Defence Procurement Procedure The Unfinished Agenda

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It has been a long time since the first set of instructions on defence procurement was issued in 1992. Since then, however, there have been several refinements and additions, based on the feedback from the stakeholders and the experience of the Defence Ministry itself, culminating in the Defence Procurement Procedure (DPP) 2011. This is presently under review and it would be reasonable to expect that the changes being contemplated will result in further refinement of the procedure and address some of the concerns expressed from time to time. There is also a view that all this effort may go waste once the Public Procurement Bill, presently before Parliament, is enacted, as the law would also apply to defence-related procurements. The apprehension seems unwarranted. The fundamental principles underlying the DPP are not materially different from what is envisaged in the proposed law on public procurement, but the DPP contains detailed instructions and formats of various documents peculiar to defence procurements. Therefore, it is quite likely that the DPP would survive, in some form or the other, the enactment of law on public procurement. Some further changes might be necessary to bring it in sync with the provisions of the new law, but these changes are unlikely to bring about any material change in the overall procedure for capital procurements which has developed over the years. The process of refining the procedure must, therefore, continue. It is in

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this context that this article highlights some of the issues that have so far not received enough attention or have not been perceived as problem areas meriting attention.

Level-Playing Field

This has been a major irritant for the private sector for a long time. The grievance is that some of the terms on which the Government deals with the Defence Public Sector Undertakings (DPSUs) are more favourable than those on which it deals with the private sector, making the latter uncompetitive. While some steps have been taken in the past, such as making provision for Exchange Rate Variation (ERV) for the Indian vendors in the 'Buy Global' cases, the private sector continues to perceive the field to be far from level vis-à-vis the DPSUs and foreign vendors. There are three specific reasons that explain why this is so. The first area of discomfort is related to the ERV. This is presently applicable to rupee contracts with Indian vendors in 'Buy Global' cases where there is an import content, but is not applicable in Buy Indian cases even if there is an import content. Perhaps this would have been acceptable to the Indian vendors but for the fact that ERV is available to the DPSUs in the same Buy Indian cases when procurement is undertaken from them on single-vendor basis or when they are nominated as the Production Agency.

The second area of discomfort is the payment terms, which are not the same for the Indian and foreign vendors. In the case of foreign vendors, advance payment is followed by full payment on proof of dispatch. In the case of Indian vendors, advance payment is followed by a part payment on proof of dispatch and the balance payment is made on receipt of the stores contracted for. There is a further sub-division within the category of the Indian vendors: DPSUs and others. The payment terms for the DPSUs are governed by a separate set of orders issued by the Department of Defence Production (DDP) from time to time; this is the case even when DPSUs compete in a multi-vendor situation. The terms of payment set out in these orders are not always the same as set out in the DPP for other vendors.

The third area of discomfort is taxation. The basic complaint is that the private sector is at a disadvantage vis-à-vis foreign Original Equipment Manufacturers (OEMs) and DPSUs with regard to input transaction taxes and local taxes, which are not reimbursable. There are other issues like payment through Letters of Credit (LC) to foreign vendors but not to Indian vendors.

Some of these grievances may be bugbears but there is a need to clear the air by addressing these, and possibly some other aspects of the level-playing field, in an equitable manner. Some further refinement can be expected as a part of the on-going review of DPP 2011 but, even if some areas remain unaddressed after that, the industry would need to articulate outstanding issues objectively and put them forward, along with suggestions to address those issues, for consideration by the Ministry. The feasibility of implementing the suggested solution has to be kept in view while doing this. This implies that the Government's perspective should be factored into any suggested solution, which is possible if there is a structured and regular interaction between the industry and the Government. The presentation made by the representatives of the Indian industry in June 2012 to the Capital Acquisition Wing is a step in the right direction. This must be institutionalized.

Selection and Nomination of the Production Agency

The second issue that merits closer examination concerns the selection and nomination of the production agency under the Buy and Make category, which involves procurement from a foreign vendor followed by licensed production or indigenous manufacture in India through Transfer of Technology (ToT). The DPP provides that in cases where ToT is being sought the appropriate Production Agency (PA) would be approved by the Defence Acquisition Council (DAC) based on the recommendation of the Services Capital Acquisition Plan Categorization Higher Committee (SCAPCHC); and that the PA could be selected from any of the public or private sector firms, including a joint venture company, based on inputs from the DDP and, if required, from the Defence Research and Development Organisation (DRDO).

