ASSOCHAM INDIA

Contents

Make in India: Achieving self-reliance in defence production

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Message from the President, ASSOCHAM

In the last two years, private participation in India's defence sector has been rising. Large Indian conglomerates have increased their exposure to defence manufacturing on the one hand. On the other hand, foreign defence contractors are showing their confidence in India by expanding their tie-ups with Indian companies. This is facilitated by policy support, both specifically for defence, and generally under the Make in India campaign, which was showcased successfully in the Make in India Week last month. After big foreign and Indian companies, we must ensure that medium and small Indian enterprises dramatically increase their contribution to defence production. To do so, they need both financial support and the requisite infrastructure, perhaps through a dedicated defence industrial park in two or three locations of the country.

This report updates and expands on the 2014 report. It also discusses the concerns of big and small companies, both domestic and foreign. Finally, it makes a good set of suggestions on the way ahead. I am sure ASSOCHAM members and others interested in the sector will find this report to be a useful companion to the exhibitions at DEFEXPO.

Sunil Kanoria
President
ASSOCHAM

Message from the Secretary General, ASSOCHAM

It gives me immense pleasure to announce the Global Investors' Summit on the Defence Sector during DEFEXPO 2016 at Naqueri Quitol, Goa, on 29 March 2016.

With the announcement of the Make in India policy and the new DPP by the Government of India, ASSOCHAM is taking this discussion forward through this summit to understand and create a proper ecosystem for manufacturing in the defence sector in India.

I thank PwC, our knowledge partner, and the ASSOCHAM team for preparing this paper for the conference. I would also like to convey my good wishes for the success of this Global Investors' Summit on the Defence Sector.

With warm regards,

D S Rawat
Secretary General
ASSOCHAM

Foreword

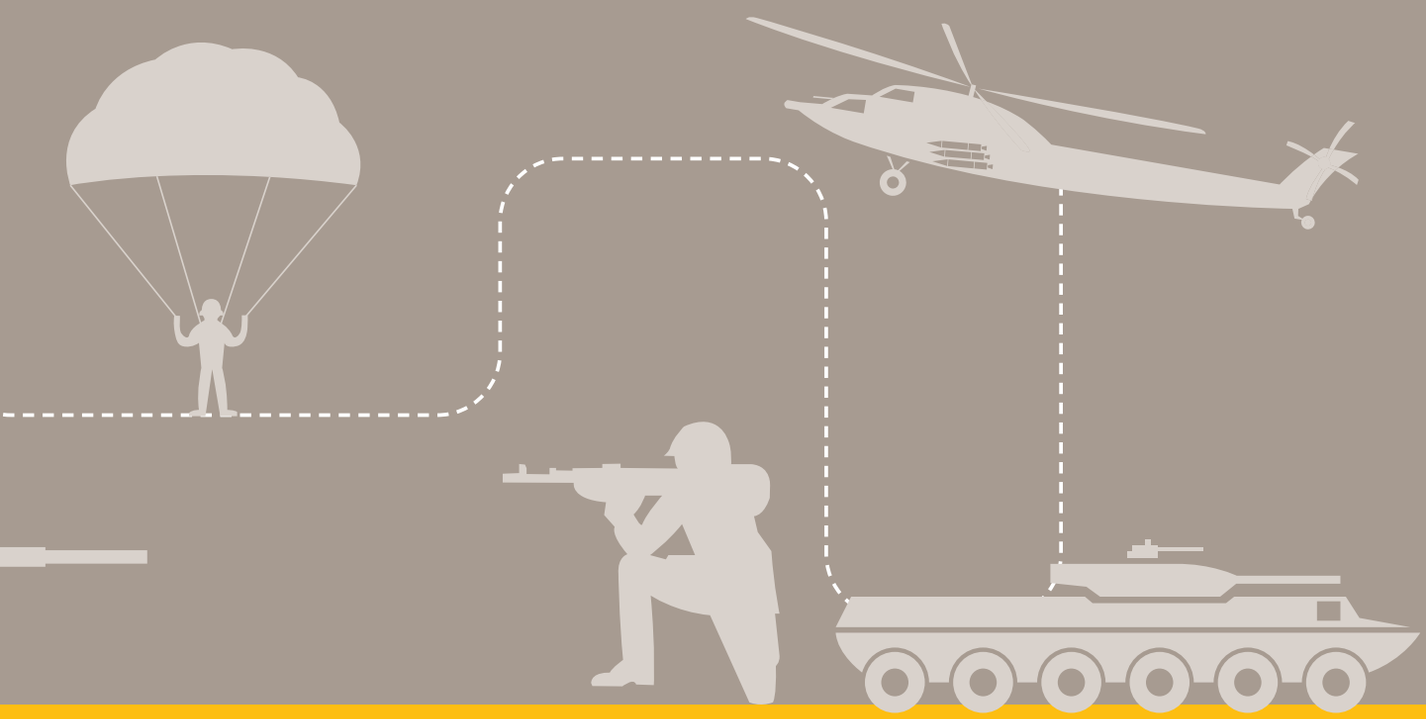
This report is a follow-up to our report 'Self-reliance in defence production: The unfinished agenda' released in 2014, after the new government assumed office. Based on an industry survey, we had made specific recommendations for boosting the indigenisation of defence equipment. We are delighted to state that the government has paid attention to the feedback from industry and addressed a number of issues we had raised, and we are confident that the balance will be addressed in the proposed DPP 2016.

In this report, we present details of the work done by the government in the past two years towards creating an ecosystem that facilitates the building of a domestic defence industrial base. The report is based upon valuable inputs from the Department of Defence Production, as well as a survey of both domestic and foreign companies, directly as well as through ASSOCHAM.

The most important initiative of the government is the Make in India campaign, which brings under one umbrella the various initiatives taken or proposed to boost domestic manufacturing. Its success in the defence sector will largely depend on the extent to which the government can leverage its massive spending programme to promote domestic manufacturing.

The government has taken several policy initiatives to lower entry barriers and improve the ease of doing business in defence manufacturing: The regime and procedure for grant of an industrial licence for manufacturing defence equipment has been significantly liberalised and speeded up, clarifications have been issued to facilitate the implementation of offset obligations, an export strategy has been announced, and export NOCs are issued online. Further, the FDI policy has been liberalised, almost 90% of the AoNs that have been approved by the Defence Acquisition Council in the last two years have been under the three Make in India categories, and a new DPP is under finalisation that should further strengthen the policy regime to promote defence production in India.

Our interviews with industry leaders bring out valuable insights for the growth of the A&D industry. Overall, the industry has appreciated the measures taken and the proposed innovations in DPP 2016. For instance, the industry



welcomes the proposal to identify select Indian private sector defence manufacturers as strategic partners and believes that the new acquisition category of 'indigenous designed, developed and manufactured' will be a game changer for the future and will foster innovation and R&D. There are some words of caution though. Some OEMs are apprehensive about achieving the indigenous content of 60% (most are struggling to achieve the existing 30%) and feel that this needs to be reduced or, at least, calibrated. For instance, almost 70% of the raw material in aerospace has to be imported as composites and many exotic alloys are not made in India. There is more that can be done through simplification of regulations and creation of an A&D ecosystem to accelerate growth. Infrastructure and skill development are critical for achieving self-reliance and the government should continue encouraging clusters. The private sector should be treated as an equal partner and a collaborative partnership approach should be followed with the suppliers. Finally, the proof of the pudding is in the eating: The government must award a major contract to the Indian industry as soon as possible!

Overall, change is in the air! The signs from the government are refreshingly positive: There is a palpable change in mindset in the government in general and in the MoD in particular. Enthused by this, an increasing number of Indian private sector companies are looking to enter defence production and the local ecosystem is ripe for foreign partnerships. OEMs have also responded with enthusiasm and expressed their commitment to Make in India. We are confident that this campaign will act as a significant enabler and catalyse the manufacturing sector to the next level of growth.

We would like to thank A K Gupta, Secretary, Department of Defence Production, and his team, our clients and senior officials in the DPSUs for their valuable insights. We are also grateful to ASSOCHAM for inviting us to be their knowledge partner. We trust that you will find this report useful and look forward to your valuable feedback.

