

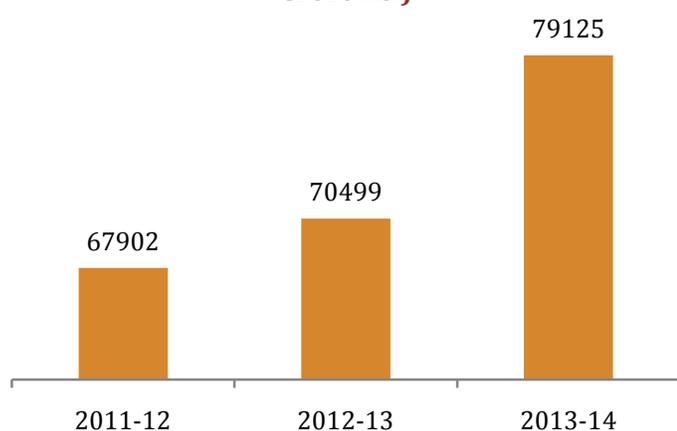
Defence Procurement and Production Scenario in India

With a budgetary allocation of nearly Rs. 2,47,000 Crore in FY 2015-16, defence remains a major expenditure head in the Union finances. Similarly, with 3rd largest standing armed forces in the world, increasing expansion of strategic interests and a technology driven transition in the nature of modern warfare; a robust policy ecosystem for procurement and production of defence material becomes profoundly important to ensure the operational readiness and lean functioning of the defence forces.

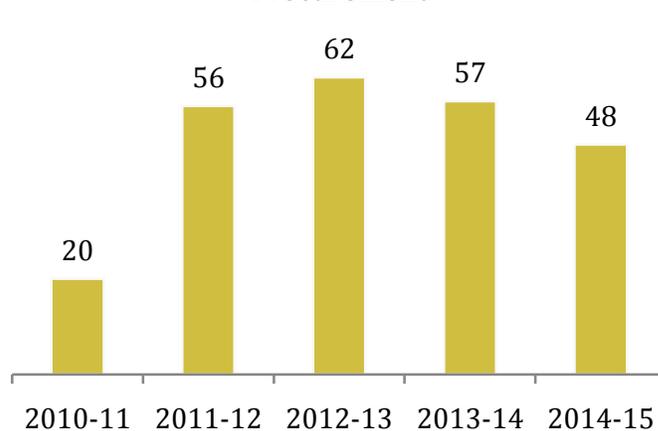
Current State Assessment of Defence Procurement/Production in India

India's defence expenditure (excluding pensions) accounts for around 1.7% of the GDP and nearly 18% of the total budgetary allocation. **Almost 38% (Rs.94,588 Crore¹) of the total defence expenditure is earmarked for capital acquisitions.** India is the biggest importer of arms in the world with over 15% share in total international arms imports. Nearly 50% of the content procured under the capital outlay is imported, as is a large percentage of raw materials/parts for equipment produced in India (especially under Transfer of Technology agreements. Due to historical legacy of restrictions on private production of defence material, the indigenous defence industry today mostly comprises of publicly run entities like the 9 Defence Public Sector Units (DPSUs) and 41 Ordnance Factories² (OFs). Even among the public sector, DPSUs account for approximately 65 percent of the total output of the defence public sector enterprises, which is about Rs. 44,000 Crores annually.

Actual Capital Expenditure on Defence (in Crore Rs.)



% of Imports in Total Capital Procurement



Private sector participation in defence sector remains in a nascent state. The private sector was allowed to participate in the hitherto reserved defence manufacturing sector in 2001 through Indian entities with up to 26% Foreign Direct Investment (FDI) and requirement of licensing. In November 2015, the FDI cap in defence sector

¹ For FY 2015-16

² This includes 2 Ordnance Factories at Korwa and Nalanda which are in project stage

was revised to allow up to 49% FDI under the automatic route, with FDI above 49% subject to government approval on a case-by-case basis. However, the impact on these policies on private investment has been marginal. **Till December 2014, Letters of Intent/Industrial Licenses were issued to by the Department of Industrial Policy and Promotion to 144 companies, of which only 49 have reported actual production.** Total FDI inflows of only Rs. 24.8 Crore were reported in defence sector till September 2015³.