While it is easy to nominate a DPSU, there is a lack of clarity on how a private PA is to be selected for nomination. There are no specific guidelines for selecting a PA from the private sector. This, in itself, is not an insurmountable difficulty and it is surprising that specific guidelines for this have not been framed so far. What must be noted, however, is that specifying the criteria for nomination of a PA would not prevent allegations of favouritism and impropriety in nominating the PA. Those who get left out could queer the pitch. This can be avoided if it is left to the foreign vendor, responsible for transferring the technology, to select an Indian partner of its choice. Since the Ministry's contract would be

only with the foreign vendor and it would be the responsibility of the latter to follow the roadmap laid down in the contract for transferring the technology to ensure licensed or indigenous production as per the terms of the contract, the risk involved in adopting this procedure is minimal. The choice of the Indian partner would be driven entirely by sound commercial considerations. To let this happen, it is important that no criteria or preconditions are laid down that would place restrictions on the foreign vendor's freedom to choose an Indian Production Partner (IPP). This issue is likely to be heard of more often in the near future as more and more cases get categorized as 'Buy and Make' through the involvement of the Indian private sector.

There is a related issue concerning the cost of technology transferred by the foreign vendor. This question was not really significant as long as the technology was coming to a DPSU or an ordnance factory. However, when the technology is coming to a private company, the cost of which will be borne by the Government, the question whether the Intellectual Property Rights (IPR) of the technology should be held jointly by the Indian company and the Government or exclusively by the latter would also need to be addressed. It may be necessary to work out some arrangement under which the Government gets appropriate return on its investment when the product is subsequently sold by the IPP in the domestic or foreign markets.

There are similar issues related to cases coming under the category of 'Buy and Make (Indian)'. This category comprises cases where the product is purchased from the Indian vendors, including Indian companies forming joint venture or establishing production arrangements with the OEMs, followed by licensed production or indigenous manufacture in the country. These products must have a minimum of 50 per cent indigenous content on cost basis. In these cases, the Request for Proposal (RFP) is to be issued only to Indian vendors who are assessed to have the requisite technical and financial capabilities to undertake such projects. These Indian firms are to be shortlisted on the basis of responses to the Request for Information (RFI) and through interaction with representatives of the industry associations by the Services Headquarters (SHQ) through HQ Integrated Defence Staff (IDS).

Assessment of whether a company has the requisite technical and financial capability is a complex exercise that needs to be carried out by a permanent professional body of experts as per pre-disclosed methodology in a transparent manner. There have been instances of Indian companies

claiming that they have the requisite financial and technical capability to take on the project but the SHQ concerned not accepting that claim and, instead, expressing the view that the project would not take off if it is categorized as Buy and Make (Indian). Assessment of financial and technical capabilities requires defining criteria for assessment—which may differ from one case to another—and assessing the capabilities of private companies against those parameters. It could result in different views being taken in different cases while framing the pre-qualification criteria or while assessing the technical capabilities against those criteria. This is because these tasks would be undertaken on a case-to-case basis at different points of time for individual procurement proposals, though not necessarily by the same set of people. Setting up of a permanent body of professionals could possibly make the procedure more robust as it would ensure greater overall objectivity, commonality in framing of criteria, and uniformity in carrying out the assessment of capabilities across all the services.

What possibly adds to the difficulty is the absence of uniform guidelines for defining what kind of technical capability would be considered desirable for a company which seeks to be short listed as a prospective vendor for a product that it has not manufactured so far. Take, for example, the case of a submarine. There may be just one or two private shipyards which have experience of being involved in submarine construction. Now, if experience in submarine construction from the design stage itself were to be included as an indicator of technical capability while laying down the pre-qualification criteria, it is possible that no company would qualify. On the other hand, if experience of being associated with submarine construction as a first-tier or second-tier vendor is prescribed as the defining pre-qualification criterion, many companies that have the potential technical and the financial muscle may still get left out only because they never had had an opportunity to be associated with submarine construction. In either case, there would be limited or no competition. Those who are not shortlisted could also queer the pitch by complaining that they were left out unjustifiably. This issue could come up in different forms when more cases get categorized under the Buy and Make (Indian) category. Therefore, there is a need to revisit the whole issue of nomination of private companies under the Buy and Make category and shortlisting of potential vendors in Buy and Make (Indian) cases.

