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# Strategic Partnership

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# Strategic Partnership

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## EXECUTIVE SUMMARY

The Dhirendra Singh Committee was constituted in 2014 with the mandate of suggesting amendments to the Defence Procurement Policy (DPP) 2013. The Committee Report provided guidelines for the implementation of a revised DPP and recommended the setting up of a taskforce, to suggest how private sector participation in domestic defence manufacturing could be increased. The V. K. Aatre Taskforce was set up for this purpose. The Taskforce submitted its report on 15th January 2016. It took stock of Indian defence procurement, the domestic defence manufacturing base and suggested the Strategic Partnership (SP) model as a means of increasing private sector participation in defence production.

The Taskforce Report focused on India's need for Strategic Partners (SPs) that are 'system of systems' integrators. It therefore recommended selection criteria and methodology that takes into account private players' established capacity rather than giving preference to the lowest bidder principle. The weapon platforms identified for production under the SP model are differentiated into Group I or 'system of systems' projects and Group II or 'critical materials' projects.

Apart from identifying groupings, the Report also provides minimum qualification criteria, which include financial, technical and segment-specific criteria for companies that wish to apply to be SPs.

While the Report was submitted in January 2016, Chapter VII of the DPP 2016 as approved by Cabinet in May 2017 is a modified version of the SP policy suggested by the Taskforce. Chapter VII only approves four platforms for production under the SP model – fighter aircraft, helicopters, submarines and armoured fighting vehicles (AFVs) or main battle tanks (MBTs). Chapter VII details the need for the SP policy, the role of the SP and foreign original equipment manufacturer (OEM), procedure for selection of SP and foreign OEM, and contract details for the strategic partnership.

While the approval of Chapter VII opened the doors to implementation of the SP model, there are significant hurdles that need to be overcome to ensure efficient and satisfactory implementation. This is especially important in light of the fact that the objective of the SP model is not only increasing private sector participation in defence production, but also improving the incidence and pace of indigenisation of weapons platforms to reduce dependency on imports.

The issues with implementation of Strategic Partnership identified by various stakeholders (elaborated on in section 4) include;

1. Limits on FDI even in Strategic Partnership, where FDI is capped at 49 per cent. This leads to the share of foreign OEMs in a JV being limited to 49 per cent.
2. With a cap on FDI and shareholding in JV/SPV, transfer of technology (ToT) from the foreign OEM to the SP becomes problematic. The intellectual property rights (IPR) for technology often does not rest solely with the OEM but with the government of the nation of origin. Scope and depth of ToT are also an issue given the lack of clear definition of the terms 'modern' and 'cutting edge' technology.
3. Private companies need firm commitments on order volumes in order to carry out changes in production and indigenisation of platforms. However, apart from the initial order security, Chapter VII does not provide a guarantee for future orders from MoD or the armed forces for the SP. In the absence of a guarantee for the future, the domino effect will be felt along the entire supply chain of defence production.
4. Given the sizeable investments that private companies will have to make, certain financial and

segment specific criteria could put potential SPs at a disadvantage.

5. Chapter VII does not have a framework or even suggestions on how the strategic partnership is to be financed.
6. SP policy is supposed to build capacity throughout the supply chain of defence production, building an environment of Tier I and Tier II vendors around the SP. However, there is no mention of how MSMEs can capitalize on these supposed benefits.

The solutions to the aforementioned issues are presented as recommendations (in section 5). These include;

1. Government should provide guidelines for considering cases that merit greater than 49 per cent FDI. A list of critical or key technologies would help government identify which cases can be allowed greater than 49 per cent FDI.
2. The SP policy should provide for government to government negotiations to be carried out simultaneously with company to company negotiations for ToT. There should be clear definitions of the terms 'modern' and 'cutting edge' technologies.

3. Government should consider a company's healthy balance sheets and domestic investments as opposed to more vulnerable investments abroad when selecting SPs based on financial criteria.
4. Two possible options for financing strategic partnerships include, all stakeholders sharing financial responsibilities or companies issuing bonds similar to green bonds in order to access capital markets for funding defence production.
5. The government needs to consider setting up an independent regulator for strategic partnership. This is important as a detailed recommendation regarding this is already laid out in section 7.3 of the Taskforce Report. A regulatory body independent of the bureaucratic hierarchy of the MoD and armed forces will be crucial to the efficient implementation and subsequent evolution of the SP policy.

## LIST OF ABBREVIATIONS

AFVs	Armoured Fighting Vehicles	MBTs	Main Battle Tanks
AON	Acceptance of Necessity	MoD	Ministry of Defence
DAC	Defence Acquisition Council	MSMEs	Micro, Small and Medium Enterprises
DPP	Defence Procurement Policy	OEMs	Original Equipment Manufacturers
DPSUs	Defence Public Sector Undertakings	OFB	Ordnance Factory Board
DRDO	Defence Research and Development Organization	OFs	Ordnance Factories
EOI	Expression of Interest	R&D	Research and Development
FET	Field Evaluation Trials	RFP	Request for Proposal
FDI	Foreign Direct Investment	RFI	Request for Information
IDDM	Indigenously Designed, Developed and Manufactured	SP	Strategic Partnership/Partner
IPR	Intellectual Property Rights	SPV	Special Purpose Vehicle
JV	Joint Venture	SQRs	Service Qualitative Requirements
		TEC	Technical Evaluation Committee
		ToT	Transfer of Technology