Historical Evolution of Procurement Policy Framework

The post-independence defence procurement in India was heavily influenced by an ideological preference for public sector and high dependence on a single foreign exporter (the USSR). Technology transfer was limited, domestic capacity was often confined to integration of systems under licensing. In contrast, after the end of the cold war and economic liberalization in India, the expansion of diplomatic and military relations with multiple countries led to complex multi-vendor negotiations with insistence on local capacity building for joint research and development and co-production. **In line with the recommendations of the Public Accounts Committee of Parliament in 1989, the Government had issued the Procedure for Defence Procurement in February 1992, to put in place robust processes for defence purchases.** These guidelines provided for a long term perspective plan (LTTP), five year capital acquisition plan for armed services and 'Make' and 'Buy' decisions of procurement.

After the Kargil War, a Group of Ministers recommended significant changes in the procedures and institutions for defence acquisition in India. A **Defence Acquisition Council (DAC)** chaired by the Defence Minister was formed to consider and approve annual, medium term and long term plans prepared by an Integrated Defence Staff reporting to the Chiefs of Staff Committee. In addition, the local production and research efforts were to be co-ordinated with the needs of the Services through institutional mechanisms. A dedicated structure for defence acquisition was created under the **Director General of Defence Acquisition** which included technical, finance and acquisition managers with appropriate skill set. **A detailed procedural manual for "Buy" decisions was notified as the Defence Procurement Procedure (DPP) 2002.**

The scope of DPP 2002 was further revised in June 2003 to include 'Buy and Make' through imported Transfer of Technology (ToT) decisions. The document was further revisited in 2005 to include mandatory offsets for high value projects and 'Make' category. DPP 2006 added an in-built mechanism for review of the document every 2 years. The DPP was subsequently revised in 2008, 2009 and 2011; with each version expanding the scope, streamlining processes and putting in safeguards based on experience and stakeholder input. **A Defence Procurement Manual (DPM) was notified in 2009 to regulate procurement of goods and services under revenue head by organizations under the Ministry of Defence** (excluding DRDO, DPSUs and OFB). The DPM 2009 also applied to certain capital purchases like medical equipment.

A Defence Production Policy was also issued in 2011 which, *inter alia*, aimed at "substantive self reliance in the design, development and production of equipment/ weapon systems/ platforms required for defence in as early a time frame as possible⁴". The policy clearly stated a preference for "indigenous design, development and manufacture of defence equipment" whenever possible subject to urgency and criticality of the requirement. Any

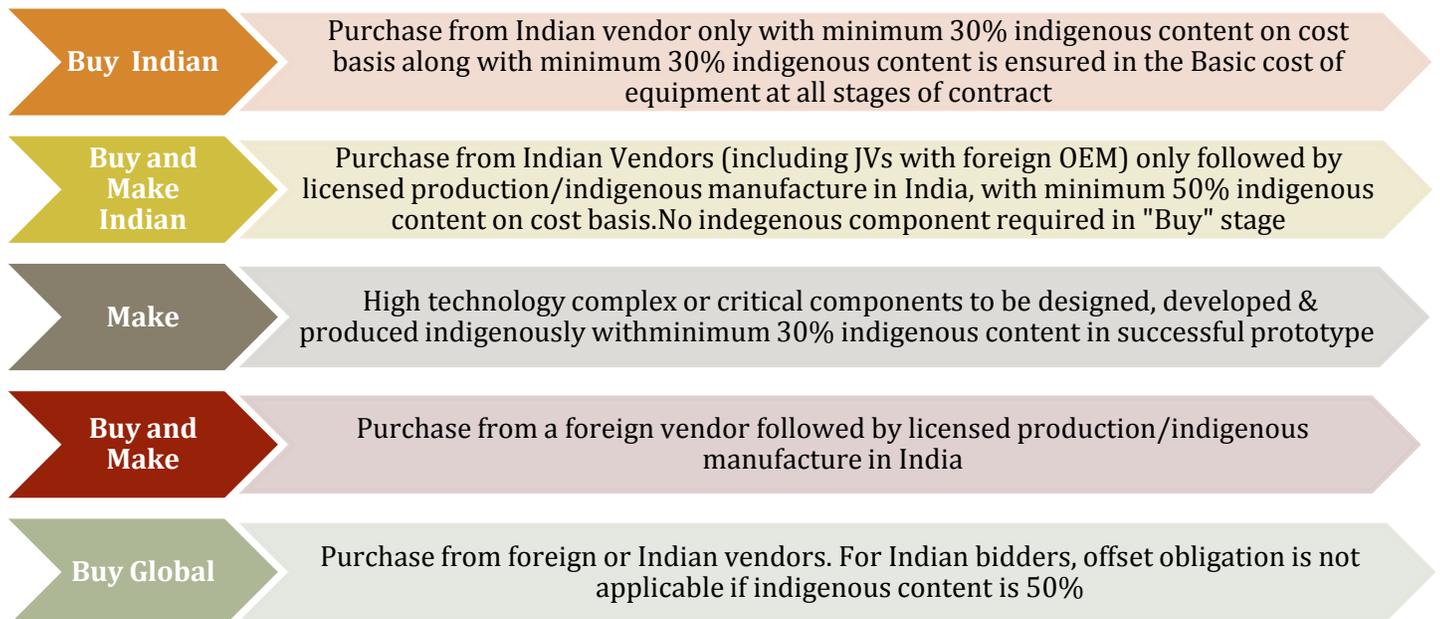
³ FDI Statistics, Department of Industrial Policy and Promotion

