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## *Special Feature*

# DPP-2016: An Analytical Overview

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## **S***ummary*

The introduction of 'Buy (Indian-IDDm)' procurement category, the revamped 'Make' procedure, structural change in the AAP, and higher and flexible indigenous content requirement in certain procurement categories are some of new provisions in DPP-2016 that are likely to deepen the involvement of the domestic industry in defence production. At the same time, the reduced validity of AoN and its sanctity, together with the measures to undertake procurement in single-vendor situations, are likely to arrest some of the delays in the acquisition process. However, much of the effectiveness of these changes would depend on how the new measures are implemented by the SHQ, MoD, DRDO and HQ IDS, which, together, constitute the larger procurement set up. In this respect, DPP-2016 has done little to strengthen the current institutional mechanism which is now more than 15 years old. Despite some notable successes, the procurement set up has been constrained to own up responsibility and drive procurement at the desired pace. The biggest issue that the procurement machinery faces is its decentralised nature, resulting in lack of coordination, diffused accountability and delay. Given this, it would have been prudent if the new DPP had reflected upon some of the structural changes necessary in the procurement set up to complement the changes made in the procedures.

After a prolonged delay, the Ministry of Defence (MoD) released the revised Defence Procurement Procedure (DPP) on March 28, 2016.<sup>1</sup> The document, coming into effect from April 01, 2016, is applicable to all projects which would be given in-principle approval (or the Acceptance of Necessity (AoN)) thereafter.<sup>2</sup> It is, however, to be noted that the released document is not a complete one, as a key chapter on strategic partnership and all the relevant annexures, appendices and schedules are still a work in progress and are expected to be released later as part of the comprehensive DPP-2016. Nonetheless, the revised document, the first under the Modi government, has set the tone for a new procurement regime with a clear intention to boost the 'Make in India' initiative in the defence sector, and to speed up the procurement process. While articulating the new features, DPP-2016 draws heavily from the report of the Committee of Experts set up by the Modi government under the chairmanship of Dhirendra Singh, to suggest a policy framework for facilitating 'Make in India' in defence and further streamlining the procurement process. Among others, DPP-2016, running into 100 pages, envisages an array of features that include: a preamble to the document which articulates the peculiar nature of defence acquisition and the imperatives of self-reliance in defence production; a brand new procurement category, favouring purchase of locally designed, developed and manufactured products; higher yet flexible indigenisation content requirement in the existing 'Buy (Indian)' and 'Buy and Make (Indian)' procurement categories; a comprehensively revamped 'Make' procedure; an institutionalised set of steps for processing the request for information (RFI); and certain measures to deal with procurement in single-vendor situations. This *Special Feature* analyses some of the key provisions of the new procurement document.

## Key Provisions

### 'Buy (Indian-IDDM)' Procurement Category

To provide a greater thrust to the 'Make in India' initiative in defence production, DPP-2016 has introduced a new procurement category, Buy (Indian-Indigenously Designed, Developed and Manufactured), or 'Buy (Indian – IDDM)'. In terms of prioritisation, the new category, which would also be used for procurement of all locally designed and developed items under the revamped 'Make' procedures, is placed above the existing 'Buy (Indian)' category which, in turn, is placed above the other categories, namely the 'Buy and Make (Indian)', 'Buy and Make' and 'Buy (Global)', in that order. Under the new category, indigenously designed equipment with 40 per cent indigenous content (IC), or equipment not necessarily designed in-house but having a 60 per cent IC, is intended for procurement from the local industry. The intent is clearly to promote in-house design capacity and higher localisation, two critical aspects, which, if implemented in the right spirit, could deepen the role of domestic industry, especially the private sector, in defence production.

It is, however, to be noted that the responsibility to prove an indigenous design rests with the industry, while the final say would be that of the government. To

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<sup>1</sup> The DPP-2016 is available on the official website of the Ministry of Defence, <http://www.mod.nic.in/forms/Mainlinks.aspx?lid=1545&Id=56>

<sup>2</sup> With specific approval of the government, the new DPP is also applicable for cases in which the AoNs have been given earlier but formal tenders have not been issued by April 01, 2016.

examine the industry's claim, DPP-2016 provides for a committee system comprising scientists from the Defence Research and Development Organisation (DRDO) and members of the concerned Service Headquarters (SHQs). The guidelines, on the basis of which the committee would verify the claims, would be promulgated later by the MoD. Pending the release of the guidelines, it would, however, not be unreasonable to argue that the newly provisioned committee has a challenging task ahead. This is in view of the fact that typical defence technologies are not patented, nor does the DRDO/SHQ have full knowledge of designs of military equipment developed by other countries. Given these constraints, it looks like that the committee would rely mostly on the undertakings and documentary proof submitted by the industry for the purpose of certification.