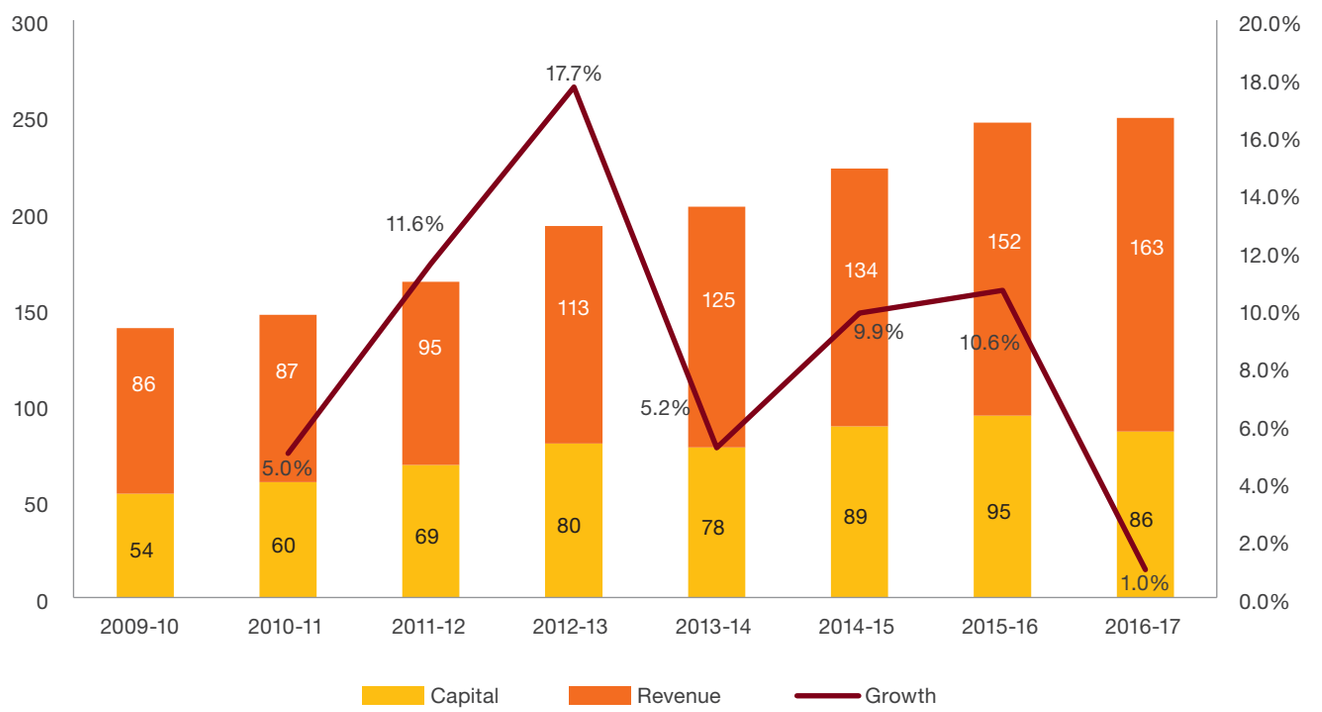
Dhiraj Mathur, IAS (Retd)
Partner, Leader, Aerospace and Defence
PwC India

The unfinished agenda

Background

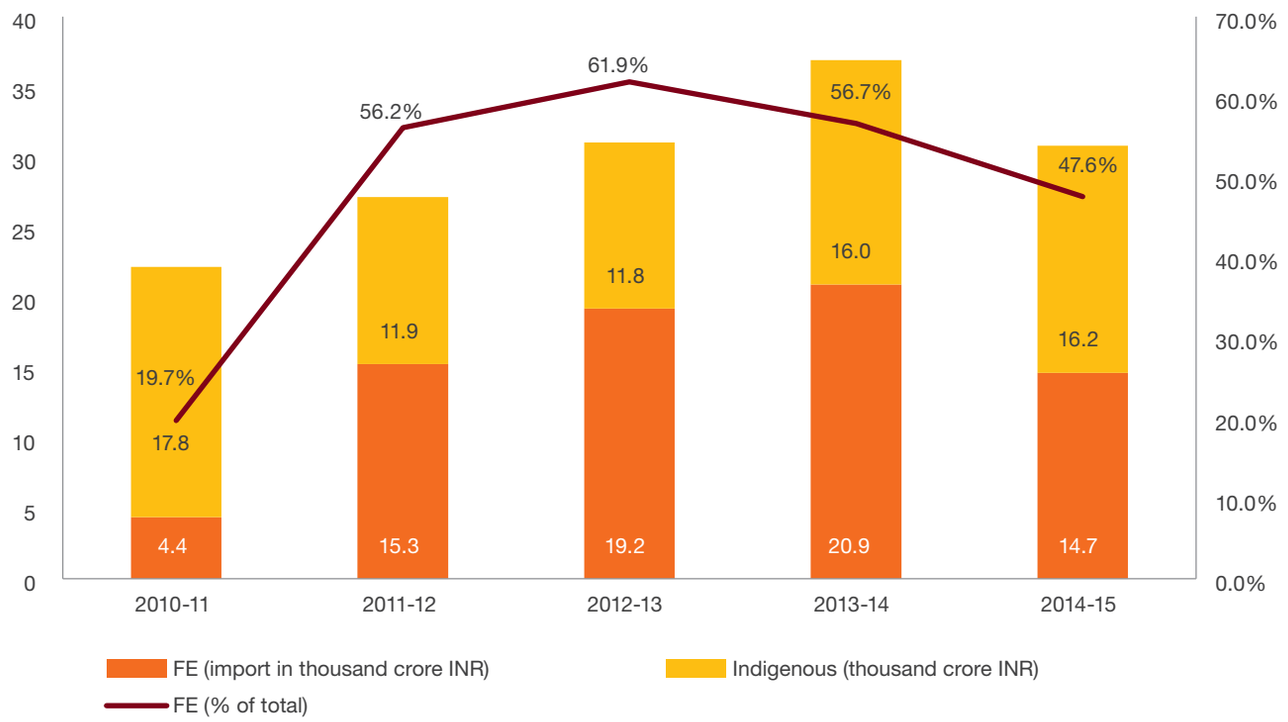
India's A&D market is among the most attractive globally and the Indian government is keen to leverage this advantage to promote investments in the sector. India ranks among the top 10 countries in the world in terms of its military expenditure and import of defence equipment. It allocates about 1.8% of its GDP to defence spending, of which 36% is assigned to capital acquisitions. However, only about 35% of defence equipment is manufactured in India, mainly by PSUs. Moreover, even when defence products are manufactured domestically, there is a large import component of raw material at both the system and sub-system levels.

Indian defence budget (figures in thousand crore INR)



Source: Controller General of Defence Accounts

Foreign exchange content in annual capital budget



Source: Dhirendra Singh Committee Report

This report is a sequel to an earlier PwC report which was released in 2014 and based on an industry survey to identify areas requiring government intervention to boost indigenisation in defence production. In that report, we had focussed on what we believed to be the unfinished agenda since there were multiple areas that needed urgent attention. Based on the findings of that survey, we had identified the following issues where the government needed to act to accelerate the pace of indigenisation.

Amendments to DPP

- **Simplification of the 'make' procedure:** The existing procedure is complex and time-consuming. Although three programmes had been initiated almost four years ago, the government has not been able to finalise even one of them.
- **Protection of exchange rate variations:** Protection of exchange rate variations should be applicable for rupee contracts to the domestic industry to provide a level playing field.
- **Selection of *navratnas***: The concept of selecting *navratnas* in the private industry needs to be revisited.
- **Reintroduce services as an eligible offset avenue:** Services, including software, constitute an integral part of the development of an indigenous defence sector. This is one domain in which India truly has a competitive advantage. Holding services in temporary abeyance has hampered future investments in this segment.
- **Allow discharge of offset obligations by vendor group companies and subsidiaries:** Under the current offset policy, the responsibility to discharge offset obligations rests with the foreign OEM who signs the contract with the MoD. Globally, the defence and aerospace industry is tiered with systems, sub-systems and components being manufactured by Tier I, II and III suppliers respectively, with the vendor/OEM doing the final integration and supplying to the buyer or MoD. Presently, any sourcing executed by group companies, subsidiaries or Tier II and III suppliers of the OEM is not counted towards offset discharge of the OEM. We had recommended the lifting of this restriction.

- **Flexibility to OEMs for offset allocation to IOPs:** Foreign OEMs are required to list specific products, values and quantities to be procured from each IOP for each year of execution before signing an offset contract. It is difficult to forecast such details for the future, particularly because of the long interval between the submission of the offset proposals and their actual implementation. We had recommended that the OEM be given a window to provide offset implementation charts for the next two years only.
- **Increase in FDI cap:** Though the FDI cap had been increased, it was felt that a limit of 49% may not suffice to achieve the overall aim of Make in India.
- **Export policy:** There was a need for greater clarity on procedures and time-bound clearances as a robust export policy is a critical prerequisite for building a domestic defence production industry.
- **Taxes:** In order to resolve the differential indirect tax structure between foreign OEMs, DPSUs and private sector players and promote MRO, we had recommended rationalisation of taxes and duties to promote domestic value addition.
- **Special support to MSMEs:** Even though the central government had announced a number of measures over the last few years to encourage MSMEs in defence production, implementation of these policies was tardy. Support to SMEs was considered essential for improving ease of doing business.

We are delighted to state that the new government has paid attention to the suggestions made by the industry and has addressed a number of these issues. We expect most of the remaining to get addressed in the new DPP.

In the following chapters, we focus on the work done by government in the past two years towards building a domestic industrial base and industry feedback. Our findings are based on valuable inputs from the Department of Defence Production as well as a survey of both domestic and foreign companies, directly as well as through ASSOCHAM.

Government initiatives and achievements

> *We believe that the Make in India is the journey that will evolve into Make for India, and later going global.*
>
> – Jayant Damodar Patil, SVP and Head, Defence and Aerospace, Larsen & Toubro Limited

The prime minister of India launched the Make in India campaign in 2014 with the central objective of boosting manufacturing and generating employment by focussing on 25 sectors, including A&D. The key objectives for the defence sector were promoting self-reliance, indigenisation, achieving economies of scale, developing capabilities for export, transfer of technology and domestic R&D. The government has taken a large number of important decisions to achieve the above objectives. In this chapter, we present details of key policy announcements as well as specific decisions taken towards this end. Through our survey and our experience in advising Indian and foreign companies, we have found that the industry is reacting positively. An increasing number of Indian companies are looking to enter this sector. Leading OEMs like Boeing, Lockheed Martin, Saab, Dassault Aviation and Eurofighter have offered to set up manufacturing bases in India along with transfer of technology.