⁴ Defence Production Policy, Department of Defence Production (January 2011)

system required 10 years down the line as per the approved Long Term Integrated Perspective Plan (LTIPP) should be developed and produced within the country as per this policy. The policy also envisaged development of research capacities, simplification of “Make” procedures and realistic Qualitative Requirements (QRs) to encourage indigenization of defence production. **The Defence Procurement Procedures was again revised in 2013 to prioritize domestic equipment over foreign sourced systems, in line with the Defence Production Policy 2011.**

Defence Procurement Procedure 2013

The presently extant Defence Procurement Procedure 2013 (DPP 2013) was possibly the biggest push towards achieving the publically stated target of 70% reliance in defence procurement. **The DPP 2013 categorizes capital purchases in 5 categories in descending order of preference.**



The hierarchy of priority is required to be followed while processing a procurement proposal with the initiators of a procurement proposal to mention the reasons for excluding the higher preferred categories. **DPP 2013 also lays down the applicability of minimum 30 percent offsets for all procurements over Rs 300 Crore.** It incorporates provisions for banking of Offsets, provision for multipliers as incentives for technology and engagement with small industries and eligibility of offset products to include Inland Security and Civil Aviation etc.

The document also requires the Services to provide Services Quality Requirements (SQRs) which are broad-based and realistic with minimum required verifiable functional characteristics and the performance parameters given in SQR classified as ‘Essential Parameters’. **It mandates the freezing of SQRs before approval is given by the Defence Acquisition Council while reducing the validity of approval period, except for Buy & Make (Indian) category, from two years to one year.** According to DPP 2013, only those bids, which are found to be fulfilling all the eligibility and qualifying requirements of the RFP both technically and commercially, are opened and