## 1. Strategic Partnership – An Introduction<sup>1</sup>

The Indian defence manufacturing sector comprises of defence public sector undertakings (DPSUs), ordnance factories (OFs) and private players including domestic and foreign companies. A sizeably large and disaggregated group of defence micro, small and medium enterprises (MSMEs) form the bedrock of indigenous defence production. Of all the contributors to the Indian defence production supply chain, MSMEs have been continuously overlooked and their contributions underestimated. Thankfully, this narrative has changed. The Make in India initiative of the Modi government, brings the objective of enabling domestic defence manufacturing to centre stage. The Make in India defence initiative, places its confidence in the domestic defence industrial base for indigenising production of major defence platforms. This vision however needs enabling policy. In the recent past, two significant reports, the Dhirendra Singh Committee Report (Committee Report) and the V. K. Aatre Taskforce on Strategic Partnerships (Taskforce

Report) have been instrumental in bringing the narrative on this in to mainstream policy. Both, the Committee Report and Taskforce Report, recognize the importance of developing the Indian defence industry ecosystem.

The Dhirendra Singh Committee was given the mandate of suggesting amendments to the Defence Procurement Policy (DPP) 2013 and create enabling guidelines for the implementation of the revised version – the DPP 2016. The Committee also recommended the setting up of an independent taskforce that would examine how to increase private sector participation in domestic defence manufacturing. The Experts Committee report also details the policy incentives and hand-holding required by MSMEs. Even while the DPP 2016 and the offset policy are aimed towards bolstering domestic defence industries' growth, a major impediment to them becoming promising platform developers has been the lack of any institutional mechanism through which they can interface with foreign original equipment manufacturers (OEMs). The Strategic Partnership model acts as a viable, albeit indirect, solution to address this.

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<sup>1</sup> This discussion paper is based on articles, 'Will the Strategic Partnership Policy Finally Kick-Start Modi's Make-in-India Defence Project?' published in The Wire on 25th May 2017 and 'Bedrock Gets Its Due: MSMEs need to capitalize on the opportunities presented by Strategic Partnership' published in Force Magazine's July 2017 issue. The issues with implementation of Strategic Partnership and recommendations to address them are based on discussions from the maiden 'Defence Economic and Policy Dialogues' seminar on 'Policy Solutions for Implementation of Strategic Partnership' held on 16th October 2017 at India Habitat Centre, New Delhi. The seminar series is organized jointly by Pahle India Foundation and Trilegal.

The Taskforce Report takes off from where the Committee Report left off and ties in with the philosophy of Make in India.

## 2. History and Conception of the 'Strategic Partnership Model'

Based on one of the recommendations made by the Dhirendra Singh Committee in 2013, a Taskforce was to be set up to lay out the criteria for selection of 'strategic partners' for weapons platforms of critical importance. The V. K. Aatre Taskforce was convened in September 2015 and was directed to submit its report in three weeks' time. However this was revised to 30th November 2015 and subsequently to 15th January 2016, when the Taskforce intimated the Ministry of Defence (MoD) regarding the need for more time to put down specific financial and technical criteria, in consultation with experts. The report was finally made public earlier this year and approved by Cabinet in the month of May.

It has been well over a decade since the private sector was directly involved in defence manufacturing. Citing security concerns, India's defence procurement had always been driven by the DPSUs and the Ordnance Factory Board (OFB). India's defence manufacturing

was liberalised in 2001 and opened up participation to not just private players but also to foreign entities (26 per cent foreign direct investment (FDI) in defence). Yet, we do not have a defence production base outside of the DPSUs and the OFB. Research and development have been the domain of the Defence Research and Development Organization (DRDO). Private sector companies have been hesitant to dive into defence manufacturing due to restrictions on products and lack of orders. Their vendor base (in this case, largely MSMEs) is limited and one that has not been given its due. Despite FDI limits having been increased to 49 per cent on automatic route and 100 per cent on a case to case basis, FDI has far from poured into the country; technology transfers or knowledge sharing, even less. The result is, the defence production sector as it is today, driven by behemoth DPSUs, are not at all efficient. The lack of private sector participation and competition in indigenous defence production has resulted in ill equipped armed forces that have been driven to rely more on imports rather than look inward.

The Taskforce Report on Strategic Partners (Taskforce/ Report) is an important document because it takes honest stock of Indian defence procurement and has re-examined and reoriented the entire process. Not only does the Report suggest an alternative model to defence

procurement, it also suggests a framework, which if successful, will be a major driving force for the growth of defence MSMEs in India. The Report has recognised the importance of defence MSMEs not only in their own right as possible strategic partners but also the crucial role that they play in the defence manufacturing value chain. The Report also takes cognisance of the current limited capabilities of the Indian private sector and rightly suggests a model where, at least for the initial years, the Indian private sector is to act as the lynchpin that brings together all stakeholders, including foreign OEMs for developing indigenous defence manufacturing. It is hoped that over the years, through the strategic partnership model, there will be a marked increase in the transfer of technology, a definite requirement for stepping up Indian indigenous defence manufacturing.