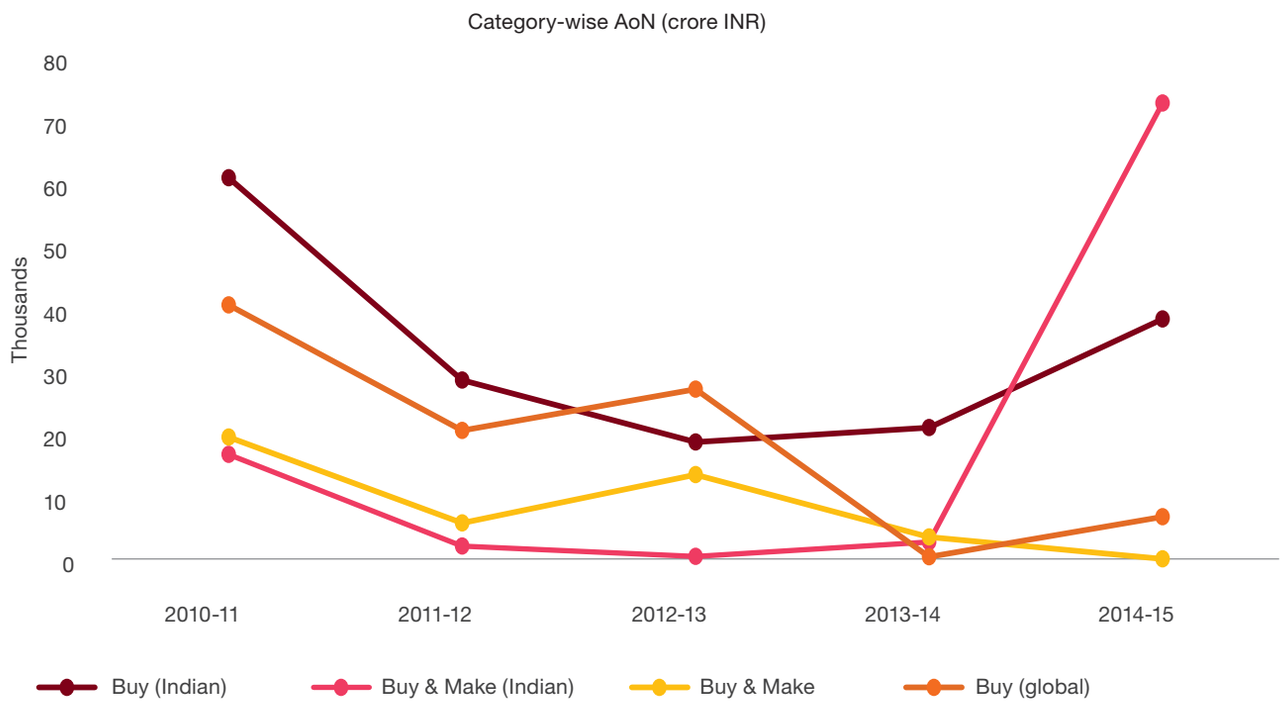
AIRBUS GROUP

Airbus Group is one of the participants in the 'Make in India' initiative, with annual procurement from India exceeding US$500 million from over 45 suppliers in 2015 and support for more than 6,000 local jobs. Thanks to this supply chain, every Airbus commercial aircraft produced today is partly 'Made in India'. The Group has set its sights on exceeding US$2 billion in cumulative sourcing, covering both civil and defence, in the five years up to 2020. It has also offered to build the C295W military transport aircraft in India along with Tata Advanced Systems and has formed a partnership with Mahindra Defence to manufacture military helicopters locally. Around 80% of the Group's nearly 500 direct employees in India are engineers. In addition, the Group operates two dedicated design centers with partners and collaborates closely with institutions such as the IITs, IIMs and the Tata Institute of Fundamental Research (TIFR).

Source: Airbus Group

AoN

During the current financial year—i.e. 2015–16—the government has accorded AoN under the 'Buy (Indian)' and 'Buy & Make (Indian)' categories to 33 capital acquisition proposals amounting to 55,800 crore INR (approximately). Moreover, in the past two years, almost 90% of the AONs by value belong to these two categories.



Source: MoD

WIPRO LIMITED

Wipro has designed, developed, integrated and maintained solutions for the INDIAN DEFENCE FORCES, DPSUs, DRDO and ISRO for several decades. It is today engaged by several Global A&D companies for providing Manufacturing, Engineering and IT solutions to support Indian as well as Global Aerospace and Defence Programs.

Manufacturing – Wipro established an A&D green field plant in Bangalore's Aerospace SEZ and supplies parts/ components for Hydraulic actuation to leading European and US air framers/tier1&2 clients. Wipro now addresses several western Commercial and Defence programs and is moving up the value chain. It today offers Advanced Manufacturing Solutions through 3D printing of parts (prototype and serial production) for several Aero, Space and Defence applications.

Engineering – Wipro along with its foreign technology partners has begun addressing the Control Systems and Avionics LRU's related systems and sub-system requirements for Indian and foreign platform integrators/ manufacturers, besides providing traditional engineering services to its clients.

IT/ ITES – While being a Valued IT Partner for 'Digitization' and Business solutions, its Business Process Outsourcing services address customers' integrated logistics support, MRO - operations support and technical publications need.

Strategic Differentiator: Ability to address entire Avionics product life cycle (Cradle to Grave) or specific sections of it! Wipro's Product Qualification and Compliance Lab (TARANG) is a 'one-of-its-kind' test facility equipped to perform mechanical, environmental, EMI/EMC and reliability testing to do pre-qualification, qualification & Safety of Flight (SOF) tests on LRU's, as well as ruggedizing for avionics and defense requirements.

Source: Wipro Limited

Amendments to DPP 2013

The government has made a number of amendments to DPP 2013 that were welcomed by domestic and foreign industry during the past year.

- Introduction of a standard operating procedure for processing change of Indian offset partners and products
- Extension of exchange rate variation benefit to the private sector on par with DPSUs and OEMs
- Taxes and duties parity w.r.t. DPSUs
- Customs and excise duty exemptions withdrawn for all defence purchases, bringing parity with foreign OEMS
- Bringing smaller defence deals under the ambit of the 'integrity pact'
- Restoring 'services' as an eligible avenue for offset discharge
- Reducing the requirement of indigenous content to 30% in 'Buy (global)' bids where an Indian firm/JV is bidding for the proposal

FDI policy

Ending years of debate and indecision, in August 2014, the new government raised the FDI cap in the defence sector from 26% to 49%. In November 2015, it further liberalised the policy and allowed FDI up to 49% under the automatic route and subject to an industrial license. FDI above 49% is permitted under the government route on a case-to-case basis, wherever it is likely to result in access to modern and state-of-art technology in the country. The enhanced FDI caps would be subject to the following conditions:

- Infusion of fresh foreign investment within the permitted automatic route level in a company not seeking an industrial license, and resulting in a change in the ownership pattern or transfer of stake by an existing investor to a new foreign investor, will require government approval.
- Licence applications will be considered and licences given by the DIPP, Ministry of Commerce and Industry, in consultation with the Ministries of Defence and External Affairs.
- Foreign investment in the sector is subject to security clearance and guidelines of MoD.
- An investee company should be structured to be sufficient in the areas of product design and development. The investee/JV company, along with the manufacturing facility, should also have a maintenance and life cycle support facility for the product being manufactured in India.

Though it is early days, this liberalisation seems to have had a positive impact. As per FDI data published by DIPP, from 2000 to 2015, total FDI inflows were a paltry 24.84 crore INR. In comparison, between August 2014 and December 2015, the inflows in defence were 125 crore INR. Post-August 2014, FIPB has received 18 proposals for approval, of which 6 were advised to access the automatic route, 7 were approved and the remaining 5 either rejected or withdrawn.

Sr. No.	JVs approved by FIPB from August 2014 to December 2015
1	M/s BF Elbit Advanced Systems Pvt Ltd
2	M/s Mahindra Telephonics Integrated Systems Ltd
3	M/s Sikorsky Aircraft Corporation
4	M/s Fokker Elmo SASMOS Interconnection Systems Ltd
5	M/s Aequs Pvt Ltd
6	M/s ideaForge Technology Pvt Ltd

Source: FIPB minutes

Announcement of partnerships

- **Lumax Auto Technologies Ltd and SIPAL S.p.A.:** The proposed JV is expected to become operational in fiscal 2017 and will be a full service provider for all types of Integrated Logistic Support Engineering having a strong knowledge and experience in Technical Publishing, Product/Manufacturing engineering, Process engineering, design and manufacture of tooling, design of systems of production lines related to the Aerospace, Defence & Automotive sectors.
- **Tata Advanced Systems and Boeing:** The proposed joint venture would be engaged in manufacturing of aero structures for AH-64 Apache attack choppers and collaborating in integrated systems development.
- **Kalyani Strategic Systems Ltd and Rafael Advanced Defence Systems Ltd:** The proposed JV will produce Spike Anti-Tank Guided Missiles (ATGM).
- **Mahindra Defence and Airbus Helicopters Ltd:** The proposed JV will produce helicopters.
- **Kalyani Strategic Systems Ltd and Saab Group:** The proposed joint venture would be engaged in manufacturing of surface-to-air missile (SRSAM) system and very short-range air defence (VSHORAD) air defence programmes
- **Punj Lloyd Ltd and Israel Weapon Industries:** The proposed joint venture would be engaged in manufacturing of guns and their components.
- **Bharat Electronics Ltd and Thales:** The joint venture would be engaged in manufacturing of new technology radars.