Make Cases

To some extent, selection of vendors is an issue in 'Make' cases also, which include high technology complex systems to be designed, developed and manufactured indigenously. These projects are expected to be undertaken by the Raksha Udyog Ratnas (RURs)/Industry Champions (not notified so far by the Ministry of Defence [MoD]), Indian industry, DPSUs, Ordnance Factory Board (OFB) or consortia on a level-playing field. This procedure is also to be adopted for all upgrades categorized as Make. The DPP provides for the funding of these projects by the government to the extent of 80 per cent of the project cost. Presently, there are just a couple of on-going Make projects at the pre-sanction stage. Since sufficient details of these cases are not yet in the public domain, it is difficult to say how the scheme would play out, but some aspects of the procedure prescribed for selecting the production agencies under this category merit a second look.

As per the existing procedure, the HQ IDS is required to undertake feasibility studies of all projects included in the 15-year Long-term Integrated Perspective Plan (LTIPP); identify the projects that should be categorized as Make projects based on these studies; obtain the approval of the DAC; and constitute an Integrated Project Monitoring Team (IPMT) for each project. The IPMT is required to be a multi-disciplinary team headed by a service officer, with members drawn from the SHQs, DRDO, Department of Defence, DDP, Integrated Finance, OFB, DPSUs and the accredited industries on an as-required basis. The team leader can co-opt other members from the eminent scientific and academic institutions, as also other specialists. The IPMT is expected to be capable of using methods and tools to analyse and assist in preparation of the Detailed Project Report (DPR) by the shortlisted production agencies.

The IPMT is a crucial factor in the entire Make procedure. It is required to prepare the Project Definition Document (PDD), defining, inter alia, the system required by the services, stages at which the proposed production agency need to be dovetailed with the project, the requirement of the Limited Series Production (LSP) after successful development of the prototype, the exit criteria, and the Minimum Order Quantity (MOQ) to be placed on the successful developer. The IPMT is also required to invite Expression of Interest (EOI), assess the capability of the prospective Development Agencies (DAs)/Production Agencies (PAs), and shortlist at least two PAs (the terms Development Agency and Production Agency have been used synonymously in the DPP). If necessary, even one PA could be shortlisted.

The IPMT is required to forward the report of the shortlisted agencies to the Acquisition Wing for approval. The Acquisition Wing is required to forward the list of shortlisted agencies to the Defence Production Board after scrutiny, which is further required to select two best agencies out of the shortlisted ones as per the laid down criteria to undertake the design and development phase. Thereafter, the IPMT is required to order preparation of the Detailed Project Report (DPR) by the nominated PAs, analyse the DPRs when received, and then forward them to the Acquisition Wing along with its recommendations, especially with regard to the exit criteria defined in the DPR. While it would be the responsibility of the Acquisition Wing to obtain necessary approvals for the project at this stage, the IPMT would again be in the picture throughout the proto-type development stage and also carry out user trial readiness review of the prototype before it is offered for the user trials. Thereafter, the project would follow the usual procedure of user trials by the services, staff evaluation, solicitation of the commercial offer, contract negotiations and the award of contract.

As can be observed from the foregoing account, firstly, the IPMT has a fairly crucial role to play in setting the rules of the game for the industry to get involved, selection of the prospective production agencies, funding of the project and user trial readiness of the prototype. It is but natural that this entire process would play out over a very long period, perhaps spread over several years, during which period the members of the IPMT are bound to change, as they would be from various departments of the ministry, services headquarters, DRDO, etc., where officers generally serve for fixed tenures. Secondly, not all of them would be domain experts. They would get nominated to the IPMT because of the position they would hold. Thirdly, despite the seemingly broad-based composition of the IPMT, it is not a permanent body of professionals with the requisite skills to carry out the various tasks assigned to it. This could impact decision-making at various stages. The argument is not that the IPMT, as envisaged in the DPP, cannot at all carry out the task assigned to it. In fact, there are very few ongoing projects under this category and it is not possible to assess the efficacy of the IPMTs constituted for those projects as they are at a nascent stage. However, what warrants consideration is whether it would not be more appropriate to set up a permanent body of professionals to carry out these tasks, as suggested earlier in the context of Buy and Make (Indian) cases.