## 2.1 Rationale for the Taskforce Report:

The strategic partnership model was envisioned in order to bring private industry in to the fold of defence manufacturing, but under the auspices of well-defined terms of agreement. Given that development and production of weapon platforms is a time intensive

process, the idea was to ensure that long-term, regulated partnerships for product development and production could be put in place.

After comparing best practices in the global defence industry, the Dhirendra Singh Committee noted that private industry can be involved in defence procurement only through *"well-defined models depending upon ... strategic needs, quality criticality and cost competitiveness."*<sup>2</sup> It has been emphasized that the 'strategic partnership model' is to be established in addition to the existing infrastructure and capacity of public sector units (DPSUs). In other words, it was time for India to bring in new players to the sector that would compete with the DPSUs and hopefully improve the latter's efficiency and reduce the existing dependence on DPSUs.

Given that weapon platforms have specific uses and involve precision and field expertise in both production and use, the terms of reference for the Taskforce was straightforward. The Taskforce was to recommend detailed criteria, both generic and specific, prescribe the methodology and parameters for the selection of strategic partners, draft a long-term covenant that the

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<sup>2</sup> Report of the Taskforce on Selection of Strategic Partners, Ministry of Defence, Government of India: pg. 7.

Government and selected strategic partners would enter into, and cover any other aspects relating to strategic partners and their selection that required mention.

## 2.2 Weapon Platform Groups for Strategic Partnership:

The platforms identified as important for strategic partnership by the Dhirendra Singh Committee were aircraft, missile systems, armoured vehicles, warships and submarines, command and control systems, and critical materials. The Dhirendra Singh Committee had also provided the broad parameters for selection criteria, which the V. K. Aatre Taskforce then detailed in their own Report. The Taskforce highlights in its Report that the main difference between the commercial bidding process under the 'Buy and Make' category of DPP 2013 and 2016 and the Strategic Partnership Model is that the selection criteria in the latter are based on "inherent capacity and ability of the entity rather and not on the lowest bidder principle."<sup>3</sup> This is a momentous change because it not only paves the way for private sector participation on the basis of capability and not cost, but also more importantly, it signals a change in the entire philosophy of defence procurement.

The Report states that India needs strategic partners that are 'system of systems' integrators, citing that this is a best practice followed in defence manufacturing internationally. In the chapter on methodology the weapons platforms identified by the Dhirendra Singh Committee report have been differentiated into two groups. This puts aircraft and submarines under Group I as 'system of systems' projects, and it puts critical materials under Group II as 'other projects'. The Taskforce suggests that under Group I the focus should be on selecting strategic partners for aircraft, helicopters, submarines and armoured vehicles and puts ammunition under Group II. The current strategic partnership model ratified by the MoD has focused only on the Group I products and does not include ammunition (which is a Group II product). This implies that no strategic partners will be considered for ammunition, at least in the short to medium term. The drawback of this is that the strategic partnerships will fail to deal with one of India's more pressing defence shortfalls in ammunition. On the other hand, this could well be interpreted as a strong warning signal to the OFB (whose main focus has been on producing artillery and ammunition) to pull their socks up and increase their production capacity or

<sup>3</sup> Report of the Taskforce on Selection of Strategic Partners, Ministry of Defence, Government of India: pg. 9.

find new ways to collaborate with the strategic partners to stay relevant.

### 2.3 Methodology and Criteria:

The Taskforce has recommended setting up of an Evaluation Committee and a Verification Sub-Committee for reviewing the applications made by companies for becoming strategic partners. The former will have the responsibility of evaluating the applications of companies competing to be strategic partners. The latter will be responsible for conducting on-site inspection and verification of all technical capabilities that companies have mentioned in their applications. Together, these will form the first two steps of the methodology for evaluation and selection of strategic partners or the 'composite gate' and 'verification' of applicant companies. The final step involves evaluating each company's application on the basis of technical, financial, and segment specific criteria (detailed in Chapter 4, 5 and 6 of the Taskforce's Report) and then ranking them. The ranking will be based on the company's preference for each segment and the outcome of the evaluation that they receive for each set of criteria.

Among the composite gate criteria, companies applying to Group I are required to have a turnover of INR 4,000

crores and those applying to Group II a turnover of INR 500 crores. This immediately puts most MSMEs out of reckoning for selection as a strategic partner most definitely for Group I but more importantly for Group II. India has only a handful of private sector companies that manufacture defence products in Group I. Since only a limited number of Group I segments have been approved under this model, the question that needs to be asked is if there will be an adequate number of applicants (private sector companies) to choose from? Another point to consider is if under this model, a greater than or equal to INR 4,000 crores turnover company fails to qualify for Group I, will it subsequently be forced to (or even allowed to) produce or develop products under Group II segments, because clearly, the non-qualifying companies can no longer manufacture the same systems as the strategic partners.

