Defense Opportunities: at takeoff or crossroads?

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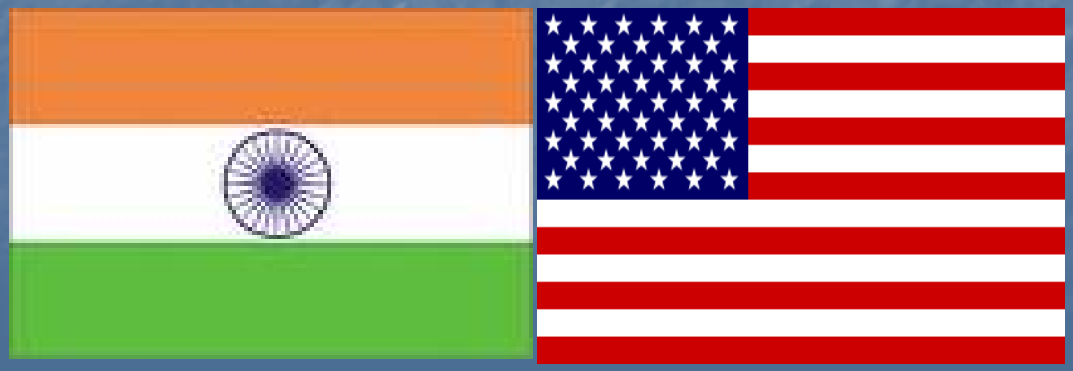

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India's National Objectives

- India seeks to establish itself as a regional power with global influence.
- The 2011 Defence Production Policy (DPP) asserts objectives of self-reliance.
- Preference is to be given to indigenous design, development and manufacture of defence equipment.
- Government is to promote larger involvement of the Indian private sector

India's Defence Requirements

- A rising power, India's regional role will grow
- Defense spending has risen from $11B ($4B capital) in 2002 to $35B in 2012 – 42% ($15B) for capital items
- India signed $35.6B in defense contracts from 2007 – 2011
- India ranked 9th worldwide in military expenditures in 2010 (SIPRI)
- Forecasts indicate $100B in military purchases over next 10 yrs

"The Government is expected to spend approximately $54 billion on defense procurement from foreign vendors during 2011-2015. As a part of a 30 percent offset, winning vendors are anticipated to source components and/or services worth $18 billion from the Indian aircraft component manufacturing and services industry."

Frost & Sullivan, "Strategic Analysis of Indian Aircraft Component Manufacturing and Services Industry," 19 January 2012

~ 70% of India's defense equipment have come from foreign sources

Signed Defence Offset Contracts Now Amount to $3.3B – and Deals Worth $10B Are In The Pipeline

U.S. Participation To Date

- U.S. is now the largest defense supplier to India
- India has awarded American companies ~$12B in defense contracts since 2007 (34% share)
- Notable U.S. successes include C-17, P-8I, C-130, Sensor Fuzed Weapon; Ultra-Light Howitzer; prospects include Jaguar Re-engine
- Disappointments include MMRCA, RAW Air Surveillance, MH-60
- India has shown it respects U.S. military hardware, but
  - Most sales (by $) are platforms (P-8, C-17, C-130)
  - Most sales (by $) are through FMS (C-17, C-130, SFW)
  - Boeing dominates, followed by Lockheed Martin, GE
  - Broad representation of U.S. industry is not present
  - Few U.S. firms have secured DCS award under the DPP

India now is the third largest purchaser of US arms. The U.S. Defense Security Cooperation Agency reported sales contracts worth $4.5 billion in FY 2011.

The View of U.S. Firms on India Defense

- Few firms have succeeded (and mostly by FMS)
- Those who have concluded sales worry about offsets
  - There are real questions about "absorption" of capacity
  - Offset rules do not allow gestation of new partners
  - New ventures face challenges of quality and supply assurance
  - FDI limits impair confidence of U.S. firms in partner output
- The DPP is seen as unwieldy and unpredictable
  - "Rule bound" with little "play in the joints" for sound discretion
  - Risk of being gamed by end-game withdrawal, artificial prices
  - "NCNC" trials are expensive but without outcome assurance
  - Actual awards seen as few, process cost & duration high
- There is fatigue with the process
- There are concerns about reputation exposure
- Questions are asked about risk-adjusted return