Source: Media reports

AEQUS India Private Limited

We expect continued growth in commercial aerospace, but seek to retain a balance between our commercial and defence portfolios. Identifying the main trends and harnessing the shifts can lead to continued growth in the defence industry. Recent changes in the Indian Defence procurement programmes are aimed at creating an 'all new world' as far as Defence manufacturing is concerned. The Defence Minister's vision of procuring close to US$8 to US$10 billion per year worth of Defence products in the next 5 to 10 years clearly indicates its favourable intent towards creating a positive environment for the Indian manufacturers. The outlook for 2017 is increasingly international and complex, but it is not without opportunity.

Source: Aequs India Private Limited

Licensing policy

In the last two years, DIPP has taken a number of decisions to further liberalise the licensing regime. It has extended the validity of an industrial license for manufacturing defence equipment to 15 years. This will provide long-term comfort and stability to investors.

In addition, it has issued a number of clarifications to eliminate uncertainty and improve ease of doing business in defence manufacturing in India:

- Ending years of confusion and uncertainty, DIPP has published the list of defence equipment that will need an IL under the IDR Act. Significantly, it has removed almost all dual use items, components, parts, sub-systems, testing equipment and production equipment, and retained only the integrated systems. This is a welcome step that will facilitate the growth of a supply chain in the sector.
- The process of applying for an IL and IEM has been moved completely to the Internet.
- The requirement of an affidavit from the applicants has been done away with.
- The restriction on annual capacity in the defence sector has been removed.
- Licensees have been allowed to sell defence items to government entities under the control of MHA, PSUs, state governments and other defence licensee companies without the approval of the Department of Defence Production.

Foreign trade policy

A key objective of the Make in India campaign is to develop export capabilities in the defence sector. This is important not only to build economies of scale but also to become globally competitive. In order to meet this objective, it is imperative not only to provide incentives for exports but also to simplify policy and make synergistic, constructive and proactive interpretations in implementation. Towards this end, the new government has taken a number of important decisions in 2015.

The MoD published a list of 16 categories of defence export equipment that require an NOC, thus clarifying which products are restricted. A defence export strategy has been formulated and placed in the public domain. The strategy outlines specific initiatives to be taken by the government to encourage the export of defence items in order to make the domestic industry more sustainable in the long run. A standard operating procedure for online application for issue of NOCs for the export of military stores has also been finalised. Moreover, the requirement of an EUC signed and stamped by government authorities has been dispensed with for most of the defence items, particularly for parts, components, sub-systems and sub-assemblies. A web-based online system to receive applications for NOCs for the export of military stores has also been developed and is operational.

Direct tax

The government has clearly stated its goal to transform India into a manufacturing hub and has emphasised the Make in India programme. Both defence and aerospace are important sectors under this programme. Industry had expected that the government would introduce measures in the budget to promote domestic manufacturing.

While no direct incentives were provided to the sector during the budgets announced by the government in the last two years, some of the proposals do indicate its vision to promote manufacturing in India. Significant tax incentives were introduced last year for new manufacturing units set up between 1 April 2015 to 31 March 2020 in the notified backward areas of Andhra Pradesh and Telangana in the form of additional investment allowance at 15% and additional depreciation at 35% on the cost of new plant and machinery.

Last year, the government announced a phased reduction in the corporate tax rate from 30% to 25% over the next four years. Under the current budget, an option of a reduced tax rate of 25% has been proposed to manufacturing companies set up after 1 March 2016, subject to the company not claiming any profit or investment-linked deductions. This is an incentive for companies looking to set up a manufacturing base in India.

In a welcome move, the requirement of PAN in case of foreign companies has now been diluted. The Indian tax law provides for a minimum tax withholding at 20% in the absence of PAN if the income is chargeable to tax. In order to reduce the compliance burden, the above provision is proposed to be amended such that it does not apply to a non-resident if the prescribed conditions are fulfilled. Weighted deduction at 130% of new employee cost has been extended to all sectors, subject to specified conditions. For the capital-intensive units, investment allowance has also been rationalised to allow acquisition and installation before the period of expiry—i.e. 31 March 2017—as against the dual condition of acquisition and installation in the same year.

On the other hand, industry has been pitching for profit-linked tax holidays to promote manufacturing. However, over the last two years, the government has repeatedly indicated its intention to move away from profit-linked incentives and has accordingly provided a sunset clause for phasing out the existing profit-linked tax incentive for eligible businesses, as referred to in sections 80IA, 80IAB and 80IB, which are presently available to the various sectors. Also, to promote investments in India, the tax holiday available to the infrastructure sector (including airports) has been replaced by an investment-linked incentive with effect from 1 April 2017, allowing a 100% deduction of capital expenditure incurred on setting up of the said infrastructure facility.

The tax rate applicable to foreign companies on royalty was reduced from 25% to 10% in last year's budget, which had reduced the cost of technology purchase and thus helped in reducing the input costs of Indian companies. Availability of technology at a competitive price is a major impediment and industry has been asking the government to provide further tax relief. Currently, tax exemption is available to foreign companies for royalties/service payments on a contract entered into with the central government in relation to the security of India. A similar exemption was expected by industry for foreign companies entering into a contract with Indian companies in order to provide a level playing field to private companies as well. While the government had reduced the tax rate on such payments to 10% last year, the demand of complete tax exemption has skipped the attention of the government.

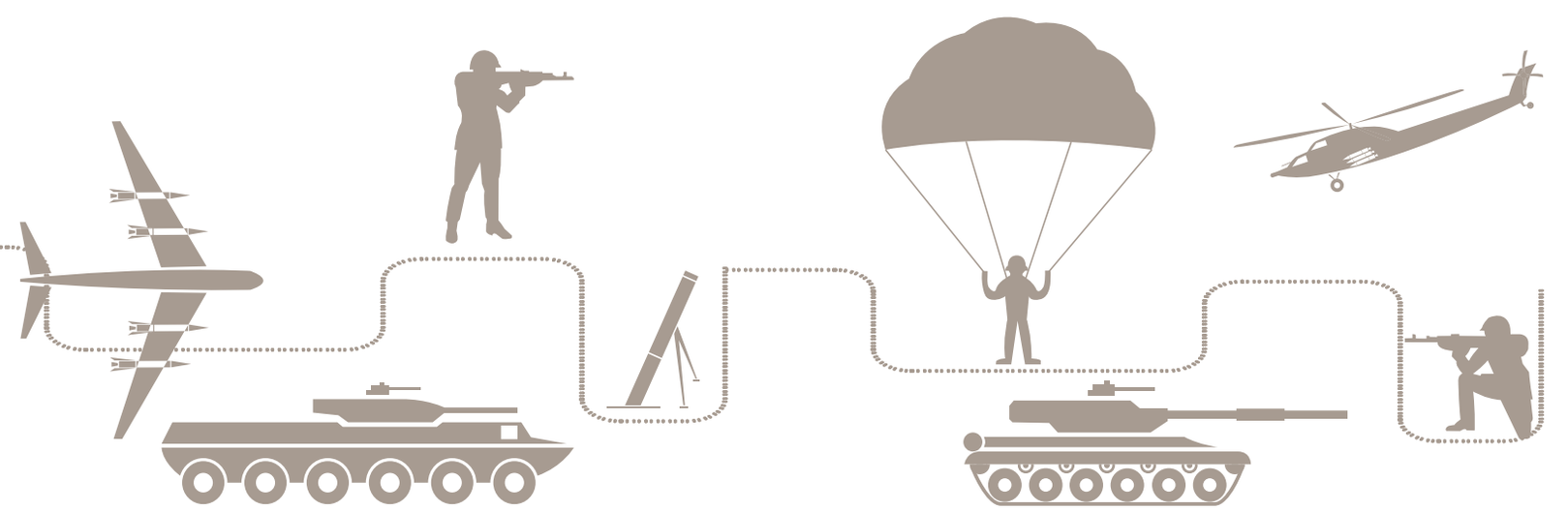
In order to encourage indigenous research and development activities and to make India a global R&D hub, it is now proposed that the royalty income of a resident (patentee) in respect of a patent developed and registered in India be taxed at a lower rate of 10% on the gross amount of royalty. Further, no MAT will apply on such income. However, while the government has introduced a special tax regime for patents, it has also proposed that weighted deduction of expenditure incurred on in-house scientific research will be restricted from the current 200% to 150% from 1 April 2017 till 31 March 2020, and 100% thereafter.

Over the past two years, the government has been focussing on ease of doing business in India as well on creating a tax environment which boosts the confidence of foreign companies. Several changes like clarity on the non-applicability of MAT provisions for foreign companies having no business presence in India, clarifications on rules relating to indirect transfer of assets, dispute resolution schemes, and rationalisation of litigation and penal provisions have been introduced, which indicates the intention of the government.

In a nutshell, while there may no concentrated benefit to the industry, the changes in direct taxes introduced over the last two years do indicate the government's aim to promote the industry with a particular focus on manufacturing in India. The impact of these efforts may be seen in the medium to long term.

> *In the recent budget for FY17, the government has announced a roadmap for phasing out incentives such as benefits on R&D expenses under section 35–2AB and benefits for infrastructure companies under section 80(IA). The fledgling defence industry needs these benefits for sustenance and growth till it reaches a state of maturity.*
>
> – A large Indian private sector player

> *India is still seen as having a very complex tax code that is difficult to implement and subject to interpretation.*
>
> – An OEM



Indirect tax

In the past few years, the government has proposed measures to spur local manufacturing and incentivise domestic value addition. The cost competitiveness of the defence manufacturing sector has also been focussed upon through rationalisation of duties and taxes.