Another point that merits some discussion is foreign market access for the selected strategic partners. While the new proposed model for strategic partners has provided for limited competition in private sector defence manufacturing and has also provided a certain degree of purchase security to the manufacturing company, we must remember that the MoD is under no obligation to purchase systems from the strategic partners. MoD may choose to continue to either buy

from DPSUs who are after all competitors to the strategic partners, or worse, continue to import. If either of the latter two were to happen, it defeats the entire purpose of strategic partnership, but it also then leaves the strategic partner with no other discernible revenue stream other than exports. Unless a new export policy is created that will work in tandem with the new strategic partnership policy and strategic partners are allowed to export some or all their production (subject to domestic procurement and security concerns) private sector participation will continue to remain muted.

The inclusion of the research and development (R&D) culture as an evaluation parameter is a double edged sword. The lack of focus on R&D in India is as much the fault of the private sector as it is of the government's and public sector undertakings. The engrained indifference to R&D is alarming and to this extent, the inclusion of R&D culture into the evaluation parameter is a masterstroke that will force the private sector to concentrate more on this ignored segment. On the other hand, the Evaluation Committee must also be prepared to face a situation where many of the private sector companies may fail to meet the prerequisites for applying to be a strategic partner merely because they

have not fulfilled the basic requirement for R&D culture.

The permissible FDI limit for strategic partners is 49 per cent, not very different from the existing FDI limits. That the strategic partner must be Indian owned and Indian controlled has been given paramount importance. The rationale behind the 49 per cent permissible FDI is to allow for foreign OEM participation. Despite increasing FDI limits in defence, actual capital inflows into the sector has been minimal. One is hopeful that this might change if the recommendations of the Taskforce are implemented in a timely manner and procurement processes are changed. What may however not change is the lack of technology transfers. This is not surprising. First, at 49 per cent FDI technology transfers are not likely to take place. Second, defence manufacturing in India in the private sector rarely incorporates cutting edge technology. Our manufacturing ecosystem has not developed enough to facilitate and incorporate cutting edge technology. The entire model of strategic partnerships rests on technology transfer and/or technology innovation through R&D. If somehow, through the strategic partnership model, India is able to harness and use technology, defence production and indigenisation will leapfrog.

### 3. Chapter VII of Defence Procurement Policy-Strategic Partnership Policy

The Strategic Partnership (SP) Policy or Chapter VII of DPP 2016, which was approved by Cabinet in May 2017, is a modified version of the SP policy as laid out in the Taskforce Report. Four segments of platforms have been approved for development under the SP policy. These include fighter aircrafts, helicopters, submarines, and armoured fighting vehicles (AFVs)/main battle tanks (MBTs). Apart from providing an introduction and rationale for the strategic partnership model, Chapter VII details the criteria for applicant companies, role of OEMs and the procedure for selection of strategic partners and OEM partners. The appendices of the Policy detail the ownership structure required for applicant companies and the selection criteria, both minimum and segment specific/technical.

#### 3.1 Role of Strategic Partners and Foreign OEMs:

What is expected of the Indian private sector has been laid out quite clearly in the Preamble of Chapter

VII. As stated in the Preamble, *"The private sector partner selected through a laid down procedure by the government to make necessary long term investments in manufacturing infrastructure, an ecosystem of suppliers, skilled human resources, R&D for modernization and upgrades as well as other capabilities, besides production of equipment."*<sup>4</sup> This is quite a tall ask for private sector companies which have been hesitant to undertake large investments in defence manufacturing. However, the guarantee of a long term contract with at least one assured order for the platform developed is a significant incentive.

It has been stated that SPs will need to tie up with foreign OEMs since the objective of SP policy is to build indigenous capacity for major defence platforms' production. Such a tie up can take the form of joint ventures (JV), equity partnerships, technology-sharing, and/or royalty to name a few. However the ownership of such a tie-up must be Indian, with a majority of Indian representation on the board of directors. The Chapter does state that the *"...limit for equity participation will not preclude other arrangements for sharing management rights in the JV mutually agreed between*

<sup>4</sup> Chapter VII 'Revitalizing Defence Industrial Ecosystem through Strategic Partners', Ministry of Defence, Government of India, May 2017: pg 2. [https://mod.gov.in/dod/sites/default/files/Chapterdppn\\_0.pdf](https://mod.gov.in/dod/sites/default/files/Chapterdppn_0.pdf)

*the SP and OEM.*<sup>5</sup> Any change in ownership structure of the JV or special purpose vehicle (SPV) will require MoD approval.

It is stipulated that the contract between the SP and OEM cover all aspects from protection of classified information and technology transferred to life-cycle support for the platform manufactured. It has also been clarified that the foreign OEM will "...provide a formal acceptance of their government(s) that necessary licenses to transfer technology will be granted..." in the event that the OEM is selected as partner for the SP. This will be done at the stage of expression of interest (EOI) and prior to the issue of the request for proposal (RFP). This is to ensure that transfer of technology (ToT) is facilitated with least resistance once the SP and OEM are selected.

### **3.2 Selection of Strategic Partners and Foreign OEMs:**

Chapter VII lays down the procedure for the selection of Strategic Partners and foreign OEMs. The process opens with the issue of an EOI to Indian private companies. After submission of EOIs by applicant companies, they

will be evaluated based on Minimum Qualification criteria and Segment Specific criteria. Evaluation can also entail on-site verification of applicant companies. This will be to ensure that companies have the requisite technical and segment specific capabilities to build on. Companies that satisfy the Minimum Qualification criteria will be shortlisted for issue of RFP.

