-gap between the discharge of the offset and the date of approval that in fact, the activity that is being certified may have little or no relevance from an offset standpoint and may in fact merely constitute an ongoing business transaction rather than achieve the benefits that offsetting of contracts seeks to achieve. The essential purpose of offset agreements being to specifically motivate eligible offset activities,⁸² such an exercise may lose its purpose and may prove to be infructuous and even counter-productive under certain conditions.⁸³ This becomes especially relevant, considering that offset obligations in India are essentially indirect, allowing for a very wide scope of activities, which may not always accrue intended benefits.⁸⁴ For instance, India already has a robust and thriving software industry, and the inclusion of defence-related software in permitted offset activities may be lucrative to vendors while not being a very attractive proposition from a national interest viewpoint.⁸⁵

The regulations are silent on the transferability of offset credits banked in anticipation of future contracts, as no subcontractors would exist at this point of time to whom the credits could be transferred in case the vendor fails to get an award. At some point of time, therefore, the regulations may also need to open up the limitations on swap to perhaps allow for full tradeability of offset credits generated either in anticipation of future contracts or generated through excess performance. If banking is allowed, trade in offsets is the next step, as both are intrinsically and mutually contingent.⁸⁶

⁸² Richard J. Russin, *Offsets in International Military Procurement*, 24 Pub. Cont. L.J. 65, 69 (1994).

⁸³ Suman, *supra* n.57.

⁸⁴ *Ibid.*

⁸⁵ *Ibid.*

⁸⁶ *Ibid.* On the other hand, a recent study conducted in 2007 recommends that trading of offsets should not be permitted (CII-RELIGARE, Study on Offset Policy for enhancing Industry Participation in Defence Production (2007), copy of extracts of the study available on file with the author).

Since the regulations place a restriction on the parties eligible to receive banked offset credits, namely, sub-contractors under the same acquisition program, mechanisms would need to be instituted so that unauthorized transfers do not get certified by mistake or otherwise. In fact, the introduction of a system of banking requires, *a priori*, the setting up of a registry of banked offset credits which can verify, for the benefit of sub-contractors, as to the value, time, and qualifications or easements, if any, of an offset held by a prime contractor that the prime contractor may be offering to sub-contractors in exchange of a consideration. Such a registry would also help acquisition managers or other official agencies involved in the monitoring of discharge of offset obligations to ensure that an otherwise “ineligible” offset credit does not get accounted for against a contractor’s performance or obligation. Some other issues that require further regulatory guidance in the context of banking of offset credits relate to issues such as assignment by bidders of these credits to more than one RFP at a time, subsequent reassignment of assigned credits from one RFP to another at the option of the bidder, withdrawal of assigned credits by bidders from one RFP and re-banking them for reassignment at a later stage, and legal status of credits once assigned by a bidder to an RFP that is subsequently cancelled (or in cases where the bidder is not the eventual contract awardee).

F. Exemptions from Offset Obligations

Under the DPP-08, like its predecessor DPP-06, the DAC is authorised to prescribe higher offset percentages or waive off the requirement in very special cases, depending upon the DPP-06 criterion and/or the type of acquisition.⁸⁷ Arguably, the DAC also

⁸⁷ It may however be noted that the defence procurement regulations in India compare favorably as compared to standard international practices. At 30% of indicative cost of INR300 crore, the minimum offset obligation in Indian defence contracts would be INR90 crore or roughly \$18 million. The international average for an offset agreement is \$101 million, starting from a minimum agreement value of \$2 million. Most countries require a 100% offset obligation vis-à-vis the main procurement contract, including many signatory-states to the Government Purchase Agreement (GPA) under the WTO (*Source:*

retains the authority to reduce or waive off offset requirements after the execution of the contract based on exceptional grounds criterion, just as the government reserves to itself the authority to extend offset contracts beyond the period of the main procurement contract.

DPP-08 has now allowed defence procurements under the “Fast Track Procedure”⁸⁸ (FTP) as completely exempt from offset obligations. Thus, while modification of an existing contract through ordering of additional quantities will attract increased offset obligations, ordering of supplies under FTP will not attract such obligations. Since the decisions to go in for FTP for particular purchases is made at extremely higher levels of authority, it is unlikely that the exemption can be misused by vendors to push sales of additional items by the adoption of the FTP rather than ordinary additional items’ ordering under ongoing contracts, during the currency of the ongoing contract or very soon immediately after the main contract has expired.⁸⁹ There may be a case, however, that since industrial base mobilization and domestic absorption of critical defence

U.S. Department of Commerce, *Impact of Offsets in Defence Trade: An Annual Report to Congress*, Department of Commerce, United States of America: Washington (December 2007), available at <http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/final-12th-offset-report-2007.pdf>).