### Higher yet Flexible Indigenous Content Requirement

With a clear intention to boost the local content in procurement and drive the larger 'Make in India' initiative, the revised DPP has enhanced the indigenous content requirement under the existing 'Buy (Indian)' category from the earlier 30 per cent to 40 per cent. However, while setting the higher target, the DPP has not lost the sight of the unique procurement cases which require a different indigenisation requirement. For such cases, DPP-2016 provides flexibility to the procurement authorities to stipulate either a higher or lower indigenisation content, depending on the merits of the projects. The flexibility in the indigenisation requirement, which is also extended to 'Buy and Make (Indian)' procurements, would go a long way in meeting a key demand of the local industry, which has long complained that rigidity in IC is oblivious to the ground reality. The industry was particularly vocal with regard to critical aerospace items, in which local capability stands at a bare minimum and achieving even 20 per cent IC is a difficult task at the present state of India's defence industrial development. It may be noted that the Hindustan Aeronautics Ltd (HAL), the state-owned monopoly in aircraft manufacturing, depends on foreign sources to the extent of 80 to 90 per cent for input materials.

### Revamped 'Make' Procedures

If there has been one big disappointment in the DPP's recent operational history, it has been the complexity, leading to ineffectiveness, of 'Make' procedures, which were first articulated in 2006 with a view to promoting in-house research, design, development and production of 'high-technology complex systems' by the domestic industry, especially the private sector. DPP-2016 has attempted to plug certain loopholes by way of making a number of changes, beginning with the planning process. The structure of the Annual Acquisition Plan (AAP), which is a subset of the five-year Services Capital Acquisition Plan (SCAP) and the guiding document for procurement, has undergone a change to include, for the first time, a number of 'Make' projects that have already been given in-principle approval or are to be considered for in-principle approval by the higher procurement authorities. Besides, the existing Technology and Perspective Plan (TPCR), which has been criticised for being too vague, is now given a new life by requiring it to reflect the "details of the acquisition plans for a period of 15 years, for use by the industry." These two developments on the planning front are likely to lead to the greater visibility of 'Make' projects and, more importantly, accountability on the part of the procurement authorities. Apart from this, changes have also been made in respect of the responsibility of SHQs, classification of 'Make' sub-categories, funding

pattern for prototypes development, and clarity as to who would be eligible for undertaking 'Make' projects.

Compared to the previous DPPs, DPP-2016 has attempted to make the SHQs own and, being responsible for, 'Make' projects. In this regard, the SHQs would be now entrusted with the task of identifying potential 'Make' projects and undertaking feasibility studies for each identified project in consultation with other stakeholders (earlier, the responsibility for both activities was entrusted with the Headquarters Integrated Defence Staff (HQ IDS)). Under the new 'Make' procedures, the SHQs, including the Coast Guard, are also required to establish a permanent Make-Project Management Unit (Make-PMU) comprising a two star serving officer as the head and officers drawn from various ranks/branches/specialisation as other members. The newly provisioned body is intended to instil a sense of ownership among the armed forces whose direct involvement is critical in any successful development of a military item. In a move to ensure continuity in decision-making, the head of the Make-PMU is required to have a minimum tenure of three years, whereas other officials are required to have a longer tenure. The Head and the members are also required to serve as key members in the important multi-disciplinary Integrated Project Management Team (IPMT), which has the key responsibilities of preparing the Project Definition Document (PDD), issuing the Expression of Interest (EoI), shortlisting the developmental agencies, and monitoring the progress of prototype development. It is interesting to note that under the revamped 'Make' procedure, the power to constitute the IPMT is vested with the Department of Defence Production (DDP), whereas under the earlier procedures the responsibility was with the Director General (Acquisition). It seems that the DDP, which has long been criticised for its limited role in defence indigenisation efforts, is now trying to acquire a larger role under the new DPP.

Effecting a crucial change, the new DPP has divided the 'Make' projects into two categories – Make-I (Government Funded) and Make-II (Industry Funded) – besides giving a decisive say to the Micro, Small and Medium Enterprises (MSMEs), which had long craved government attention for their role in defence indigenisation efforts. As the names suggest, for the category of Make-I projects, it is the government that would take the lead in funding prototype development by the industry; whereas for the latter category, which is largely confined to import substitution, it is the industry that would bear the full cost of development. For Make-I (Government Funded) projects, the new procedure envisages a higher government funding commitment of up to 90 per cent (in comparison to up to 80 per cent under the earlier 'Make' procedures) for prototype development, with a further provision that 20 per cent of the total developmental cost would be paid in advance. In order to bring in a degree of accountability and to follow best commercial practices, the new procedure provides for the mandatory issuance of the request for proposal (RFP) within two years' of successful development, failing which the balance 10 per cent funded by the industry would be reimbursed to it. For the MSMEs, the new procedure provides them the first right to undertake prototype development up to Rs. 10 crore under the government-funded 'Make' projects (up to Rs. 3.0 crore in case of Make (Industry Funded)). In other words, only when MSMEs are not interested in taking up small valued projects, it can be opened up for participation by the bigger industry players.