A request for information (RFI) will be issued to foreign OEMs at the same time as the EOI is issued to Indian private companies. This is to ensure a simultaneous selection process for both the SP and OEM. Based on the response to the RFI, service qualitative requirements (SQRs) will be formulated. An EOI will be issued to OEMs in each segment based on the SQRs and information collected. A Technical Evaluation Committee (TEC) will check OEMs' compliance to SQRs, range, depth and scope of technology transferred, extent of indigenous content proposed, plans to train skilled manpower, and extent of future R&D planned in India among other requirements. OEMs that meet the TEC's requirements will be shortlisted with the approval of the Defence Acquisition Council (DAC).

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<sup>5</sup> Ibid: pg 5.

Upon approval of Acceptance of Necessity (AON) by the DAC, segment wise RFPs will be issued to Indian private companies which will include a list of short-listed OEMs. This is to facilitate tie-ups between the potential SP and OEM. It has been specified that only 10-15 per cent of units of a platform being procured may be manufactured in the OEM's premises specifically for purposes of training and skill development of SP's manpower. This will help the SP to gain the know-how it needs to further develop and manufacture the defence platform.

The response to the RFP is to be submitted in two parts, the first a technical offer and the second a commercial offer. Based on the technical offers received Field Evaluation Trials (FET) will be conducted except for equipment which has been previously tested or for which the FET can be waived (for example, submarines). Staff evaluations will be carried out and platforms that meet SQRs and ToT requirements will be shortlisted. Finally, the companies with the lowest price bid in their commercial offer will be designated as SP for that segment.

### **3.3 Contract Details:**

Once SP and OEM have been selected for each segment, the MoD will set up a Contract Negotiation Committee (CNC) to negotiate terms and sign a contract for

deliverables with the SP. The OEM may only participate if required. If a JV/SPV is formed by OEM and SP, a tripartite contract between the MoD, SP and JV/SPV will be concluded on the condition that this does not dilute the SP's responsibilities towards delivery timelines, quality and other criteria.

The SP in each segment must provide an indigenisation roadmap. This includes a plan to indigenise value of production or manufacture of platform, building a tiered eco-system of domestic manufacturers including MSMEs and an R&D roadmap for achieving self-reliance in that segment. The MoD will have the right to carry out periodic assessment of the SP's technology absorption and development of a domestic ecosystem for manufacturing. The MoD will also have the right to conduct special audits of all certifications and costs related to the segment at any stage of manufacturing or assembly. The MoD can terminate the contract in the event of a breach of any of the contractual terms by the SP or JV/SPV, if it loses over half its net worth as submitted in its application or if there is a declaration or judgement of insolvency or bankruptcy.

Finally, with regard to subsequent acquisitions the Chapter states that acquisition of identified platforms should be from Indian companies under the Buy

indigenously designed, developed and manufactured (IDDM), Buy (Indian) and Buy and Make (Indian) and Make categories under DPP 2016. There is therefore no guarantee of the SP receiving subsequent orders. However, while evaluating bids by SP for subsequent acquisitions they will be given weightage for factors such as investment in segment specific infrastructure, building of test and evaluation facilities, extent of vendor eco-system created and willingness for taking on DRDO, DPSUs or OFs as development partners.

The approval and inclusion of Chapter VII set the ball rolling for implementation of SP policy. There has been a lot of debate regarding issues with implementation of the SP policy. The following section will detail what some of these issues are and the concluding section will elaborate the path ahead for Strategic Partnership.

## 4. Issues with Implementation of Strategic Partnership

Among the many issues that can affect implementation of the SP policy, priority is accorded to FDI limits in SP, ToT from foreign OEMs, lack of purchase security and

consequently absence of a guaranteed revenue stream, financial criteria for selection of SP, avenues for financing SP, and participation of MSMEs as Tier I and II vendors (or the lack of a supply chain and vendor development process).

### 4.1 FDI Limits in Strategic Partnership

Despite the increase in FDI limits in defence (from 26 per cent to 49 per cent under automatic route), actual capital inflows into the sector have been abysmal. Answers to questions in Parliament state that over the past three years, "FDI of USD 0.77 lakh (USD 770,000) and USD 0.01 lakh (USD 100,000) has been received from France and Israel respectively. In the year 2015-16, FDI of USD 0.95 lakh (USD 950,000) has been received from France. In the year 2016-17, FDI of USD 0.01 lakh (USD 100,000) has been received from Israel. In the current year, till May 2017, no FDI inflow has been received."<sup>6</sup> The hope is that the numbers will improve if the SP Policy is implemented in a timely manner. All policy enablers need to be in place for this.