Considering the multiple levies of indirect taxes in India, the following are the keynote comments on indigenisation in the A&D industry:

Customs duties: The effective rate of customs duty on the import of goods is 29.44%. A majority of goods imported in relation to defence and commercial airlines were earlier exempt from the levy of customs duty. However, in order to provide a level playing field to local manufacturers and promote the Make in India initiative, the government has withdrawn customs duty exemption on import of specified goods for defence purposes by the government of India or a state government[1] or its contractors/sub-contractors.

To further provide impetus to indigenous manufacturing, the government also amended the custom laws to provide for exemption of customs duty on import of 'tools and toolkits' when procured for aircraft, subject to fulfilment of certain specified conditions. The time limit on stay of foreign aircraft undertaking maintenance, repair or overhauling has been increased from 60 days to 6 months or such extended period as approved by DGCA.[2]

Earlier, under the Standard Exchange Scheme, import of aircraft parts for repair/overhaul in India was subject to levy of customs duty. However, the benefits of exemption have now been extended to such imports in India.[3]

For ease of doing business in India, the procedure for availing of duty exemptions on aircraft parts, testing equipment, and tools and toolkits has been simplified and the restriction of one year for utilisation of duty-free parts for MRO of aircraft has also been removed subject to fulfilment of specified conditions.

With respect to the defence sector, these amendments would significantly support the indigenisation policy of the government. The immediate impact of the above amendments would be an increase in the cost of procurements.

Excise duty: The effective excise duty rate is 12.5%. Exemption from excise duty is available for aircraft, if sold to the government or to commercial airlines engaged in specified activities.

To give a boost to the Make in India initiative, the amendments in the MRO operations have also been provided for in the excise laws, and the duty on indigenous procurement of tools and toolkits for aircraft has been exempted.

1 With effect from 1 April 2016 vide Notification no 13/2016-cus dated 1 March 2016

2 With effect from 1 March 2016 vide Notification no 12/2016-cus dated 1 March 2016

3 With effect from 1 March 2016 vide Notification no 23/2016-cus dated 1 March 2016

The procedure for testing equipment and tools and toolkits for MRO operations of aircraft has been simplified, and the restriction of one year for utilisation of duty-free parts for MRO operations of aircraft has been removed subject to fulfilment of specified conditions,[4] similar to what has been proposed under customs law.

Goods supplied against ICB are exempt from excise duty subject to prescribed conditions. The challenge is to ensure that these benefits actually accrue. With the government's plan on indigenisation, though imports have been made subject to customs duty, a blanket exemption still needs to be carved out for the supply of goods to the A&D industry.

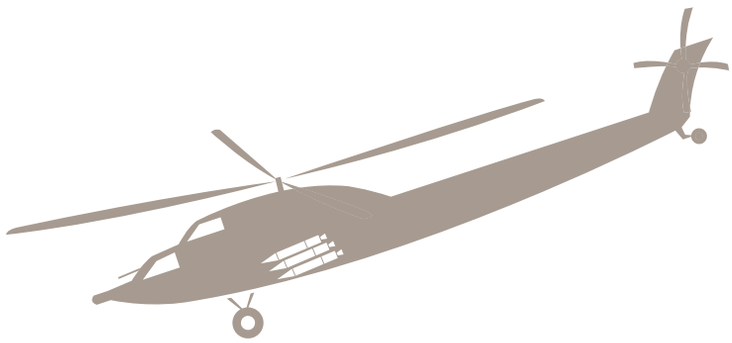
VAT and CST: While interstate sale of goods is subject to CST, intrastate sale of goods is subject to VAT. The CST rate is 2% if the prescribed statutory form (i.e. Form C) is issued by the purchaser. If no forms are provided, the VAT rate applicable in the originating state of the seller will be applicable. For most goods, the VAT rate ranges from 5–15% depending on the nature of goods. Sale of spares under the MRO operations are charged to VAT, which range from 5–15% across the states. Typically, airline operators do not have the option to buy it at concessional rates of CST against usage of Form C as they do not meet the eligibility criteria for the issuance of Form C.

No general exemptions or concessions are available on the sale of goods to defence and commercial airlines. Accordingly, the relevant state VAT legislation should be examined and the possibility of special dispensation if required from the state government should be explored so that the domestic procurement of goods is economically on a par with imports. Participants in India's MRO industry believe that the tax regime needs to change in order to enable India to position itself as an MRO hub.

Service tax: As per Union Budget 2013, exemption for services provided to the government in relation to the repair or maintenance of an aircraft was withdrawn with effect from 1 April 2013. Exemption on services by way of construction, erection, etc., of original works pertaining to an airport and port was withdrawn with effect from 1 April 2015. The same has now been restored[5] for contracts entered into prior to 1 March 2015 (on which appropriate stamp duty has been paid, where applicable) subject to production of certificate from the Ministry of Civil Aviation or Ministry of Shipping with retrospective effect. The tax paid for the period of April 2015 to February 2015 shall get refunded. Further, this exemption will be available till 31 March 2020.

The burden of input taxes is reduced to the extent of service tax credit admissible to MRO customers. With the proposed procurement plan, exemptions or concessions from the service tax perspective need to be introduced for boosting the domestic service industry.

Others: The states are also authorised to levy other local taxes such as entry tax, octroi and local body tax. Moreover, an R&D cess at 5% is also applicable on the import of technology in specified situations.



> *The success of 'Make in India' for the defence industry is in ensuring the success of 'Design in India', thus leveraging the strength of Indian engineers for India's success.*
>
> – Pritpal Singh Chhinna, Head, Aerospace and Defence (Strategic Initiatives), WIPRO Limited

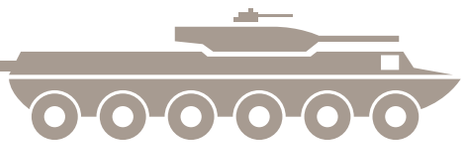
Initiatives by state governments in the A&D sector

Enthused by the initiatives of the government of India and recognising the huge potential upside from the defence sector, many state governments have taken a number of initiatives to promote investments in defence manufacturing. States like Karnataka have a dedicated an industrial park for aerospace companies. This state was also the first to announce a separate Aerospace Policy 2013–23. In addition, Karnataka has taken numerous initiatives to strengthen the ecosystem, including creating skilling infrastructure by partnering with industry, creating a technology centre and special processes facility. Gujarat is in the process of formulating a new defence manufacturing policy. Telangana is home to a large number of defence research laboratories like DRDL, RCI and DMRL. A group of innovative aerospace SMEs also exist in Hyderabad who have supplied components to the Chandrayan and Mangalyaan initiatives. The state's industrial policy (2014) lays down a large number of benefits for the defence manufacturing units. Madhya Pradesh, Chhattisgarh and Andhra Pradesh are considering the defence sector as the priority sector under their respective industrial policies.

4 *With effect from 1 March 2016 vide Notification no 12/2016-cus dated 1 March 2016*

5 *With effect from 1 April 2016 vide Notification no 09/2016-st dated 1 March 2016*

Industry feedback



Proposed DPP[6] 2016

The government had set up a committee under the chairmanship of Dhirendra Singh to propose measures to boost indigenisation. A key recommendation of this committee is the selection of strategic partners from the Indian industry for six major groups of platforms. Subsequent to this, the Aatre Committee was appointed to suggest the criteria for selecting the partners. It is widely believed that many of the recommendations of both committees will be incorporated in the new DPP 2016.

In an unusual and bold move, the defence ministry has circulated key proposals for DPP 2016 to industry associations.[7] In this section, we discuss the findings of our survey as well as reactions of domestic large companies, domestic MSMEs and foreign companies to these proposals. We were pleasantly surprised to find that there is a broad-based consensus among all three segments on most of the issues, particularly their enthusiasm for Make in India and appreciation of the measures taken by the government to increase ease of doing business and providing a level playing field to the Indian industry with both DPSUs and foreign OEMs.

> *The Make in India campaign has given a thrust to indigenisation of the defence sector with strong emphasis on enhanced role for the private sector.*
>
> – A large Indian OEM

> *Encouraging private sector players to play a major role in defence manufacturing by being strategic partners is a positive move.*
>
> – A foreign OEM

Review of single-vendor situations

The new DPP is likely to have a policy for single-vendor situations. Such a situation is an emerging reality in an industry with limited suppliers for different platforms. Rejecting such proposals for the sake of competition would unnecessarily delay acquisitions. Retracting an RFP has been a common practice in case of a single vendor. This has been done even in cases where more than one bid was received initially but others withdrew at different stages, including after the TEC. Hence, the decision of the government to review its policy for single-vendor situations has been welcomed by the entire industry.

> *MoD should grant ERV from the date of submission of bids instead of opening of bids, as presently followed.*
>
> – A large Indian private sector player

Introduction of IDDM categorisation

DPP 2013 had introduced an acquisition hierarchy: 'Buy (Indian)', 'Buy and Make (Indian)', 'Make', 'Buy and Make', 'Buy (Global)'. DPP 2016 is likely to introduce a new category—IDDM, in addition to the existing ones. Under this category, it would be mandatory to have 40% IC for indigenously designed equipment, or 60% IC for other equipment. Moving a step ahead of DPP 2013, the Buy IDDM procurement category will be given the highest preference.