India's Defence Procurement Procedure

- **2001:** India opened its defence industry sector to 100% Indian private sector participation, with Foreign Direct Investment (FDI) allowed to 26%.
- **2005:** DPP released to increase accountability and transparency and to promote free competition and impartiality.
- **2006:** DPP establishes formal guidelines for capital procurement and sets offset guidelines including 30% offset requirement.
- **2008:** DPP introduced three principal categories of defence acquisition:

  "Make" – high technology systems designed, developed and produced indigenously

  "Buy" – outright purchase including "Buy (Indian)" (≥30% Indian) & "Buy (Global)"

  "Buy and Make" – purchase from a foreign vendor followed by licensed production and/or indigenous manufacture in India
- **2009**: **"Buy and Make (India)"** added – RFP issued only to Indian industry -- . may be issued to both DPSUs and private sector companies; requires 50% indigenous content on a cost basis.

DPSUs are not subject to the D.P.P.

D.P.P. not used for system development

Key Features of the DPP

- Principles: Self reliance – Transparency –Expeditious –Fair competition
- Types of Procurements: "Normal," "Fast-Track" and "IGAs"
- Categories: Buy (Global | Indian); Buy & Make (B&M| B&M (Indian); Make
- RFP is key event: includes specifications and requirements, contractual obligations, price and delivery terms, offset requirements
- "Single-stage, Two Bid" System: requires two fully compliant tenders
- Three evaluation stages (technical, field, staff) precede the Commercial phase. Only the lowest bidder (L1) proceeds to Contract Negotiations
- Offsets:
  - Commitment to Offset compliance – due at RFP response
  - Separate Technical Offset and Commercial Offset Proposals
  - Offset Offer evaluate in two stages: Technical Offset Offer first, to assure compliance, then Commercial Offer Offset Proposal, opened along with main offer, can be revised at this stage
  - Commercial Offset Offer has no bearing on L1 selection

Key Questions as to the DPP

- What explains the "rule-based" approach of the DPP?
- Has the DPP succeeded? Where has it fallen short?
- Is the DPP constrained by the size and training of the "acquisition work force"?
- Versus "L1," should the DPP permit "best value" acquisition?
- Can the DPP recognize (and evaluate) life cycle costs?
- What barriers frustrate evaluation of FMS offers under the DPP? What solutions?
- Can the DPP accommodate sole-source awards?
- How could the DPP evolve for application to design and development projects?

The DPP: Recommendations (I)

- Adjust the DPP for Better Alignment with FMS Procedures
  - Objective is "fair" competition for "comparable" requirements
  - India could state "life cycle" requirements to align with sustainability costs and commitments in FMS LOAs – but India need not buy "total package"
  - The L1 determination could compare hardware and sustainability costs
- Securing "Best Value" in Direct Commercial Sales under the DPP
  - Premise is that lowest L1 bid is not exclusive measure of best value
  - Qualitative factors such as superior performance, lower risk and life-cycle support have real-life consequences for cost and mission satisfaction
  - The SQR could identify qualitative discriminators (positive, negative)
  - The Tender Document could describe qualitative factors and present a numerical evaluation scheme weighted by priority
  - A stage could be added for "discussions" after the Technical Evaluation to vet qualitative factors and assure vendors of opportunity for "best offer"

The DPP: Recommendations (II)

- Revise the Selection to weigh reflect Price and Qualitative Factors (including Risk)
  - Selection of a higher price offer would require justification of the "cost-technical" tradeoff and ratification by high level MOD officials
  - Gaming of the L1 selection (by artificial price) will be discouraged
  - Transparency can be assured by documentation of selection decisions
  - Disappointed bidders can be extended MOD or judicial review if selection decision is "unreasonable" or a "violation of law or regulation"
- The MOD should enhance its acquisition workforce
  - Seek additional funding
  - Provide additional training and professional development
  - Encourage Armed Forces to treat procurement as a favored specialty
  - Document policies, priorities, process and "best practices"

Integrity Considerations: Requirements

- Pre-Contract Integrity Pact
  - A binding agreement for all proposals above Rs 100 Cr (~$22M) to ensure procurement process and that there is accountability.
  - Both parties promise that neither they nor any of their officials will offer or accept any kind of illegal gratuity during the procurement process.
  - Earnest money deposit is Rs 1 Cr ($220,000) in cases where estimated cost is between Rs 100 - 300 Cr ($22M - $66M) and Rs 3 Cr ($660,000) if above Rs 300 Cr.
  - Violation may lead to legal and other actions that include:
    - Termination of negotiations
    - Cancellation of contract if signed
    - Call on Bank Guarantees
    - Debarment
  - Independent monitors are appointed in in consultation with the C.V.C (an independent statutory body mandated to look into complaints about violation of the Integrity Pact)