The SP Policy requires that the Strategic Partner (SP) be Indian owned and Indian controlled. Appendix A

<sup>6</sup> Answer to Part (a) of Lok Sabha Unstarred Question No. 2164, 28th July 2017. [www.loksabha.nic.in](http://www.loksabha.nic.in)

of Chapter VII which explains 'Ownership Structure' recognises that partnerships or tie-ups between SP and OEM may also take the form of JVs, equity partnerships, technology-sharing, royalty or any other mutually acceptable arrangement. However, such arrangements have also been made subject to the aforesaid overall FDI limit i.e. a foreign OEM would only be permitted up to 49 per cent stake in the JV. It is expressly stated that, "No pyramiding of FDI in Indian holding companies or in Indian entities subscribing to shares or securities of the Applicant Company or the Strategic Partner shall be permitted."<sup>7</sup> This runs counter to the statements made by different government officials which imply that 100 per cent FDI in defence is now possible. Industry stakeholders require clarification on where the government stands on FDI limits in SP.

## 4.2 Transfer of Technology

The cap on FDI at 49 per cent and the lack of share of administrative control for the foreign OEMs makes them wary of sharing technology. Defence manufacturing entails huge capital expenditure on the part of domestic companies. Even if Indian

companies are willing to invest in expanding their manufacturing and technological capabilities, it would be on the condition that a government to government negotiation process is pursued in parallel. Transfer of technology, specifically the intellectual property rights of the concerned technology rests, in most cases, not solely with the foreign OEM but completely or jointly with the government of the nation of origin (in most cases with more than one consent being required from the government). This means that even if the foreign OEM is willing to transfer technology, mere company to company negotiations may not suffice. Government to government negotiations will have to play an active part in determining the range and depth of technology transferred by foreign OEMs to Indian companies.

However, it needs to be emphasized that scale of production and integration of Indian companies (along with their product or sub-systems expertise) into the global supply chain will be crucial to their success in the medium and long term. Foreign OEMs have expressed a willingness to transfer core technologies, as long as terms and sub-elements of ToT are clearly defined and certain assurances on intellectual property rights

<sup>7</sup> Chapter VII – Revitalising Defence Industrial Ecosystem Through Strategic Partnerships', May 2016: pg. 15. <https://mod.gov.in/sites/default/files/Chapterdppn.pdf>

(IPR) is provided to them. Another point that must be highlighted is that 100 per cent ToT is unlikely, except under very rare circumstances, without paying for the technology being sought.

Indian industry representatives have requested that even as the government may negotiate for higher percentages (if not 100 per cent) of ToT from foreign governments and OEMs, absorption of technology takes both time and skill. It is neither feasible nor practical to move from developing low-end technologies to state-of-the-art technology in a single attempt. Given current limitations of the Indian defence industrial base, a more prudent approach would be to adopt a phased development from current outdated systems to Mk 1 and progressively to Mk 2 and 3 systems.

One aspect of ToT is the definition or lack of it, of the terms 'modern' and 'cutting edge' technology. The DRDO defines ToT as provision of the 'know how' and 'know why' of weapons and platform building. These terms are touted as vague and nebulous. There is no specific definition for ToT, the lack of which becomes an issue specifically for the combat readiness that the armed forces seek. End users have made known their willingness to adapt combat operations and tactics to the technology available to them. However, this still leaves the question

of defining what both industry participants (whether DRDO, DPSUs or the private sector) and end users define as modern or cutting edge technology.

The issue of defining and differentiating between 'modern' and 'cutting edge' technology is intrinsically related to the cap on FDI, which hampers foreign OEMs' ease of doing business in India. Modern technology or simply stated the latest or most upgraded technology available in the global market is often required in order to maintain satisfactory levels of combat readiness. Cutting edge technology on the other hand could often be in the experimental or testing stages, which brings with it a host of testing and development issues and a plethora of IPR issues.

Both industry and end users can engage in dialogue in order to come to an agreement on a definition for ToT and what constitutes modern technology. This would also help prioritise what end users consider critical or key technologies, thus contributing to better long-term planning, procurement and combat readiness.

#### **4.3 Future Procurement and other prospects for SPs:**

While the strategic partnership model has provided for limited competition in private sector defence

manufacturing and has also provided a certain degree of purchase security to the manufacturing company (the initial contract for supply of platforms), the MoD is under no obligation after the initial contract to subsequently purchase systems from the SPs.

Private companies will need a firm commitment on business volumes in order to affect any change in the production through the value chain mainly because of the investment volumes that are warranted. The initial strategic partnership contract provides order security for the SP, however, vendor management and supply chain innovation could become a burden given the lack of guarantee of future orders.

Private companies are sceptical about involving the DPSUs or DRDO in the process, as the approach to technology, innovation and research is vastly different in the public and private sectors. It must be emphasized here that for any sizeable private sector participation, the government (especially since it is the only buyer in defence, unless it relaxes export norms) needs to commit on minimum order quantities. Simultaneously, it is incumbent on private sector players to abide by strict project timelines. The private sector must also be aware of the demands of field evaluations and testing, which can add to project timelines.

#### **4.4 Minimum Qualification and Financial Criteria for Selection:**

Another hurdle to implementation of the SP Policy is the selection criteria and methodology. Among the financial, technical and segment-specific criteria, it is the financial criteria that are of great concern to both domestic private sector companies and foreign OEMs. When it comes to consolidated turnover and net worth, some Indian companies have suggested that government prioritise healthy balance sheets and investments in India over the company's investments abroad.