The second issue related to the Make procedure concerns the stipulation that a minimum of two production agencies would always be shortlisted for the development of a system. The DPP also provides that there may be compulsions that some developments can only be undertaken by one production agency, in which case approval of the Defence Acquisition Council (headed by the Defence Minister) would be taken before the project is sanctioned. It further provides that even in such single-vendor cases, it would be ensured that development of components, subsystems and systems is on a multi-vendor basis, but it is not clear how this could be achieved. Given the fact that the Make projects would, in all probability, be high-value projects, it is unlikely that the selection of only one PA would go unchallenged by the potential competitors. This provision in the DPP could be perceived as an assured entry route for DPSUs and the OFB because their selection as production agencies is likely to be the least controversial. It is not to say that the provision for selection of only one PA is ill-intended. But it would certainly make this enabling clause more acceptable if the circumstances in which a single PA could be selected are defined in greater details than is the case at present.

In any case, the basis on which the Defence Procurement Board would select 'two best agencies' out of the shortlist also requires greater clarity, as it is not enough to say that the selection would be made as per the criteria laid down for undertaking the design and development phase, which is what the Defence Procurement Procedure says. Any lack of clarity in this regard is bound to impact decision-making by creating a bottleneck at the stage of selection of production agencies.

Whether it is selection of one or more than one prospective PAs, it is not going to be a simple affair. According to the DPP, the IPMTs are required to invite EoI from the DPSUs/OFB/all the RURs (not yet notified)/Indian industry/consortia that would participate in the programme. Indian industry is required to meet the criteria as per the guidelines given in the DPP for selection of RURs. The DPP further says that an essential requirement for shortlisting of development agenc(ies) is identification of the firms with proven excellence and the capability to contribute due to their technical, managerial and financial strengths. The IPMTs are also required to examine some other aspects for shortlisting of development agenc(ies). These include: (a) product structure with specifications; (b) competence to address the critical technology areas of the project through indigenous means; (c) past supplies/contracts for defence products; (d) financial status of the company; and (e) annual

reports. Firstly, it must be made clear—if that is indeed intended—that this yardstick would apply equally to all prospective vendors, and that the DPSUs and the OFB would not be deemed to be pre-qualified vendors if they are also in the race. Secondly, it is not enough to say that the IPMT would examine the product structure with specifications, the annual report, etc. What is important is that there should be clear guidelines regarding such examination. To illustrate, it must be clear what inference the IPMT would be expected to draw if after looking at the 'past supplies/ contracts for defence products', it finds that in certain contracts the vendor in question had delayed the delivery and liquidated damages were imposed. Similar uncertainty could arise while examining the financial status of the company or the annual report, if IPMT finds that the company is involved in some dispute with the tax authorities. These are mere examples of what could happen in the absence of a precisely-defined methodology for shortlisting of vendors.

The third issue concerns the award of contract for the minimum order quantity, based on which the PAs would have participated in the contract. The DPP says that in multi-vendor cases, on opening of the commercial offers, once the L-1 vendor is identified, the contract should be concluded with him. But the entire procedure is predicated on the selection of only one or at the most two vendors. Therefore, there is going to be no real multi-vendor situation. But, more importantly, since the projects under the Make procedure are design and development projects, it is to be expected that a particular project would eventually be awarded to the first-past-the-post PA because it would be impractical to wait for the second PA to also come up with the prototype before proceeding further. Even the DPP does not say so.

Where does it leave the unsuccessful PA? What happens to the investment made by the Government and the company? What if the second PA is also on the threshold of producing a prototype, which may eventually turn out to be better and cheaper? The second PA could participate in the subsequent tender, but what if there is no subsequent requirement? What if there is a subsequent requirement but the second PA does not turn out to be L-1, which is more likely because the first vendor, having already amortized his cost while executing the first order, could afford to keep his cost low? Even if these questions have not arisen so far, they are likely to come up at some point of time in future. Therefore, there is a need to look at these questions and either rule out the possibility of their ever coming up and causing any difficulty in the procurement

process, or be ready with the answers so that the projects already in the nascent stage, and other projects likely to come up in future, do not run into difficulty at the advanced stages of their implementation.

