

MOD's Role and Reforms— Shri Vivek Rae, Additional Secretary, MOD & DG Acquisitions.

Shri Vivek Rae highlighted key issues and initiatives to be taken:

First, there is a need for clarity **about** the role of the MOD, which has several departments and multiple mandates.

The role of the Government today as a facilitator is to create a policy framework and not make things and do everything itself as it used to when India was a command economy.

The PSUs, the Ordinance Factories all have a role to play as Government needs to keep some capabilities within its domain, but beyond that Government has to create an enabling policy framework and environment for the efficient functioning of the economy, in which the private sector can flourish and serve the objectives of the Government.

First of all the objectives have to be clear.

Then, the right signals ~~to the right people~~ have to be delivered **to the right people**.

We have a Defence Production Policy of 2011 which sets out the objectives, but we need to move beyond and have an implementation strategy and plan.

It is time to take stock of how this policy has been taken forward and a critical evaluation has to be undertaken of progress achieved.

Second, while manufacturing is important we need to note that services, software engineering services, India's intellectual and design capabilities etc. make a very important contribution to both GDP and high-value employment. Both manufacturing and services need to figure in our strategy. We need to empower the growth of the services sector in the area of high-technology.

Third, we need to address the issue of the public versus ~~the~~ private sector in the **Defence** manufacturing base in India.

Our DPSUs are doing well and have enormous capabilities. The real challenge today, if we are to **strengthen** ~~sharpen~~ the defence industrial base of the country, is to create a policy for the private sector to thrive.

At the same time the nomination culture has to give way and the public sector should not expect orders only on nomination basis.

There is a need to expose the public sector to competition/bidding over getting orders through the nomination process. Competition allows cutting of costs while enhancing the competitiveness of the public sector.

There has been a positive development in MOD - in Naval warships projects a decision has been taken RM has announced that we shall opt for competitive bids and not the nomination route from Indian shipyards.

We have found that in some cases the public sector has lost out to the private sector, while they have won in others.

Overall, the bidding route can lead leads to cost savings of 20-25% 25%.

We need to expose the public sector to greater competition. The general thrust has to be on that line.

Fourth, harmonisation of the FDI, licensing, export (under DGFT) and offset policies is necessary to ensure delivery. Otherwise they do not deliver.

An export policy is required in order to get volumes and scale. In case of insufficient domestic orders, we must encourage exports and therefore there is a need to look at the export policy regime. There should be some restrictions from the security angle in place but there is no reason why we shouldn't export armaments. We can thus increase the viability of enterprises in this business.

There is also a mismatch between the industrial licensing and offset policy. There is no clear list of eligible products. It becomes very confusing to identify which item requires a licence or not; there is no clarity on when will a person be held for non-compliance etc. These grey areas need to be addressed.

These are areas the Department of Defence Production has to look at.

The issue of FDI will not be taken up here. What percentage the FDI cap should be is a political issue. MOD looks RM has said he will look at it on a case by case basis if high technology is coming in.

The fifth issue is relating to the viability of manufacturing. Hi-tech Defence manufacturing is costly, capital intensive and has few players.

Governments need to make long term commitments with vendors through repeat orders, long-term and sole-source contracts.

Sole-source contracting can be feasible in the Indian context if the costs of the vendor, especially if he is in the private sector, are objectively probed. It should be done through a strong and powerful government instrument. The costs incurred in both the public and the private sectors need to be probed.

If you want big Indian players in defence we need to be able to probe costs, Because no one will question orders going to the public sector even if they cost a little bit more since there is inadequate no price discovery through the market / competitive bidding

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The lack of such an institutional framework has caused problems. Failure to probe costs has resulted in resorting to the DPSU nomination route which is more convenient. If this issue - - is not addressed it could become ~~an~~ the most important bottleneck for the growth of ~~the~~ a defence manufacturing base in the country. Because if there has to be competitive bidding every time there will be no investment by the private sector because of the uncertainty.

The US tackles the sensitivities raised through a Defence Contract Audit Agency.

The sixth issue is integration of manufacturing and design capability. There is a huge disconnect between manufacturing capability and design capability. R&D is done by DRDO while DPSUs do manufacturing. In order to spur defence manufacturing in India, there needs to be a stronger connection between R&D and manufacturing. Not much R&D is attempted by the DPSUs.

There are two important points – both public and private sector needs to invest more in R & D. We are simply not spending enough. Number two, DRDO needs to be unbundled of some of its labs and these should be transferred and brought under the umbrella of the manufacturing entities for better delivery. ~~For example, labs dealing with aerospace could be brought under one umbrella, not the DRDO.~~ China, Russia, other countries have done this. The US does R & D in private labs. This is a strategic issue and needs to be ~~done~~ addressed.

Finally, offsets. Changes are coming which will facilitate the discharge of offsets. The offset pipe is narrow and the volume of offsets is too large so it creates a heart attack or traffic jam. We need to widen that pipe and we need a few more windows and we are doing this to get offsets flowing.

Within offsets the biggest opportunity is in aero-space wherein we will get about \$10 bn worth of offsets in the next ten years. Tier I, II, & III companies will have huge opportunities. This is a great opportunity which should not be missed - of building aero-space manufacturing capabilities within India. ~~otherwise we will miss the opportunity for the next 10-15 years.~~ Such opportunities do not come frequently.

The challenge is to have integration. This entire 10 bn opportunity needs to be synergised under one umbrella – if it cannot be done through restructuring then you can do it by creating a Steering Committee or Task Force which is charged with the responsibility of building up the aerospace manufacturing capability. And All concerned these agencies need to report to that authority for purposes of coordination.

We need to have cross-cutting channels of command and control to achieve this.