India's Anti-Corruption Regime

- Prevention of Corruption Act
  - Prohibits and penalizes corruption of public servants
    - No exception for "facilitating payments" (as in FCPA)
  - Applies to the maker and recipient of a bribe; abetment also an offense
  - Public servants may neither accept nor retain any "gratification" as a motive or reward from taking/forbearing from an official act
  - Private persons may not accept or obtain any gratification as motive or reward for "inducing" any public servant, "by corrupt or illegal means" to take or forbear from an official act
  - Offenses are punishable by imprisonment and/or fine

However: as evident from the "Anna Hazare" movement – and the Jan Lokpal bill – the widespread public perception is that corruption remains endemic

Integrity Considerations: Requirements (III)

- U.S. Foreign Corrupt Practices Act (FCPA)
  - Anti-bribery provisions prohibit bribes (or offers to bribe) made to foreign officials, political parties, etc., "whether made directly or through a third party for the purpose of obtaining or retaining business or securing a business advantage."
  - Accounting provisions require accurate books and records and adequate accounting and financial controls – no allegations of bribery are required
  - Sanctions include criminal and/or civil penalties, loss of export licenses, debarment or suspension
- U.K. Anti-Bribery Act (UK)
  - Three offenses (bribery, taking a bribe, bribing a foreign official) apply to UK nationals or residents, entities incorporated in the UK, or foreign persons acting in the UK
  - A strict liability offense (failure on the part of a corporation to prevent bribery) applies to UK entities and to entities "carrying on business" in the UK, even if incorporated elsewhere
- **Comparing the FCPA and the Anti-Bribery Act**
  - The Bribery Act applies to bribes offered or given to any person; the FCPA applies only to corruption involving foreign officials; no exception for "facilitating payments"
  - No "corrupt intent" is required for the offense of bribery of a foreign official
  - Subject to the defense of "adequate procedures," an offence is present under the Bribery Act for failure to prevent bribery

Integrity: Practical Consequences

- Fear of accusation produces risk-adverse official conduct if not (near) paralysis
- "Web" of Overlapping Requirements Presents Challenges
  - India's acquisition rules are complex; objective of Armed Forces may be uncertain, but risks are present in the use of outside experts
- Corruption consequences constrain engagement by US & UK OEMs
  - Conduct which may be "ordinary" by local mores can violate the FCPA and/or the UK Bribery act
  - 26% FDI limit raises questions of "discipline" or control over JV acts
  - FCPA applies both to "controlled" and "affiliated" entities – and agents
- Public and media attention deter some from defense sector work
  - Losing bidders have initiated CVC investigations – e.g., *Scorpene*
  - Pre-award "clearance" has been sought from CVC (single source)
  - Reward of MOD contracts may not justify reputational risk

Integrity Considerations: Questions

- How do public corruption scandals affect private sector participation in defense?
- What are the biggest risks to U.S. and Indian companies?
- What risk assessment and management techniques suffice?
- Is the DPP "rule bound" by integrity considerations?
- In the present environment, can acquisition proceed on where exercise of discretion are required?
- Would more rigorous enforcement restore trust and confidence?
- If not the Lokpal bill (Ombudsman), then what?

Integrity: Recommendations

- Private Sector
  - "Best practices" exist to manage risk – but require rigor emphasize the importance of "knowing your partner"
    - Documentation of Policies, Practices & Prohibitions
    - Thorough due diligence of prospective partners/reps
    - Contractual protection, e.g., Reps & Warranties, terminate on violation
    - Disciplined record-keeping, financial controls and audits
    - Periodic compliance reviews; Internal reporting mechanism
    - Training; Certifications internally and of outside support
- Public Sector
  - Enactment of Lokpal bill and creation of Ombudsman?
  - Assuring independence of Central Bureau of Investigation?
  - Enforcement of existing laws, e.g., PCA, Integrity Pacts?
  - Debarment of Companies found in violation?