The Indian industry has welcomed IDDM and sees it as a *'game changer for the future as this would push other Indian companies to do more within the country and eventually lead to real technology development'. They believe that this category will also foster innovation and R&D and are of the view that "for the first time in the history of Indian defence procurement, the importance of design and development has been recognised by the Ministry of Defence'.*

They expect that the technology and the IP in the products shall be owned by Indian companies. Moreover, *this category is going to bring huge inflow of funds into R&D and will ensure that the scientific talent in India is engaged in*

6 *Please note that we do not have access to the draft version of the DPP as it is not in the public domain. We are relying on the draft press note circulated by MoD to industry associations. It has been attached as an annexure.*

7 *Ibid.*

developing cutting-edge technologies in defence. However, they also feel that there is a need to conduct deliberations through industry forums and establish methodologies in the qualification of indigenous content.

Foreign OEMs have also welcomed the change but with certain reservations. They feel that this category will be difficult to implement as OEMs have moved away from manufacturing systems and components in their factories. They rely on a global supply chain and have limited influence in mandating suppliers to localise in a given country unless economics and technical capability justify the investment. *Therefore, achieving indigenous content of 60% would be difficult and the timing to achieve such a target needs to remain flexible. There also does not appear much justification in having two levels of IC, since a 40% IC reduces the distinction between the IDDM and 'Buy (Indian)' categories*.

Moreover, in the segments where the Indian industry is not yet mature, it will be difficult to have a foreign company ready to transfer state-of-the-art technology and related IP rights from the onset to an Indian company, for the Indian company to compete in the IDDM category. *Either this foreign company will sell outdated technology or sell modern ones at a high cost, rendering the project non-competitive*. Furthermore, once the technology is sold, the foreign company would not have any incentive to ensure the success of the transfer and the end result could lead to costly failures. On the contrary, the 'Buy and Make' category would allow combining speedy deliveries through the 'Buy' while developing local capabilities through the 'Make'.

> ***One of the major challenges faced while working with DPSUs is their inherent unwillingness to work with the private sector and slow pace of decision-making to execute MoUs and partnership agreements.***
>
> – A large Indian company

> ***The success of IDDM shall depend on the ability of Indian companies to partner with foreign technology providers at the current levels of FDI permitted in defence.***
>
> – A large Indian private sector company

> *We have a good working relationship with DPSUs. We believe there are and would be programmes wherein we would compete. Bringing about a level playing field would enable the partnership to mature and contribute to enhancing the indigenisation of the defence sector.*
>
> – A large Indian private sector player

> *The A&D sector should be granted 'infrastructure' status. It must also defer section 10AA of tax exemptions.*
>
> – A large Indian private sector player

Splitting the 'Make' category

The 'Make' category has not taken off in the country so far. In DPP 2016, this categorisation is likely to be split into three parts: The 'Make I' category would be for government-funded projects, 'Make II' category would be for industry-funded projects, and 'Make III' category projects would be reserved for MSMEs.

The extent of funding under the first category will be increased from the existing 80–90% and the remaining 10% will also be reimbursed if the RFP is not issued within 24 months from the date of successful development of the prototype. The cost of development will have to be borne by the developer under the 'Make II' category. However, if the RFP is not issued within two years of successful development of the prototype, the MoD will reimburse the full cost of development to the developer.

Projects with an estimated development cost of less than 3 crore INR, to be self-funded by the developer, would fall in the 'Make III' category. This category is reserved for the MSMEs.

'Make' projects will be steered and monitored by a dedicated project management unit, chaired by a major general or equivalent officer from each service headquarters. Companies having a majority stake by an Indian and controlled by resident Indians will be eligible for projects under the 'Make' category. These companies need to have a minimum credit rating of B++, issued by recognised credit rating agencies. For acquisitions covered under the 'Make' procedure, developed equipment should have 50% indigenous content.

The Indian industry is of the opinion that *the details of schemes, which are considered amenable for the 'Make' procedure, be shared with the industry during regular interactions. They recommend that the private industry should be involved in such projects at the feasibility stage itself. Further, the 'Make' procedure must be simplified to be implementable. The SME sector is of the view that the ceiling fixed at 3 crore INR is unreasonable.*

> ***There is a need to support SMEs financially. The proposed limit of 3 crore INR for funding Indian SMEs under the 'Make' category in DPP 2016 is low and needs to be increased.***
>
> – An SME

Changing the layout of QRs

In a measure to allow for moving beyond a rigid 'L1' approach, future RFPs are expected to have 'essential' as well as 'desirable' technical parameters or staff SQRs. The essential parameters will have to be demonstrated at the trial stage and will have to be present in the final product. This will reduce the retraction of RFPs. In fact, it will be helpful if the MoD goes a step forward and institutes a suitable mechanism to address the situations, such as minor deviations, typographical errors or minor omissions, which do not materially alter the character of the RFP in terms of capability being sought, associated deliverables or have major commercial implications. The RFPs will also contain enhanced performance parameters to provide for additional capabilities over and above the essential parameters. Vendors who meet them will be provided additional credit score while evaluating their product cost.

Both foreign and Indian industry feel that this is a welcome departure from the L1 concept and will encourage them to go the extra mile in product quality.

> ***The A&D acquisition process most of the time is long, burdensome and uncertain with changing regulations (DPP, taxes). It is difficult for suppliers to align their commercial and industrial strategy with the Indian acquisition programmes.***
>
> – A foreign OEM

Private industry as PAs

At present, the defence sector, except for general equipment and systems, is dominated by DPSUs, a few PSUs and OFBs. There are very few private industry participants in the spaces marked 'select segments' and 'equipment/system/platforms'. Further, the capacity constraints of DPSUs/OFB are evident in many acquisition schemes. Therefore, while existing DPSUs, PSUs/OFB would continue to occupy the core position in the area of their competence, within the limits of their existing capacity, there is a need to encourage the private industry to create the much-needed fresh capacity. An area of encouragement for the private sector can be earmarking them as production agencies.

The new DPP is likely to allow this in 'Buy and Make' cases, especially with the advent of 'strategic partners'. Both foreign and Indian industry feel that this is a step in the right direction. However, they are of the opinion that the eligibility criteria for the selection of PAs to receive ToT for manufacture or maintenance should be simple and transparent. The private industry is also of the view that the government should discontinue grants to DPSUs to establish a level playing field.

Raising the offset threshold

The DPP 2016 is likely raise the offset threshold level to 2,000 crore INR from 300 crore INR. This will reduce the quantum of offsets flowing into India.

The Indian industry has two points of view—one section of the Indian industry feels that raising the threshold to 2,000 crore INR is a hasty move. Keeping offsets applicable to 'Buy (Global)' programmes above 300 crore INR will provide the necessary support to IOPs in building capabilities and technology partnerships that support their future efforts to

bid for 'Buy (Indian)' or Make in India programmes. Select SMEs have also pointed out that the move to increase the offset threshold is detrimental to the Make in India campaign as the sector requires ploughing back of capital to develop and enhance local industry participation. Another section of the Indian industry is of the opinion that the increase in threshold is beneficial as the management and monitoring by the MoD will become more efficient as the number of programmes decreases. If combined with a directed and outcome-based approach, it will deliver essential technologies and compensate for the reduction in offset opportunities.

Foreign OEMs see this as a positive and a logical step. However, they perceive the offset policy as complex and requiring further simplification in the implementation stage, as the documents to be submitted to the MoD are voluminous and without any scope of e-filing. *The administrative process is just not compatible with industrial timing. The offset credit mechanism for banking of offset claims should therefore be time bound and efficient. There must be a time limit of three months for the DoMW for replying to questions.* They are also of the opinion that services create value and high-skilled jobs in the country and should not be subject to any cap.

> ***To negate the ill effect of abeyance and actually derive benefit from the offset policy, the government should provide a multiplier effect for engineering services.***
>
> – A large Indian private sector company

Strategic partnerships

A major recommendation of the Dhirendra Singh Committee was to identify select Indian private sector defence manufacturers as strategic partners. These companies would play central roles in developing complex and strategic systems within the country, or receive technology transferred from foreign suppliers in large defence contracts. A company that has been declared a strategic partner in any one platform, say submarines, will not be chosen as a strategic partner for any other programme, such as aircraft or artillery guns. This is to prevent creation of monopolies. The defence ministry formed a task force headed by former DRDO Chief V K Aatre to recommend the modalities of the strategic partnership model. It divided the sectors eligible for strategic partnerships into two groups. In Group 1, there are aircraft, helicopters, aero engines, submarines, warships, guns (including artillery guns) and armoured vehicles, including tanks. In Group 2, the segments are metallic material and alloys, non-metallic material (including composites and polymers) and ammunition. The task force recommended that in the initial phase, only aircraft, helicopters, submarines, armoured vehicles and ammunition be considered for strategic partnerships.

The idea of strategic partnerships may not form part of DPP 2016, however, it needs to become an integral part of the DPP at the earliest.

Large Indian private players have welcomed this initiative and see it as the first step in recognising the investments made and potential of the private sector, on a par with DPSUs. They believe that in the long-run, it will speed up and reduce the cost of acquisitions. They believe that there is also a need to carry it to the Tier I level such as aircraft engines, avionics and landing gears to build national assets and capabilities. They also recommend that there should be no monopoly and competitiveness should be ensured. Further, there should be no restrictions on inter/intra sector participation to build economies of scale.

On the other hand, SMEs believe that only big companies with large capital bases will benefit from this proposal. Most small defence manufacturers will get left out with the orders going to select large private players and foreign OEMs unless a foreign OEM has supported the initiative but has stated that for it to succeed, the private industry must have assurance of long-term orders to be able to make the huge investments needed. It has been recommended that the entire process be kept simple to avoid over-regulation.