⁸⁸ Fast Track Procedure for meeting urgent operational requirements was first promulgated vide MoD ID No: 800/SS (A)/2001 dated 28 Sep 2001. The procedures were updated in DPP-06 as “The Fast Track Procedure-2006” (FTP) and have been continued in DPP-08. The objective of FTP is to ensure expeditious procurement for urgent operational requirements foreseen as imminent or for a situation in which a crisis emerges without prior warning, and FTP will cover acquisitions undertaken by the Ministry of Defence and Defence Services under “Buy” category or outright purchase. FTP covers procurement of new equipment as well as procurement of equipment already inducted into service. Essentially, filed trial procedures are eliminated and simplified procedures are permitted through single/multi-vendor purchase or procuring from “friendly” countries ex-stock or through lease. See Chapter IV “Fast Track Procedure – 2006”, DPP-08 at 191 to 199 for more details on FTP.

⁸⁹ In some cases of repeat orders relating to subsequent procurement of already contracted equipment (DPP-08, para 64 and 65, at 18-19), the guidelines are silent on the issue whether offsets would be applicable in such cases where only a commercial RFP is issued to the existing supplier or where a fresh techno-commercial RFP is issued soliciting offers from multiple vendors. However, since repeat orders in at least the first category of cases would be issued under the terms of the existing contract, it is being assumed here that an enhanced offset obligation, commensurate with the value of additional items orders, will apply.

technologies are important policy objectives, that a delayed offset contract performance could be negotiated under such procedures so that formation and execution of an offset contract does not delay the process of ordering of urgently needed equipment, instead of completely exempting FTP procurements from offset obligations.

VI. CONCLUSIONS

Offset contract administration is complicated “business”, and these contracts need close monitoring and support mechanisms in order to achieve desired objectives of industrial base mobilization and acquisition of core competencies in domestic manufacturing and support services. Quite apart from the industry demand for indirect offsets under defence procurement regulations, which will require even tighter monitoring of offset contracts, there are now some indications that there may be mandatory offset requirements in general government purchasing on the horizon: a *civilian* offset policy using countertrade measures to enable access to sophisticated technology, investments and joint ventures.⁹⁰ It is therefore possible within the next few years that India will witness offset contracting on a much aggressive and wider scale than hitherto observed and experienced, and thus present a far more challenging and dynamic area of economic activity that will need mature and careful handling.

As discussed in this paper, the use of offset agreements requires implementing a number of consequential, well-designed and focussed techniques in contract administration. The detailed legal analysis in this paper leads us to conclude that existing offset contract clauses are in need of some degree of refinement and detailing,

⁹⁰ Confederation of Indian Industry, Offset Policy will leverage India’s buying power to upgrade technology, improve infrastructure and make it part of the global defence supply chain (February 13, 2008), http://www.ciidefence.com/pressreleases_015.asp?id=3, last visited December 9, 2008.

in order that they are seen to be offering enhanced predictability and reliability in the implementation process. These changes will lead to increased bidder confidence in their ability to participate in the contracts in a meaningful and mutually beneficial manner, and the Government will also benefit from such an exercise, as the same is likely to lead to more effective and timely discharge of offset obligations by defence contractors. In particular, there may be a need for such detailing and refinement in the provisions particularly relating to banking of offset credits by laying out the complete mechanisms for certification of offset credits in terms of value and time-stamping, establishment of a registry allowing private vendors and public officials to quickly verify claimed offset credits, and issues regarding transfer of credits between connected or unconnected vendors. The statutory role of DOFA in the contract administration process needs to be more clearly specified, especially vis-à-vis the Offset Monitoring Cell. DOFA's actual role being limited to the contract formation process and only force-majeure conditions does not appear to be consistent with its broad and important mandate.

Suggestions outlines above will provide the requisite regulatory guidance and legal framework for effecting reforms in offset contracting under defence procurements and are expected to directly impact the efficiency of offset contracts. Even without some of these elements, the scope for procurement reform in offset contracts is considerable, and the range of possible options and strategies for further strengthening the ability of these contracts to achieve their desired objectives remains an enticing area for applying legal analytical techniques to public procurement and contracting.