In a move to clarify as to who would be eligible for the 'Make' programme, DPP-2016 has restricted the participation in such a programme to "only Indian vendors including Association of Persons (AoP)" to be detailed in an appendix that would be notified separately as part of the complete DPP-2016. Pending the release of this

crucial appendix, it is believed that entities with majority resident Indian holding would be eligible for 'Make' projects. In other words, Joint Ventures (JVs) having foreign equity of more than 49 per cent would not be eligible. This would ensure that decision-making and the crucial intellectual property rights (IPR) of the 'Make' designs would stay in the hands of the resident Indians. It is also believed that the eligibility criteria would include a minimum five years of operational experience (three years for MSMEs) besides a credit rating of B++ issued by reputed credit rating agencies.

### **Institutionalising the RFI Process**

DPP-2016 has institutionalised the request for information (RFI) process, which was followed in not so a disciplined manner under the earlier DPPs. Although the new measure has increased the number of procurement steps involved in 'Buy' and 'Buy and Make' schemes by one more to 12, it has nonetheless brought about much needed clarity in the vital step of procurement, which has a far reaching implication on the source of procurement, indigenisation, the degree of competition, and more importantly, the timeliness of procurement. Besides articulating the objectives and format of the RFI process, it also stipulates the specific inputs that the procurement authorities would seek through the institutionalised step. In addition, in a departure from the past, the RFI is now required to be formulated by the concerned SHQ in consultation with other relevant stakeholders, including DRDO, DDP and HQ IDS (earlier the SHQs were solely responsible for preparing the RFI). This would ensure that any alternative views that the other stakeholders might have on a particular proposal would be taken into consideration at the very beginning of the procurement stage, rather than leaving these to later stages and thus causing unnecessary delays.

### **Introduction of L1-T1 Methodology for Award of Contracts**

In a clear departure from the past, DPP-2016 has, for the first time, introduced what is widely known as the L1-T1 methodology for selecting the supplier of military goods under the 'Buy' and 'Buy and Make' schemes. The new methodology, in essence, means that the final bidder would not necessarily be selected on the basis of lowest price quoted by the technically-compliant vendors (the so-called L1 methodology), but by a combination of price and superior technology offered by qualified vendors. The new methodology is intended to buy equipment with Enhanced Performance Parameters (EPP) – a newly introduced feature – which are a notch higher than the Essential Parameters required to be mandatorily met by all the suppliers participating in MoD tenders, in order to stay in competition. The new methodology is also intended to provide an additional incentive to equipment suppliers who would otherwise be reluctant to participate in the bidding process because their products are much superior and, therefore, expensive and uncompetitive vis-à-vis the ones fielded by rival bidders with no EPP.

As per the DPP-2016 provisions, for the purpose of evaluation of the final bidder, vendors offering approved EPP would get an additional credit score of maximum 10 per cent, with each parameter not exceeding a score of three per cent. In other words, the commercial quote of a vendor offering EPP would be suitably deflated by a credit factor ranging between  $\geq 0.9$  and  $< 1.0$ , to arrive at the bid selection. As an illustration, if a vendor quotes USD 1.0 billion for a product with EPPs attracting a maximum 10 per cent credit score (or a credit factor of 0.9), the commercial quote

for the purpose of the L1 evaluation would be USD 900 million (1.0 billion x 0.9). The vendor would, however, get USD 1.0 billion if it wins the contract.

The above illustration, while showing certain merits of the new methodology, also, in some way, shows, some drawbacks of the L1-T1 methodology, which have been the main reasons why the MoD has so far been reluctant to adopt it despite repeated demands from several quarters. Apart from the complexity and the implementation-related challenges that the new methodology invites, it has also a clear financial ramification. The new methodology, in a crude sense, allows certain war equipment with more features than the minimum inescapable parameters (best captured in the EPs) required to fight and win a war. Because of this, the MoD would now be forced to pay more for some features which are not critically important to wage a war. Moreover, by keeping the new methodology open to foreign companies, the MoD would also incur extra foreign exchange outgoes at a time when its procurement budget is under a great deal of pressure because of a hefty increase in manpower costs. (In 2016-17, the capital procurement budget has witnessed a drastic 9.4 per cent fall). Given this, it would have been prudent to limit the new methodology for the selection of bids to the local industry only. The benefits, at least in terms of incentivising local companies with superior products, would have been confined to the domestic industry, which is at the centre of the 'Make in India' programme.