One option that needs deliberation is to award greenfield projects to just one PA on cost-plus basis with concurrent audit of expenditure by a dedicated cadre of cost accountants. This would be somewhat on the lines of the system prevalent in the United States of America. This might create a monopoly but so would the existing procedure because it is only one of the two selected PAs who would eventually get the contract. It should be possible to introduce enough safeguards to prevent the ill-effects of the monopoly that this option entails.

There is yet another aspect of the Make procedure which merits attention. The DPP provides that the unsuccessful agency would hand over the drawings and documents of the prototype to the Quality Assurance Agency for projects funded by the Ministry after L-1 has been determined. This situation would arise only if both the PAs come up with an acceptable product at the same time, which is unlikely. In any case, this provision effectively seals the possibility of the second PA of manufacturing a competing product if he is divested of the drawings and other documents of the prototype even before it is developed. It does not matter, though. If the first-past-the-post PA bags the order, it is improbable that any other competitor will get a share of the same pie subsequently, as the quantity already ordered is unlikely to be reduced and awarded to the second PA.

Lastly, the issue of increasing the Foreign Direct Investment (FDI) limit and permission to export is likely to come up in a big way in the context of the projects under the Make category, as also under Buy and Make, in order to make the projects commercially viable and attractive. It would help if the MoD assumes the leadership role in this regard and provides a single-window solution to the prospective PAs.

Indigenization in Buy (Indian)

Buy (Indian) cases require that the equipment must have 30 per cent indigenous content if the system is being integrated by the Indian vendor. The expectation is that it would already have a minimum of 30 per cent indigenous content when it is fielded for trials. This is so because the trials need to be carried out on a system that is finally going to be offered. The flip side is that it is perhaps a commercially risky proposition to achieve

the requisite level of indigenization before the equipment is offered for trials, as the investment will go down the drain if the equipment fails the trial. Even if the equipment passes the trials, one would have to be L-1 to be able to win the contract. This might be a problem area that needs a resolution that addresses the concerns of both the buyer and the seller.

Advance Intimation to the Industry

It is the stated objective of the DPP to keep the goal of achieving self-reliance in view while procuring equipment and systems required by the services. To achieve this objective, the DPP provides that (a) it is important to share the future needs of the armed forces with the industry; (b) HQ IDS would bring out a public version of the perspective document, outlining the technology perspective and capability roadmap covering a period of 15 years; and (c) this document would be widely publicized and made available on the MoD website.

Since the purpose of making the requirement public is to provide advance intimation to the industry about the requirements of defence in the long run, so that the industry could gear itself to meet those requirements, it is important to do it fast. Now that the 15-year LTIPP and five-year 12th Defence Plan of the services have been approved by the DAC (on April 2, 2012), the public version should be available soon. What is not known is whether it would contain the kind of information that the industry requires to prepare itself for meeting the requirement of the services. This might probably be the first occasion when the information is placed in the public domain. It is, therefore, not clear how this disclosure would further the cause of self-reliance and indigenization. But there is a need to maximize the advantage accruing from the information being made public. It is possible that inputs were taken from the industry regarding the format of the public version of the LTIPP. If not, it would help if there is a dialogue between the industry and the HQ IDS so that the advantage of making the information public could be maximized by tweaking the format in which it is disclosed. This seemingly small step could prove to be extremely significant in the long run in achieving the objectives of self-reliance and indigenization.

Since achieving the complex goal of meeting the present and futuristic requirements of the services through an increasingly indigenous route requires synergy between the government and the private sector, the issues that have the potential of causing impediments in decision-making or

time and cost overruns need to be resolved as they arise. This requires creation of a forum for regular and structured interaction between the ministry and the industry in order to resolve all such issues and explore the possibility of simplification of procedures, which comes in for a lot of flak without any specifics being suggested for their improvement. This will go a long way in strengthening the military industrial base.