A few more issues were flagged by Shri Rae: There are a few problems with the defence procurement procedures which need to be fixed. The criterion for nomination of private companies is non-existent when compared to DPSUs. To get around the problem it has been suggested that the OEMs should be free to choose the production partner in the Indian private sector. We will have a transparent process, the private sector and domestic production. We are working on the DPP to include this. Buy and make with OEM free to pick his partner.

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Another very important issue is the fundamental contradiction in the DPP in that it allows only OEMs to bid. Since there are **few** ~~no~~ Indian OEMs, Indian companies are not allowed to bid. We should have some mechanism for Indian companies to bid for contracts even if they are not OEMs. But there have to be conditionalities. This is one area we need to work on. ~~If there are no Indian OEMs, then we cannot build a defence manufacturing base in the country.~~ Indian company representatives can think on this and give suggestions to the Ministry ~~on this~~.

Another important mechanism to build the defence manufacturing base in the country is joint ventures (JVs). For instance our shipyards are overloaded and they do not have capacity. They should be allowed to form joint ventures with the Indian private sector shipyards. The same model can be followed by HAL and some other companies. A policy to allow DPSUs and Indian private companies to form JVs in a transparent manner would be a great step forward. ~~After entry the capability to make (submarines for example) on their own can develop.~~ This cuts across all sectors – ~~armed~~ Army Navy Air Force. A good JV policy is required and the policy is under consideration by the **Department of Defence Production**.

As Prof. Tai Ming Cheung **notes** ~~says~~, the armed forces have **driven** ~~to drive~~ the process **in China**; they have **been** ~~to be~~ at the centre of the R&D effort, the manufacturing effort and the acquisition effort. So we need to address this issue if armed forces are to be at the centre. If not then what is the alternative? This needs to be debated.

Last issue is on the QRs. While the armed forces need to be at the centre of the debate - the way QRs are formulated impinges on the flow of orders in India. If QRs are so high-tech that no Indian company can manufacture then they will be left out. Therefore some moderation of QRs to give orders to Indian companies is called for. This is also a challenge – Armed Forces want the best and don't want to compromise. In the US the QRs are finalised by the Joint Chiefs of Staff who take all factors into consideration, especially since the orders ~~will go~~ **mostly** to their domestic companies ~~mostly~~. This is an issue which needs to be addressed.

Q&A: Some suggestions that the audience highlighted were (some queries were not audible):

1. The Ministry of Defence needs to go through deep structural reforms.
2. There are huge opportunities in the aerospace sector, which HAL cannot meet as its order book is full. The business model should not be licenced production as its scope is limited to the numbers you are allowed to produce. The OEM will never allow the licenced partner to challenge it. So the initiative on JVs is very useful. We should not go for licenced production. Once the OEM has a stake in India we don't need to pay for TOT.
3. Identifying the Indian agency - 25 (a) procedure in DPP is very good. The CDD (Capability Definition Document) should be developed. The aerospace projects should be looked at in a different format. The CKD/SKD model will not work. The CDD is a document Indian industry can work on – identify resources, do the costing and hire the best talent. The JV route seems a better way of building Indian capabilities.
4. The talk met expectations of Indian industry. There is one way which can help build up capabilities and innovation in a very big way. Instead of the tendering process to which industry has to respond, in US the requirement is posted and innovation companies are invited to make a pitch for funds. They select 5 or 10 and pay them to develop a prototype (approx. 100 000 dollars each). In 6 months they come back with a prototype. Two are selected for a pilot run. This is a

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programme which could make a difference and could be included in the DPP. This was taken note of by MOD.

5. We have an opportunity under offsets to develop academia. 2% should be allocated under offsets to fund centres of excellence, this would lead to multiplication of knowledge and skills. MOD's response was that they are planning to do that but only for defence institutions and think tanks. But the request was to extend it to all academia – both private and public institutions.

6. Some wondered why it was not possible to achieve goals in office what we think we should do in private. The Answer was that the decision making process is very complex and the political leadership has to take a call on this. Moreover this dialogue needs to be taken further with the political leadership as bureaucrats can only make recommendations.

7. ~~In the DPP 2011~~ - There is a conflict of interest in the post of the Secretary of Defence Production in India as neither he nor any joint secretary has charge of the private sector. He should be Secretary for Indian industry whether it is private and public sector and/or there should be a JS in charge of the private sector. The Secretary of Defence Production should **submit** ~~seek~~ annual reports on the contribution of the private sector to defence production. And it should not be confined only to reports, he should have responsibility for the sector, private companies should also be given targets to achieve. ~~There was agreement that there is a huge conflict of interest in the post and something had to be done for a structural change.~~

8. Regarding QRs, we need to integrate capability definition and procurement and reform the system. Exports, civil-military integration should be included in the framework so as to ensure volumes without which there will not be any R & D investment by the private sector. And there has to be a more liberal policy for promoting RURs: we need some national champions. The Answer was that on export policy, this can probably be fixed together with the Commerce Ministry. The issue of pre-selection of champions is more complex, as the Ministry cannot exclude any firm. We need to find ways to address the issue of transparency. ~~The RUR policy has been buried.~~

In concluding remarks the Chair said that the fundamental problem with QRs was that we did not have the skills to manage the whole acquisitions system. People who are trained in it at CDM, Secunderabad are not posted to these jobs! The MOD needs to undergo structural reform as otherwise nothing will change. People charged with protecting the status quo will not allow it. It would be better to leave only the strategic production units under MOD and hive the rest off to M/Industry for example. DRDO must focus only on critical technologies which no one else will give us. These structural issues are as important as political decisions. This will not change in a hurry but there will be an incremental push towards change.