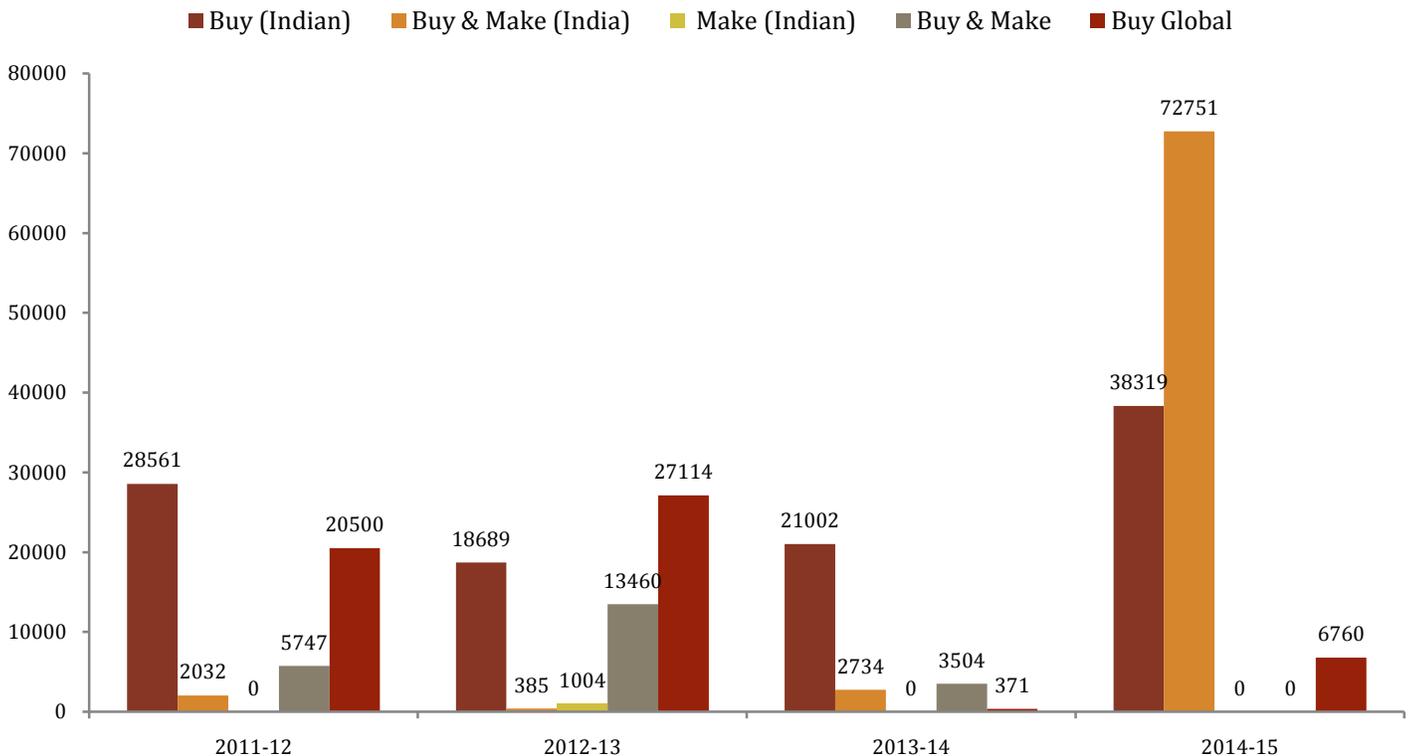
subsequent contract negotiations carried out only with the bidder, whose price is arrived at as the lowest as per evaluation criteria given in RFP.

DPP 2013 also did away with the process of nominating Defence Public Sector Undertakings (DPSUs) and Ordnance Factories (OFs) for receiving Maintenance ToT (MToT) allowing private players to compete for MToT contracts. **As specified in the DPP 2013, the Long Term Integrated Perspective Plan 2012-2027 was also made public to provide guidance to vendors on the roadmap of procurement to be followed by the services.** In addition to these changes, DPP 2013 also specified the procedure for expedited and fast-track procurement.

Analysis of DPP 2013

Introduction of DPP 2013 did result in a visible shift in favour of Buy (Indian) and Buy and Make (Indian) categories as compared to previous years. However, the DPP did not have enough provisions to incentivize design and development in India as compared to manufacture. No 'Make' category project has been successfully implemented, since the introduction of the category in 2006. **The overall procurement process from RFP to signing of contract is still perceived by the stakeholders as very prolonged, owing to delays related to technical evaluation, field evaluation, rigidity of adherence to SQRs, resolution of complaints.** Similarly, other issues like vague definition of Indian vendor, lack of specificity in the public version of LTIPP and scope for unrealistic framing of SQR without reference to industry capacities have been reported.

AoNs Category wise Approvals (in Crore Rs.)



One of the other major issues with the DPP2013 has been the **inordinate delays and difficulties faced by vendors in discharging offset obligations**. Offset obligations are governed by the procedures in force at the time of the original contract without retrospective application of improved offset guidelines, resulting in a highly complicated compliance regime. **Since 2008, foreign manufacturers were able to report only 51.5% achievement till 2014 against contracted obligations**. The provisions for 'blacklisting' of entities in case of complaints or allegations of malpractice has also resulted in a large negative impact on procurement timelines and availability of eligible vendors. In view of these issues, almost all stakeholders (including the Services) agree on a need to make significant changes to revamp DPP 2013.