Offset Requirements - Introduction

- Since 2005 the DPP has required offsets for major defense contracts.
- The requirement applies to all "Capital Acquisitions" in the "Buy (Global)" and "Buy and Make (Global)" for acquisitions > Rs. 300 crores (~$60M).
- Uniform offset of 30% of acquisition cost (for "Buy Global") and 30% of foreign exchange component (for "Buy and Make").
- Defence Acquisition Council (DAC) has power to waive or vary.
- 2011 Amendments
  - 1- expanded eligible products to include civil aviation and homeland security
  - 2 – allows Tier-1 sub-vendors to discharge offset obligations for their workshare

Role of Defense Offset Facilitation Agency (DOFA)

- Facilitate implementation
- Assist vendor interface
- Monitor offset provisions
- Interact, consult with Indian Armed Forces, DRDO and MOD

Revisions reportedly Will be released soon

Offset Requirements – Basic Mechanics

- How are offset requirements satisfied?
  - Direct purchase/execution of export orders for eligible products
  - Purchase of eligible services provided from Indian industry
  - Investment for infrastructure for service, co-development, JVs and co-production of eligible products and services
- What are eligible products?
  - Defense products, products for internal security, civil aero
- What are eligible services?
  - Maintenance, overhaul, upgrades, life-extension, engineering, design, testing services, QA and training
- Other key features
  - Co-terminus with main contract
  - Surplus credits can be banked for 2 years (but not transferred)
  - Penalties of 5% of unperformed annual obligation

Offsets: Questions

- How well has India's offset policy worked?
- What are the principal restraints on success?
- Is India's capability to partner or satisfy offsets already absorbed?
- How much will it help to include sub-tier supplier?
- Should multipliers be granted for ToT? For SME participation?
- Should the "credit sphere" be expanded outside A&D and homeland security?
- Do current FDI limits operate against achievement of offset goals?
  - Why exclude offset credit if 100% U.S. owned firms are: in India, licensed, using Indian employees and operating under Indian laws?
  - As to FDI, should not the Government distinguish between companies in India which do civil aeronautics and those key for national defense?
- Are offsets worth their price?
- What could India learn from "best practices" of other countries?

Offsets: Recommendations

- Policy
  - Expand Eligible Purchases & Services to other national objectives
  - Increase allowable FDI < 26% for new ventures
  - Grant credit to U.S. firms using existing India aerospace subsidiaries
  - Incentivize ToT by using multipliers earned by technology delivery
  - Encourage use S/MEs w/ multipliers and allow banking for "gestation"
- Administration
  - Increase staffing and increase authority of DOFA
  - Establish "cycle times" for bureaucratic action
  - Confirm vendors may rely on DOFA rulings (certainty of actions)
  - Assure transparency through disclosure and regular reporting
- Implementation
  - Cap offset contractual liability with reasonable max penalties
  - Enable DOFA to grant relief for changed circumstances
  - Extend period of performance for offsets to 7-10 years

Private Sector Opportunities: Questions

- Why has India not engaged its private sector?
- Where are real opportunities for India's private sector?
- What restrains the private sector from participation?
- What is the proper relationship between PSUs and private concerns?
- Should the national government take a more proactive role?
- Is the private sector "frozen out" of design/development by the PSUs?
- Would an increase to the 26% FDI limit benefit India companies?
- How best to involve India's vibrant S/ME community?

Private Sector Opportunities

- On January 1, 2011, the Indian Government released a new document, the "Defence Production Policy."

> The objectives of the Policy are to achieve substantive self reliance in the design, development and production of equipment/ weapon systems/ platforms required for defence in as early a time frame as possible; to create conditions conductive for the private industry to take an active role in this endeavour; to enhance potential of SMEs in indigenization and to broaden the defence R&D base of the country.

  - It points towards increased opportunity for the private sector, in contrast to reliance upon the DPSUs and Ordinance Factories.
  - Also envisioned is greater use of "public private partnerships"
- Evidence to date is that this policy is more "aspiration" than real
  - Design and development are exclusively the domain of the DPSUs
  - Indian private companies today cannot satisfy defense system needs

How well is it working? One perspective

- Commerce Ministry "Discussion Paper" of May 2010
  - India one of the world's largest importers of defence equipment
  - Cumulative defence budget grew at 13.4% CAGR from 2006-2009 (40% capital)
  - Ratio of defence article import to indigenous production: 70:30 (vs 30:70 goal)
  - Ratio of defence import to export: 194:1 (vs. 1.3:1 (Israel), 9:1 (So Korea))
  - 15% of India's defence equipment is "state of the art" while 50% is obsolescent
  - "Buy and Make" RFPs yet to achieve "fructified" results in production
  - Protection of DPSUs and OFs deters both foreign investment and new domestic private sector market commitment
  - Indigenous R&D (to "Make") has not kept pace with goals – ToT to DPSUs has proven "ineffective and slow"
  - Less FDI received less than sought –about 130 private sector companies have been issued letters of intent or manufacturing licenses but "on ground" accomplishment reportedly is limited

