KOCHHAR & CO.
ADVOCATES & LEGAL CONSULTANTS

India: Implications of The New Policy on Defence & Aerospace Sector

30 September 2016

by Suhas Srinivasiah (Gurgaon)

Kochhar & Co.

Introduction

India has the third largest armed forces in the world, with a phenomenal 31.1% of its annual budget spent on capital acquisitions of defence equipment. At present, a staggering 60% of the defence equipment requirement of the armed forces is met by imports. Based on available statistics, a close ally and the world's oldest democracy, the United States of America is known to be the largest supplier to the Indian defence sector.

The aerospace sector is another key area of potential foreign collaboration for India, having seen remarkable growth over the last decade in the civil and defence aerospace fields. India is currently the 9th largest civil aviation market in the world, with projections seeing India as the 3rd largest aviation market by the year 2020. It has been announced that the allocation for the defence sector in India's 2016-17 budget is approximately Rs. 2244.56 billion (approx. USD 38 billion). Further, it is predicted that India will invest more than USD 130 billion for modernization of the defence sector over the next 7 – 8 years. Based on available statistics, the Indian aviation sector is likely to see investments of USD 12.1 billion during 2012-17, with an investment of USD 9.3 billion projected from the private sector alone.

In order to facilitate and attract substantial investments in these two key sectors, the year 2016 has seen crucial and strategic policy announcements by the Government of India in the form of the new Defence Procurement Manual 2016, the National Civil Aviation Policy 2016 and liberalization of the foreign direct investment regime in both the defence and aerospace sectors.

These policy announcements coupled with the economic potential makes the Indian defence and aerospace sectors two of the most attractive areas for future investment by American (and other foreign defence and aerospace players) as well as by local Indian companies.

Policy Initiatives in the Defence Sector

Background to the defence procurement Process

Capital defence procurements in India are regulated by the Defence Procurement Manual ("**DPP**") issued by the Ministry of Defence ("**MoD**"), Government of India. First issued in 1992, the DPP has been amended over the years, with the latest version being the Defence Procurement Manual, 2016 ("**DPP 2016**"), issued by the MoD on June 8, 2016, in its most comprehensive form. The DPP 2016 is directed at increasing the participation of India's private sector in military manufacturing, thereby supplementing the Indian Government's "Make in India" initiative for the defence sector.

Key aspects of the DPP 2016

- Overall, the DPP 2016 seeks to introduce provisions and procedural measures to make the defence procurement process more efficient and effective. For example, the Request for Information process has been clearly stipulated, which was not very clear under the earlier DPPs.
- Generally speaking, the procurement of defence equipment under the DPP 2016 follows a graded system of priority, viz., (i) Buy Indian- IDDM; (ii) Buy (Indian); (iii) Buy and Make (Indian); (iv) Buy and Make; and (v) Buy (Global).
- Buy Indian-IDDM (IDDM stands for Indigenous Designed Developed and Manufactured) category has been made a priority under the DPP 2016. This category refers to procurement of defence products from an Indian vendor, where the products that are indigenously designed, developed, and manufactured need to have a minimum of 40% indigenous content ("**IC**") on the cost basis of the total contract value, or products need to have 60% IC on the cost basis of the total contract value, if not designed and developed within India. It appears that the intent of this new category is to promote in-house and local design capacity, thereby increasing the participation of Indian private sector companies in defence production.
- The DPP 2016 has liberalised the threshold for offset liabilities for foreign vendors in the Buy (Global) (i.e., outright purchase from a foreign/Indian vendor) and the 'Buy and Make' categories of procurements. Under the DPP 2016, the offset obligations apply where the estimated cost of the acquisition is Rs. 2,000 crores (approx. USD 305 million) or more. This is a significant increase from the previous amount of Rs. 300 crores (approx. USD 50 million) stipulated under the DPP 2013.
- Offset obligations on foreign suppliers has been generally retained at 30%. This means that at least 30% of the estimated cost of acquisition in the Buy (Global) category and 30% of the foreign exchange component in the 'Buy and Make' category should be locally sourced by the foreign suppliers.

- The DPP 2016 is aimed at encouraging growth of the micro, small and medium enterprises (MSMEs), with a certain category of "Make" projects reserved exclusively for this sector.

Appointment of agents by foreign Vendors

One of the key changes of the DPP 2016 relates to use of agents by foreign vendors. The DPP 2016 contains specific guidelines for the appointment of an agent by a foreign vendor, thereby bringing in greater transparency in the defence procurement process.

Foreign vendors can now appoint agents to market its products, subject to specific conditions such as (i) disclosure of agents at the time of submission of the offer, and if hired in any subsequent stage of procurement, within two weeks of the engagement of the agents; (ii) the MoD retains the right to reject or accept, at any point of time, any agent; and (iii) the foreign vendor must ensure complete transparency in payments being made to an agent, with a prohibition on conditional payments or penalties based directly or indirectly on the success or failure of the award of a contract.