Recommendations of Expert Committee of July 2015

The Ministry of Defence had appointed a **committee of experts in May 2015, under the chairmanship of Shri. Dhirendra Singh** to "evolve a policy framework to facilitate 'Make in India' in defence manufacturing and align the policy evolved with the Defence Procurement Procedure 2013"⁵ and "to suggest requisite amendments in DPP 2013 to remove the bottlenecks in the procurement process and simplify/rationalize various aspects of the Defence Procurement". The committee in its report, submitted in July 2015, made comprehensive recommendations for reforming defence procurement in India. Some of the key recommendations were as follows:

- 1) A **"Strategic Partnership Model"** should be instituted to build capacity beyond public sector with selection of strategic partners in six key equipment segments
- 2) "Make" category should be made more broad based with **5 further sub-categories** based on the lead developer and size of the project
- 3) **Defining attributes** of categories for capital acquisitions should be incorporated in the DPP to make the categories unambiguous
- 4) **RFI should be listed as the first function in the acquisition process** before SQR function in the DPP to enable submission of realistic SQR based on industry capacity
- 5) Period of validity of **Approval of Necessity (AoN)** for 'Buy(Indian)', 'Buy&Make' and 'Buy(Global)' categories be **reduced to 06 months** from the existing one year
- 6) Suitable provisions should be made in the DPP to address **"single vendor, multiple bids"** and **"multiple vendors, single product"** which are likely to emerge in 'Buy & Make (Indian)' or 'Buy & Make' cases
- 7) In addition to the currently prevalent L1 model of bidding, other **bidding models like L1-T1, PBL and TCA** should be considered for specific cases
- 8) Minimum indigenous content threshold for **'Buy (Indian)' and 'Buy & Make (Indian)'** categories should be revised to **40% and 60%** respectively. For **'Make'** category, minimum indigenous content for prototype stage should also be revised to **40%**
- 9) The **offset policy should be fine-tuned** to make it more easily implementable including differentiation between direct purchase and execution of export orders, allowing discharge of offsets by effectively utilizing the capabilities in his entire supply chain etc. The cap of 30% for discharge of offsets for government institutions should be removed in specific cases.
- 10) The **misdeed of individuals or entities should not be visited upon the equipment or system**. The guidelines for putting on hold, suspension and debarment of Entities should be in line with this principle.

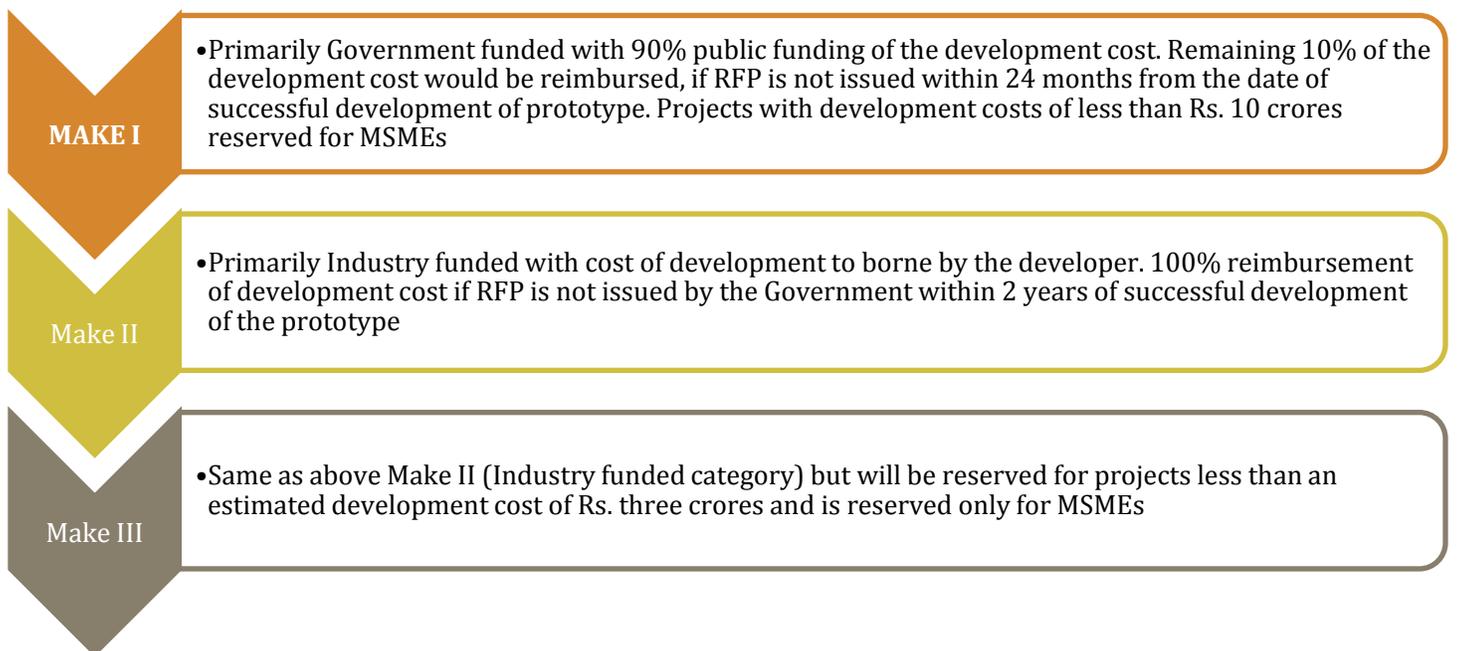
⁵ Convening Order-Committee of experts for amendments to DPP 2013 including formulation of policy framework 1st May 2015