A foreign OEM welcomed the initiative, as long-term assurance on orders is essential before making huge capital investments. Long-term investments are the best way to become globally competitive. However, it felt that the scheme has to be well designed to ensure the foreign OEM has the incentive to commit to transfer critical technology in the long run.

> *The strategic partnership route should be kept simple and allow private initiatives without too many interferences.*
>
> – A foreign OEM

FDI

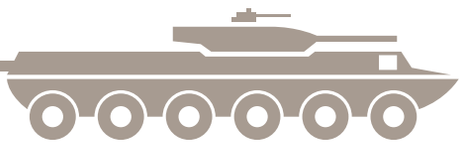
The divide on FDI continues, though with less fervour. Select foreign OEMs have recommended an increase of FDI cap to 74% as they feel this will bring in more investments and advanced technologies. They are of the opinion that this will allow smaller and medium sized Indian companies not having big investment capabilities to team up with foreign investors who are ready to bear the majority of the investments. Once the increase in FDI is carried out, there can be a phased reduction of FDI, allowing domestic companies to gain control over time.

Sections of the Indian industry feel that a further increase to 74% may be practical only for true high-tech items in India's shopping list of technologies, especially in areas where we have not been able to achieve consistency in spite of years of decades of R&D. It may be provided where technology can lead to other major industrial spin-offs, and where the Indian market alone would not provide a scale to justify the investment made by the Indian partner, (e.g. production of aircraft engines and aviation platforms). And finally, there is also the view that this limit should not be raised.

Providing a level playing field

All respondents have unanimously welcomed the measures taken by the government to provide a level playing field to the Indian private sector vis-à-vis DPSUs and foreign OEMs. These include the changes in the excise and custom duty regimes, providing ERV to private industry on a par with DPSUs, allowing private companies to use government-owned trail facilities, and the entire Make in India campaign as well as the measures discussed above.

Way forward



The next five years will see considerable change in the dynamics of the industry. The results of liberalisation and proactive policy decisions by the government in the last two years are beginning to bear fruit and will gather momentum as decisions are executed. From a demand perspective, while the overall size of the market is anticipated to grow, there is uncertainty related to the functional aspects of the new DPP. From a supply perspective, DPSUs/OEMs will continue to meet the needs of the services till RFPs are issued in the new categorisation and contracts awarded. This will also give private companies time to form partnerships and ramp up capabilities and capacities.

The development of key technologies and manufacturing skills related to setting up a comprehensive industrial base is in its early stages of evolution. Both domestic players and international entrants need to lay emphasis on setting the foundations of their businesses so that they are able to capture value as the Indian aerospace and defence market matures over the next five years. In doing so, stakeholders need to understand the nature of the market, their participation in key sectors of the value chain, making investments in building capabilities in niche areas of the value chain and executing for the long run.

Creating an eco-system for building an industrial base in A&D

Infrastructure will play a major role in the sector's development. As India moves towards more complex aerospace and defence manufacturing, an ecosystem must be made available for the industry to sustain its advantage and ensure further growth. The fragmented supplier base needs well-developed infrastructure to leverage efficiencies. The government should continue encouraging A&D hubs, which in turn will see many more players entering this industry and making sizeable investments.

Creating clusters is particularly relevant for MSMEs who supply components and sub-assemblies to the DPSUs, ordnance factories, DRDO and private players. Long gestation period and uncertainty about repeat orders makes it difficult for MSMEs to operate in the defence sector. Clusters ease access to employees, suppliers, technology, warehouses and transportation, leading to collective efficiency. It also allows MSMEs to take higher risks.

Skill development

Skill development is critical for achieving self-reliance. Aerospace and defence production requires high precision manufacturing which needs a talented pool of personnel having specialised training and certifications. The government must take steps to strengthen the skilled manpower in the country.

- Introduce formal education institutes and universities in aerospace and defence technology disciplines (like military engineering)
- Upgrade existing Indian training institutes to produce technically sound individuals
- Formation of Defence Sector Skill Council and institution of Defence Industry Internship program
- Subsidise important international accreditations for the SME

Change in the mindset

There has been a dramatic and welcome change in the mindset in the government. The Department of Defence Production, till recently, perceived as DPSU/OFB oriented, has become extremely proactive in building a domestic defence production ecosystem. There is also a perception that DPSUs treat the private sector as potential competition. This mindset is changing and the private sector is increasingly being treated as an equal partner. This should continue and a collaborative partnership approach should be followed with the suppliers as against a customer-vendor relationship. In many programmes, the private industry is willing to make investments and only expects the government to offer them support in terms of additional timelines and hand-holding by the armed forces to incorporate domain operational nuances. The private industry must be looked upon with trust and viewed on a par with DPSUs as nation-builders rather than profiteers. The private sector should also identify platforms, systems, sub-systems that it wishes to produce and start finalising technology tie-ups and partnerships. And finally, foreign OEMs need to appreciate that indigenisation is the future and re-work their strategies to align themselves to the Make in India mantra.

Increase outsourcing

A vibrant government private sector collaboration, which is essential to ensure that Make in India becomes a reality, will require the government to simplify procedures of doing business with DPSUs/OFB and increase their outsourcing to private players. Under guidance from the Department of Defence Production, DPSUs and OFB have made/ are finalising outsourcing policies. They must gradually increase their outsourcing and develop Tier I and Tier II vendors for creating a supply chain within the country and themselves focus on becoming integrators.

Further, *most of the times, DPSUs deny advance payment to their private sub-contractors even though they get an advance payment from the government. There should be a direction by the government to pay pro-rata advance to the private sector. In addition, there should not be a requirement of multiple registrations in various divisions of the DPSUs, as is the prevalent practice*.

Clarity in execution of IDDM

The government is making an effort to ensure that Make in India does not become Assemble in India with no control on design. The new category, referred to as indigenously designed, developed and manufactured (IDDM) platforms, is bound to give a fillip to indigenously designed systems. However, the overlap, if any, with existing 'Buy (Indian)' and 'Buy and Make' category must be clearly addressed in the forthcoming DPP, or else the categorisation of procurement proposals and their execution will become more challenging. Further, the rules of procurement should be clearly enunciated as the challenge lies in its comprehensive implementation.

The time frame to meet the increased requirement of 40–60% IC should be flexible. It may be noted that in the aerospace sector, almost 70% of the raw material is imported as composites and many exotic alloys are not made in India, and are unlikely to be in the foreseeable future, as the market size does not support the huge investments required. Hence, achieving 60% IC is likely to be a challenge, particularly when OEMs are struggling to meet the existing 30% requirement. Placing an IDDM programme at the top of the hierarchy may risk delays in acquisition unless the programme nominated for IDDM is carefully chosen and wisely implemented. Definition of IC should include both cost of raw-material and value addition which is a common practice in most countries. In India, only value addition is allowed as IC but not the cost of raw-material when imported.

Overall, having three different levels of IC (40%, 50% and 60%) increases the complexity of implementation without any significant gain.

Transparent, clear and realistic guidelines for selection of strategic partners

Strategic partners will play a central role in developing 'complex and strategic systems' within the country, or receive technology transferred from foreign suppliers in large defence contracts. Clear and simple guidelines are required regarding their selection as well as the percentage of proposed cost of project that will be outsourced to entrepreneurs and MSMEs by defence PSUs, Ordinance Factory Board and potential strategic partners. The strategic partner should also be mandated to develop a supply chain of MSMEs.

Create a clear demand profile

The medium and long-term perspective plans for A&D sector have been framed but not shared with the industry. The industry is of the opinion that sharing equipment requirements over the long term in a transparent manner, without compromising national security, will provide the industry with information and confidence to invest in a production process that is measured in decades rather than years.

Maintain status quo in FDI

We believe that status quo should be maintained as the present liberalisation seems to be having a positive impact as seen from the fivefold increase in FDI in defence between August 2014 and December 2015 compared to the total inflows between 2000 and 2014. In any case, FDI above 49% under the government route is already allowed on a case-to-case basis, if it results in access to modern and state-of-the-art technology in the country.

Align tax policies to create synergies

An Indian or foreign company that wishes to operate in this sector has to comply with multiple polices that are often contradictory. The government must continue to rationalise the tax framework to encourage the use of local resources to build the country's skills and expertise across the aerospace and defence value chain. No general exemption or concessions are available on the sale of goods to defence and commercial airlines. Accordingly, the relevant state VAT legislation should be examined and the possibility of special dispensation, if required from the state government, should be explored so that the domestic procurement of goods is economically at par with imports. Participants in India's MRO industry believe that the tax regime needs to change in order to enable India to position itself as an MRO hub. Exemptions or concessions from the service tax perspective need to be introduced for boosting the domestic service industry.

From the direct tax point of view, the industry is looking at tax incentives that promote manufacturing in India. Availability of technology at competitive price is a major challenge and government should consider reducing the tax cost attached with import of technology and related services by Indian companies, which may provide a boost to the industry. Currently, tax exemption is available to foreign companies for payments for royalties and services on the contract entered into with the central government in relation to the security of India. The industry was expecting that similar exemption would be allowed to foreign companies entering into contract with Indian companies, in order to provide a level playing field to private companies as well.