In the selection criteria, 80 per cent weightage is accorded to the cost of the venture (financial and technical criteria) and 20 per cent to segment-specific capabilities. Further, there is a condition that "promoters and directors of the Applicant Company and the Segment Group Company should not be wilful defaulters to the banking system as on the date" of the application. The SP will have to make sizeable investments for production. Currently, recourse to financing has largely been through the banking sector. In the absence of any guaranteed purchases, investments of such magnitudes will yield delayed or no returns. This will result in creation of more non-performing assets, which would deter prospective SPs

as financial criteria will be applicable throughout the initial contract.

End users have pointed out that base criteria, specifically the technical gates for different product groups, need to be more detailed. However, it must be noted that it is not possible to include these details until the evaluation stage. This means that selected SP and OEM(s) would have to be prepared for changes in technical specifications or SQRs at a later stage of product development. This would add significantly to costs and affect project timelines adversely. Both government and end users would have to take these points into consideration when selecting SP and OEM(s) as well as make provisions for such changes/delays.

#### **4.5 Financing Strategic Partnership:**

Chapter VII provides significant detail on the selection criteria for SPs and OEMs, however there is no mention of any framework for the financing of strategic partnership. While normally such decisions are left to market forces, Indian industry is almost certain that given the high value investments required for SP, no financial institutions will come forward with alacrity to finance such defence projects. The lack of assurance on future orders further reduces the prospects of receiving finances or accessing capital markets.

With the banking sector already under a lot of stress, it cannot be expected of them to finance large defence deals. The burden of financing can be shared by all stakeholders by setting up an SPV. Relevant companies may also consider accessing the capital markets by way of issuing bonds (similar to green bonds) or other instruments. Typically, defence bonds have been used as a means of funding war, however it would be helpful if the government facilitates a framework for such capital raises for relevant companies to serve the purpose of funding defence production.

Policymakers continue to assure industry stakeholders that the government is a reliable customer and that once orders are confirmed, payments will be disbursed in a timely manner. However, the one variable in this equation is the single vendor situation that the SP model is liable to give rise to in the approved product groups. This may not be conducive to a competitive environment in the long term. The partnership between the end users, MoD and the SP will not be limited to the time of production. This relationship will have to continue through the life cycle of the product in the form of maintenance contracts and upgradations. Under the current SP framework, the single vendor problem, which hinders competition may become a problem that has not yet been considered.

#### 4.6 Participation of Micro, Small and Medium Enterprises (MSMEs):

The SP Policy is touted as an enabling policy for MSMEs in the defence sector. However, there is no mention of what has been done to provide a push for MSMEs to develop further. MSME representatives have suggested that there be a more open procurement system that encourages innovation. They stated that when it comes to delivery timelines they would appreciate patience from both government and armed forces. When it comes to hardware it takes time, effort and at least two iterations in order to deliver a great product to the satisfaction of the user. The Policy will help in building capacity of MSMEs and this will take time.

Supply chain development is mentioned in passing in the SP policy as the avenue to build capacity among MSMEs as Tier I and Tier II vendors. OEMs noted that skilling is a huge issue when they work with MSMEs. Some suggested that skill development be made an avenue for discharge of defence offsets. This would fulfil two requirements of the Make in India campaign. First, skill development in a technology intensive sector like defence and second, effective use of offsets for employment creation. It would bring both medium and

long-term benefits for the domestic defence industrial base.

Cost of capital, especially for R&D is very high for MSMEs. The Ministry of MSME has the Cluster Development Programme (MSME-CDP) under which funding of up to INR 15 crores is available to MSMEs building capacity in certain sectors or clusters. However, no MSMEs involved in defence manufacturing have approached the Ministry of MSME for this funding as yet. This could be one avenue that MSMEs can use to help with their financing requirement in defence manufacturing.

Despite being developers of technology often in partnership with government labs or larger private players, MSMEs often get short changed when it comes to offering lowest cost and highest technology bids. This is because the MSME is often not recognised as an individual or joint IPR holder for the technology developed. The larger partner, whether DPSU, government lab or private company, is often unwilling to offer reasonable commercial value for the IPR to the MSME.

### 5. The Path Ahead:

Since the major issues with implementation of strategic partnership have been identified, solutions to address

these issues need to be outlined if the objectives of the SP policy are to be achieved. The following are recommendations on how the aforementioned issues can be dealt with.

### **5.1 FDI Limits in Strategic Partnership:**

The provisions of the SP Policy need to be aligned with those of the FDI Policy in recognising the possibility and avenues of greater than 49 per cent FDI in the sector.

All stakeholders have concerns regarding IPR of technology, especially in the context of getting technology export approvals from foreign governments. Given this and the difficulties in obtaining export approvals, it is important that specific provisions be allowed for control rights for the foreign technology transferors, in companies where such technology is being received in India. One must recognise the role that these companies play in supporting potential SPs. The concerns of the Government will be addressed when they receive ToT and those of OEMs by giving them visibility and an administrative share in the Indian companies receiving the technology.