Export Control Overview

- License Jurisdiction:
  - Dual-use items: Department of Commerce (BIS)
  - Munitions: Department of State (DDTC)

  -- DTSA authorizes foreign access to U.S. military technologies
- Export controls apply both to FMS and Direct Commercial Sales (DCS)
- Current Licensing Policy towards India
  - No sanctions in place
  - India no longer cited on "Entities List"
  - India subject to same license rules/policies as other countries
- Key U.S. Objectives in Export Control
  - National security concerns
  - U.S. Foreign policy initiatives
  - Economic concerns
  - International agreements and regimes (e.g., NPT, MTCR)
- Special Sensitivities – Technology Release (e.g., LO/CLO, UAVs)

Export Control Concerns

- Key Issues from India Perspective
  - Reliability of U.S. as a supplier
  - Time and process required
  - Access to especially-sought technologies
  - Perceived "Affronts" to sovereignty
  - View that FMS adds unnecessary expense
- Key Issues from U.S. Perspective
  - Bilateral issues to be resolved (next slide)
  - Adherence to traditional objectives of U.S. Security Assistance
  - Assurance of technology security
  - Reservations about impact on domestic industrial base
- Key Issues from Contractor Perspective
  - Faster processing of licensing and greater certainty
  - Means for license aggregation, e.g., on a "project basis"

Key U.S.-India Bilateral Issues

- "New Framework in the India-US Defence Relationship" – signed in June, 2005 between India Minister of Defence and US Secretary of Defense.
  - Defence Joint Working Group and Defence Procurement and Production Group (DPPG) formed
- India-US Joint Declaration of March 2006 (President Bush and PM Singh).
- Concluded Agreements:
  - Agreement for Security Measures for Protection of Classified Military Information (GSOMIA) – signed January 2002.
  - Master Information Exchanges Agreement (MIEA) (to facilitate exchange of defence R&D and information) – signed February 2004.
  - RDT&E Agreement – signed January 2006.
- End-User Monitoring Agreement (EUM) – agreed to in 2009.

Issues to Be Resolved

- Logistics Support Agreement (LSA)
- Communications Interoperability and Security MOA (CISMoA)
- Basic Exchange and Cooperation Agreement for Geo-Spatial Cooperation (BECA)
- India not a member of the MTCR – though a professed "unilateral adherence"

Final Questions

- Are U.S. export controls a continuing barrier to U.S.-India industrial cooperation?
- As the U.S.-India strategic relationship evolves, how will it affect export controls?
- How important are bilateral agreements (e.g., CISMOA) to export control outcomes?
- How can the U.S. and India accommodate each other's perspective on CISMOA, MTCR, etc.?
- Is FMS the vehicle to improve export control outcomes? Can FMS be aligned with development scope?
- What might India seek for "exceptional" treatment vis-à-vis export controls? What can the U.S. do?

Enhancing the Bilateral U.S.-India Relationship

- Assumptions
  - India and the U.S. Share Key Security Objectives
  - Shared Characteristics and Values Encourage Growth in the Relationship
  - The Bilateral Relationship Ultimately Will Drive Industrial Opportunity
- Premises
  - FMS goes part way but cannot satisfy India's unique requirements
  - India wants U.S. to assist in design and development for India
  - The U.S. can assist India in certain of its goals for self-sufficiency
- Execution
  - The U.S. and India should identify a Project important to India's national objectives and consistent with U.S. military and security objectives
  - To secure ToT of necessary military technologies, India must find a common ground with the U.S. for technical bilateral agreements
  - India must create a means to award to a capable private sector company
  - The U.S. must deliver on export control and technology release
  - Successful execution of the Project should be a relationship centerpiece

Conclusions

India's regional role and global importance points to increasing investment in defense capabilities.

The U.S. is a natural partner to assist India in its security needs and in achievement of national economic aims.

For its own sake, India needs to take certain steps, including containment of PSU roles and to encourage its private sector and to facilitate the partnerships with foreign firms for technology transfer.

The DPP can evolve to be more flexible and to produce better acquisition outcomes while remaining fair and transparent.

Offset requirements create opportunity to create and sustain an Indian aerospace design and manufacturing sector – but only with changes to increase the sphere of work eligible for offset credit and with improvements to offset administration.

Increasing FDI limits is the single most important change for India to make to secure ToT and build a domestic aerospace industry.