It is expected that this key progressive step will curb corruption in defence deals which was earlier a key stumbling block in ensuring swift, effective, strategic and competitive procurement for the armed forces.

Foreign Direct Investment in the Defence Sector

Shortly after issuing the DPP 2016, on June 20, 2016, the Government of India substantially liberalized the Foreign Direct Investment ("**FDI**") policy in the defence sector.

FDI up to 100% is now permitted in the defence sector (subject to the industrial licensing requirement under the Industries Development and Regulation Act, 1951). FDI up to 49% in the defence sector is now under the automatic route (i.e., without the need for any prior foreign investment approvals). Wherever it is likely to result in access to modern technology in India or for other reason to be recorded, FDI beyond 49% and up to 100%, has now been permitted under the Government approval route on a case-by-case basis.

The above FDI limit for the defence sector has also been made applicable to manufacturing of Small Arms and Ammunitions covered under Arms Act, 1959.

Policy Initiatives in the Aerospace Sector

FDI in the aerospace sector

The Indian Government encourages private investment in both the civil and defence aerospace sector, with 100% FDI allowed under the automatic route for most activities. There are certain investment limits for domestic and foreign private participation in various aerospace activities, as listed below:

- 100% FDI under the automatic route is permitted for Greenfield airport projects. l Up to 74% FDI under the automatic route is permitted for existing airport projects with up to 100% permitted under the Government approval route.
- Up to 49% FDI under the automatic route is permitted in domestic scheduled passenger airlines with 100% FDI permitted for Non- Resident Indians ("NRIs").
- Up to 49% FDI under the automatic route is permitted in Non-Scheduled Air Transport Service with FDI above 49% and up to 74% permitted under the Government approval route. 100% FDI is permitted for NRIs in this sector.
- Foreign airlines are also allowed to invest in the capital of Indian companies operating scheduled and non-scheduled Air Transport Services up to the limit of 49% of their paid-up capital, subject to Government approval.
- Up to 100% FDI under the automatic route is permitted in helicopter services and seaplanes.
- Up to 49% FDI under the automatic route is permitted in ground handling services. FDI above 49% and up to 74% is permitted under the Government approval route. 100% FDI is permitted for NRIs in this sector.
- Up to 100% FDI under the automatic route is p e r mitted in maintenance and repair organisations, flying training institutes and technical training institutes.

The investments are subject to relevant regulations, approvals from the aviation regulatory authorities and security and other conditions.

Outlook for the Aerospace Sector

India announced a new National Civil Aviation Policy in 2016. This Policy relates to areas such as regional connectivity, safety, air transport o operations, bilateral traffic rights and aeronautical "Make in India" initiative. Certain Indian States such as Karnataka and Andhra Pradesh have issued their own aerospace policies. Recognizing the huge potential in this sector, the policies are aimed at creating a conducive environment for investors, including in the development of the maintenance, repair, and overhaul segments and in R&D activities for the aerospace industry.

Karnataka is known as the aerospace capital of India with prestigious institutions such as the National Aeronautics Limited (NAL), Hindustan Aeronautics Limited (HAL), Indian Space Research Organization (ISRO), Indian Institute of Science (IISC), Defence Research and Development Organization (DRDO), etc., based in Bangalore. Karnataka seeks to further this reputation and retain its top position by leveraging its established strengths in aerospace manufacturing and R&D activities. In this regard, it has framed the Karnataka Aerospace Policy 2013–2023, which has a phased implementation, with Phase-1 (2013-18) being a growth phase and Phase II (2018-23 and beyond) being a medium-to-long term consolidation phase. Under the Karnataka Aerospace Policy, the State has ambitious plans of attracting investments of Rs 60,000 crores (approx. USD 9.2 billion) in the two phases.

Conclusion

Even prior to the "Make in India" program and the other policy announcements, the National Manufacturing Policy 2011, amongst other sectors, specified defence and aerospace as focus and thrust sectors. In this regard, India has already taken steps such as excluding a large number of components of defence products from the requirement of compulsory industrial licensing. Further, manufacture of several defence items has been thrown open to the private sector, which items were earlier reserved only for manufacture by the public sector.

It is believed that the combined effect of the progressive policy announcements in the form of the "Make in India" program, the DPP 2016, the National Civil Aviation Policy and the liberalised FDI regime in both the defence and aerospace sectors will result in foreign manufacturers/ suppliers entering into strategic partnerships with Indian companies, thus contributing to substantial development of the local domestic market and also enabling India to become a substantial supplier to the global market in the years to come.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

AUTHOR(S)

Suhas Srinivasiah

Kochhar & Co.