- 11) Steps should be initiated to set up a **specialised Defence Acquisition structure** outside the formal structure of the Ministry of Defence
- 12) The Defence Production Policy may be reviewed to facilitate and incentivise Private Industry including MSMEs to move towards 'Make in India'

Changes Approved in January 2016

On 11th January 2016, the Defence Acquisition Council under the chairmanship of the Raksha Mantri approved some significant provisions in the procurement procedure. **These changes would be eventually incorporated in the DPP, which is due for revision.** The approved changes include some recommendations of the experts committee. Some of the key provisions approved are:

- 1) **New Category of Equipment:** The Dhirendra Singh Committee had not recommended any changes to the existing categorization of equipment. However, with the view of encouraging indigenous design and development, a new category of **Indian Designed, Developed and Manufactured (IDDM)** equipment will be introduced. This will be the most preferred category, ahead of 'Buy (Indian)'. Under this category, indigenously designed equipment with 40% indigenous content or equipment with 60% indigenous content will be considered for acquisition. The minimum required indigenous content for **'Buy (Indian)' category has been clarified to be 40%**. The existing requirement of 50% indigenous content in 'Buy and Make (Indian)' will be extended 'Buy and Make' category as well.
- 2) **Sub categorization of the 'Make' category:** In order to streamline the procedures for 'Make' category, the DAC has decided to further divide this category in 3 sub-categories.



A dedicated **Project Management Unit** will be constituted at the Service Head Quarters and will be headed by a two star rank General to drive all 'Make' projects for the Service.

- 3) **Applicability of Offsets and Technical Oversight:** Offset obligations and Technical Oversight requirements will be applicable only in cases where the acquisition **cost exceeds Rs. 2000 Crores** compared to the existing threshold of Rs.300 Crore.
- 4) **Splitting of the Essential Parameters:** Essential parameters will now be classified as Essential Parameters A and B. Contracts would now be signed if the equipment meets category A essential parameters, with the vendor having the liberty to modify the equipment to incorporate category B essential parameters to ensure compliance with SQRs. **Vendors meeting the category B Parameters specified in the tender will be given additional credit score while evaluating their commercial bid** for the purpose of determining the lowest bidder in departure from the current L1 model.

Conclusion

A robust procurement policy framework can help better arm the forces to effectively deal with the entire threat spectrum. In addition, it is important to ensure that indigenous capacities for design, development and manufacture of defence systems are developed with a long-term perspective. The Indian defence procurement framework has been adaptive based on experience and feedback from stakeholders but some challenges still remain. This process of progressive development of a comprehensive procurement regime will have to be continued to keep pace with the fast changing needs of national security and nature of modern conflict.