The SP Policy should either, provide for a description of “modern technology” and set out the circumstances that could merit greater than 49 per cent FDI in the SP/

SPV, or provide a list of key technologies where the government will be open to FDI above 49 per cent.

### **5.2 Transfer of Technology:**

Unilateral confirmations from OEMs regarding the ToT requirements may not suffice, and in certain circumstances may not practically be available given laws governing IPR and sharing of technologies in other countries. Therefore, to ensure a fool proof ToT regime, the SP Policy or the RFPs to be issued thereunder should provide room for government to government negotiations. This would cover for dual comfort of performance surety on the part of the OEMs as well as non-disclosure/security comforts to OEMs.

It is also very important to have relevant and extensive discussions on the required technologies. In this context, it is strongly recommended that the relevant stakeholders be involved in this process before issuance of the final parameters and requirements vis-à-vis the technologies being sought by the end user.

The delivery timelines under contracts should be re-assessed, recognising the fact that even with the availability of technology, the process of absorption would take longer as the learning curve would be steeper. Specific focus needs to be put on skilling and

training programs by the government, potential SPs as well as the OEMs to facilitate quicker absorption of technology.

Measuring ToT warrants continuous interaction between manufacturers, end users and the government during the development and life cycle of a product. The government must pursue dialogue with the OEMs in order to determine the cost and quality of product platforms and available technologies. A straight jacket formula for ToT cannot be made applicable across all segments for all platforms that end users may require.

### **5.3 Future Procurements and other prospects for SPs:**

Private companies will need a firm commitment on business volumes in order to bring about change in the production value chain. The initial strategic partnership contract provides order security for the SP, however, vendor management and supply chain innovation could become a burden given the lack of guarantee of future orders. In this light, government may also have to consider relaxing the extant export norms to permit an additional revenue opportunity for the SPs.

Alongside the implementation of the SP Policy, government must review the provisions of ancillary

laws governing the defence sector and enforce necessary relaxations/amendments to ensure smoother functioning of the sector.

### **5.4 Minimum Qualification and Financial Criteria for Selection:**

When it comes to consolidated turnover and net worth, government should consider prioritising healthy balance sheets and investments in India over the company's investments abroad.

Government could consider allowing potential SPs to rely on their parent/group companies as long as the parent/group companies furnish a support letter/affidavit of comfort. Reliance on parent/group companies may be allowed subject to the condition that such entity will infuse equity in the SP in a phased manner.

### **5.5 Financing Strategic Partnership:**

The high value investments that defence manufacturing necessitate and the relative shortage of capital in financial markets make for a difficult environment for financing SP projects.

As already outlined in section 4.5, there are two ways of easing the burden of financing. One, all stakeholders

involved in the project pitch in and share financial responsibilities. Two, have relevant companies issue bonds (similar to green bonds or infrastructure bonds) in order to raise capital for funding production. The latter option will require some help from the government, which can facilitate such capital raises by drafting a framework under which defence bonds can be used (not to fund war, but to raise capital for defence manufacturing).

### **5.6 Participation of Micro, Small and Medium Enterprises (MSMEs):**

Government to also consider allowing MSMEs the right to match lowest/highest offer for commercialization of technology developed in identified areas where MSMEs have the capability to execute. This would provide a significant boost to domestic defence industry.

### **5.7 Need for an Independent Regulator for Strategic Partnership:**

The Taskforce Report clearly states in section 7.3 the need for an independent regulator for “regulation and development of the Strategic Partnership model”<sup>8</sup>.

The Taskforce Report also states that such a body is needed because the SP model will require continuous modification and improvement, as opposed to an annual or multi-year review. However, this sentiment does not seem to have been echoed in Chapter VII in the form in which it was approved. The only mention of any new organisational structure is that an “institutional and administrative mechanism for effective implementation of the Strategic Partnerships will be set up within the MoD, with adequate expertise in relevant fields like procurement, contract law and ToT arrangements”<sup>9</sup>. This does not seem adequate and does not address the purpose for which the recommendation for an independent regulator had been made by the Taskforce Report. In fact, the Taskforce Report recommends the setting up of a specialised wing and auditing wing in MoD for Strategic Partnership in sections 7.4 and 7.5. Neither of these recommendations seem to be reflected in Chapter VII.

It is important that an independent regulator be set up to oversee implementation of SP Policy. The functions of this body as envisaged in the Taskforce Report range from dealing with development and regulation of the SP

<sup>8</sup> Report of the Taskforce on Selection of Strategic Partners, Ministry of Defence, Government of India: pg. 51.

<sup>9</sup> ‘Chapter VII – Revitalising Defence Industrial Ecosystem Through Strategic Partnerships’, May 2016:

model, reviewing pricing mechanisms and adjustments, publishing binding rules or regulations, recording and monitoring contracts to investigating allegations of fraud or breach of contract by SP.<sup>10</sup>

Given the trust deficit and procedural delays that have been elaborated on in earlier sections, having

a regulatory body independent of the bureaucratic hierarchy of the MoD and armed forces will be crucial to efficient implementation and evolution of the SP Policy. The details of this have already been provided in the Taskforce Report. The Government need only act upon the recommendations made in this regard.

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<sup>8</sup> Ibid: pg. 52.







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