High cost of capital

The defence industry is capital intensive and has a long gestation period. To become risk-sharing partners within the ecosystem, private companies need to make significant investments in R&D plant and machinery, certifications, building capability and buying technology from foreign OEMs. The higher interest rate regime in India places Indian companies, particularly MSMEs, at a great competitive disadvantage. There are suggestions that a part of the technology development fund may be reserved for funding development projects. Non-collateralised funding through the defence SME fund should be implemented to allow SMEs to benefit from the low-interest loans from the banking system to develop SME ecosystem. However, any attempts to provide "reservation" should be avoided to ensure these business establishments compete as per free market dynamics.

Leverage M-SIPS of the Department of Electronics and Information Technology to encourage defence production

In promoting defence production, the government should learn from the experience of and leverage M-SIPS of the Department of Electronics and Information Technology. Imports of electronics items constitute the third largest category of imports after crude and gold, and are expected to become the number one import item by 2025, when the demand-supply gap is expected to cross 300 billion USD. This scheme was, therefore, launched to boost the negligible domestic production of electronics goods in the country. It provides up to 25% cash subsidy on eligible capital expenditure as well as refund of central indirect taxes for setting up both greenfield and brownfield manufacturing of a very wide range of electronics products, including defence items.

Based on our considerable experience assisting companies to apply under this scheme, we have found that the M-SIPS policy has given a tremendous boost to electronics manufacturing. This is evident from the fact that India has witnessed a six-fold jump in proposed investments in local electronics manufacturing of 1.14 lakh crore INR (16.8 billion USD), with global firms such as Samsung, LG and Sony setting up or expanding their factories in the country.

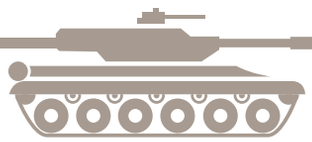
While the A&D industry should leverage the M-SIPS policy to drive down capital expenditure and improve return on investment, the government could perhaps consider extending this scheme to other strategic defence equipment.

Include R&D as an eligible offset activity

Domestic R&D is a critical component of the ecosystem for building a manufacturing base. This will also be the defining activity for the IDDM and 'Make ' categories. Hence, the government must encourage R&D. This can be done by allowing R&D as an eligible offset activity. To leverage the vast talent pool and physical infrastructure available at institutions like IIT and IISc, both outcome-/application-based investments in as well as long-term R&D at such institutions, or in those recognised by the Department of Scientific and Industrial Research of the government of India, should be eligible activities for discharging offset obligations. In addition, the government should restore the income tax allowance for R&D investments, which has been scaled back in budget 2016, to domestic companies.

> *Enable MSMEs to build and showcase expertise by providing easy access to capital. We must understand the sector's uniqueness in terms of working capital cycle and timelines.*
>
> – Indian company entering the defence sector

Annexure



Reference for industry feedback section: Proposed DPP 2016[8]

The DAC met under the Chairmanship of the Hon'ble Defence Minister on 11/01/2016 and key provisions of the DPP, as listed under have been approved.

1. The revised DPP, envisages to provide a boost to the Indian government's Make in India initiative, enhance the involvement of the private sector, build indigenous design and development capabilities, promote absorption of world-class technologies, provide premium consideration to high quality products, promote the growth of the MSME sector, reduce time lines across various stages of procurement, among other procedural refinements effected to enhance efficiency and effectiveness of the defence procurement process. The salient features of the approved procedures of DPP are listed below:

2. Introduction of a new category of acquisition: 'Buy (Indian)' (IDDM), to promote indigenous design development and manufacturing. Under this category, indigenously designed equipment with 40% indigenous content (IC), or equipment with 60% IC will be considered for acquisition. This category will be the most preferred acquisition category, above the existing 'Buy (Indian)' category.

3. 'Buy (Indian)' category of acquisition requires a minimum IC of 40%. 'Buy and Make (Indian)' and 'Buy and Make' categories require an overall IC of 50%.

4. Essential parameters have been classified as Essential Parameters A and B. Essential Parameters B are those parameters that can be developed by vendors, who have been selected and contracted based on Essential Parameters A. This is to increase vendor base by allowing participation of vendors who will make changes to existing product specifications, only on receipt of assured orders.

5. RFPs will also contain Enhanced Performance Parameters, to provision for additional capabilities over and above the essential parameters; vendors meeting the same will be provided additional credit score while evaluating their product cost.

6. Offset obligations will be applicable only in cases where the acquisition cost exceeds 2,000 crore INR.

7. Provisions to involve private industry as production agencies and technology transfer partners have been made.

8. Single vendor cases at the bid submission stage, TEC stage, and Staff Evaluation stage will be processed, with due justification. Retraction of RFP in case of single vendor situations is not the norm.

9. TOC will be applicable only in cases above 2,000 crore INR, instead of the 300 crore INR as per the existing norms. The following provisions have been made under the 'Make' procedure:

1. Three sub-categories of the 'Make' procedure 'Make I' (government funded), 'Make II' (industry funded) and 'Make III' (MSME funded) have been provisioned.

2. 'Make I' (government funded) involves 90% funding of the development cost, by the government. Remaining 10% of the development cost would be reimbursed, if RFP for the equipment developed is not issued within 24 months from the date of successful development of prototype. Projects under 'Make I' sub-category, with estimated development costs of less than 10 crore INR will be reserved for MSMEs; and will be opened up for non-MSMEs, only if it is not feasible for MSMEs to develop the required prototype.

3. All programmes under 'Make I' (government funded) scheme will be eligible for a mobilisation advance of 20% of the estimated development cost, which will be deducted during the course of the development phases.

4. 'Make II' (Industry funded) involves no funding by the government for prototype development. However if RFP for the equipment developed, is not issued with two years from the successful prototype development, 100% refund for successful developers, who were selected through due process.

5. 'Make III' (MSME funded) is same as 'Make II' (industry funded), and will be reserved for projects less than an estimated development cost of 3 crore INR and is reserved only for MSMEs.

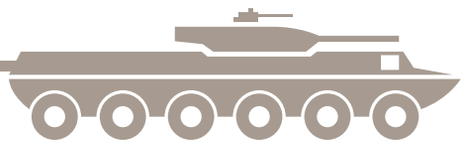
6. A dedicated project management unit is being constituted at the service headquarters level, and will be headed by a two-star rank General. The PMU head will be responsible for driving all 'Make' projects pertaining to the respective services.

7. Only firms with majority stake and controlled by resident Indians will be eligible for projects under the 'Make' category. Companies need to be registered for a period of five years; three years in case of MSMEs. Companies need to have a minimum credit rating of B++, issued by recognised credit rating agencies.

8. For projects with development costs equal to or exceeding 5,000 crore INR, a minimum 'net worth' of 5% of the development cost, subject to a maximum of 1,000 crore INR. In all other cases (where the development cost is less than 5,000 crore INR), the positive net worth is the minimum eligibility criteria.

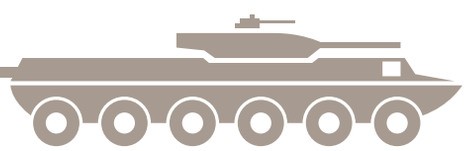
8 Taken from press note issued by MoD

Abbreviations



AM	Additive manufacturing
AoN	Acceptance of necessity
A&D	Aerospace and defence
CCS	Cabinet Committee on Security
CST	Central sales tax
C4I2SR	Command, control, communication, computers, information, intelligence, surveillance and reconnaissance
DAC	Defence Acquisition Council
DGCA	Directorate General of Civil Aviation
DoMW	Defence Offset Management Wing
DGFT	Directorate General of Foreign Trade
DMRL	Defence Metallurgical Research Laboratory
DIPP	Department of Industrial Policy and Promotion
DPP	Defence procurement procedure
DPSU	Defence public sector undertaking
DRDO	Defence Research and Development Organisation
DRDL	Defence Research and Development Laboratory
ERV	Exchange rate variation
EUC	End-user certificate
FDI	Foreign direct investment
FIPB	Foreign Investment Promotion Board
FTP	Foreign trade policy
GDP	Gross domestic product
IC	Indigenous content
IIT	Indian Institute of Technology
IT	Information technology
ISRO	Indian Space Research Organisation
IL	Industrial license
IEM	Industrial Entrepreneur Memorandum
ICB	International competitive bidding
IDDM	Indigenous design, development and manufacturing
ICB	International competitive bidding
IDR	The Industries (Development and Regulation) Act
ITC (HS)	Indian Trade Classification based on Harmonised System of Coding
IOPs	Indian offset partner
IP	Intellectual property
JV	Joint venture
MoD	Ministry of Defence
MSMEs	Micro, small and medium enterprises
MHA	Ministry of Home Affairs
ToT	Transfer of technology
MRO	Maintenance, repair and overhaul
MAT	Minimum alternate tax
M-SIPS	Modified Special Incentive Package Scheme

NOC	No-objection certificate
OFB	Ordnance Factory Board
OEM	Original equipment manufacturer
PA	Production agency
PAN	Permanent account number
PSU	Public sector undertaking
PPP	Public-private partnership
QR	Qualitative requirement
RCI	Research Centre Imarat
RFP	Request for proposal
R&D	Research and development
SME	Small and medium enterprise
SQRs	Staff qualitative requirements
SRSAM	Surface-to-air missile
SCOMET	Special chemicals, organisms, materials, equipment and technologies
SEZ	Special economic zones
TEC	Technical Evaluation Committee
TIFR	Tata Institute of Fundamental Research
VAT	Value added tax



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The case studies have been prepared based on the information given by Airbus, WIPRO and AEQUS respectively and is without any PwC inputs.

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