### **Provision for 'Single OEM, Multiple Bids' and 'Multiple Bids by Single Indian Vendor'**

Accepting the uniqueness of defence procurement, DPP-2016 has incorporated two provisions – 'single OEM, multiple bids' and 'multiple bids by single Indian vendor' – in which although the bids are single-vendor in nature they would not be retracted because of lack of competition. The first case is likely to arise in 'Buy and Make (Indian)' category in which a single foreign original equipment manufacturer (OEM) offers the same product through multiple bids in collaboration with a number of Indian companies. In such a situation, the new provision allows the authorities to continue with the procurement process, provided that the Defence Acquisition Council (DAC), the highest decision-making body of the defence ministry, decides that changes in the RFP condition will not invite participation of any more foreign vendors.

The second case is likely to arise under the 'Buy and Make' procurement category in which one Indian company submits multiple bids in collaboration with a number of foreign vendors. Such a case is now acceptable under the new DPP. The main argument for accepting such a case as not a single vendor situation is that the technical and commercial arrangement of one foreign vendor would vary from that of others.

### **Provision of Procurement in Single Bid Situation**

In a major departure from the earlier DPPs, DPP-2016 has allowed the procurement process to continue in certain situations where only one bid is received in response to an RFP. The continuation of the process is, however, subject to the approval of the DAC, which must certify that there is no scope for change of the RFP conditions.

### Reduced Validity and Sanctity of AoN

In a move to cut down the procurement time frame under the 'Buy' and 'Buy and Make' schemes, the new DPP makes two subtle changes, one by reducing the validity of the AoN from the earlier one year to six months, and the other by making the validity period sacrosanct. The reduced validity of AoN would mean that the RFP has to be issued within six months (from the date sanction of AoN), failing which the SHQ would "re-validate the case and seek fresh AoN with due justification for not processing the case in time." Making the AON validity sacrosanct, the new provision makes it mandatory for the SHQs to re-issue any retracted RFP within the original validity of AoN. Earlier, the validity of AoN for the re-tracked RFP was increased by one year from the date of retraction, causing unpredictable delay and lack of accountability in the procurement process.

### Essential Parameters A and B

In a move to increase vendor participation, DPP-2016 has divided into two parts (A & B) the non-negotiable Essential Parameters (EP) that the armed forces want a particular equipment to possess. As per the new provisions, the EP-A would capture some of features of the "contemporary equipment available in the market, and form core of Services Qualitative Requirements (SQRs)" for the purpose of testing and validation at the crucial Field Evaluation Trial (FET) stage. The EP-B, on the other hand, may not be available at the time of FET (hence won't be tested/validated at that stage), but can be developed/achieved by the vendor after entering into a contract. To ensure that a vendor does not renege from its commitment of meeting the EP-B, it is required to provide an additional bank guarantee of up to 10 per cent of the contract value. It is important to note that EP-B, whose inclusion in the RFP is necessarily to be approved by the DAC, must be met prior to the commencement of delivery of the contracted item. It is also important to note that the incorporation of the EP-B will not be part of the RFP if at least two vendors claim to possess the same at the RFI stage.

### Definition of Indian Vendor

Providing clarity as to who is an Indian vendor, DPP-2016 defines the same as an Indian entity (which could include incorporation, ownership model, and proprietorship, among others) that is established under the Companies Act or any other applicable regulations. The definition does not, however, mean that all Indian vendor are eligible to participate in all types of defence tenders. Bringing further definitional clarity, the DPP divides Indian vendors into two categories: one for defence products requiring industrial licence (IL) and the other for not requiring IL. (The Department of Industrial Policy and Promotion (DIPP) has already announced a list of defence products that are subject to IL). What this division means is that companies in the first category could participate in almost all defence tenders (subject to certain restrictions under the 'Make' procedure), whereas companies falling under the second category can participate in tenders involving non-licensable items only.

The critical point to note here is that the definition of Indian vendor paves the way for JVs, in which the FDI component can go up to 100 per cent (up to 49 per cent through automatic route and beyond that through the Foreign Investment Promotion Board (FIPB) route), to be treated as Indian vendors. However, as explained earlier in the context of the 'Make' procedure, the JVs in which foreign

equity is more than 49 per cent would not be eligible to participate in the 'Make' programme which is reserved for entities in which the majority stake is to be controlled by resident Indians.

### Hike in Offset Threshold Limit

In a surprise move, DPP-2016 has raised the offset threshold limit to Rs. 2,000 crore (approximately USD 305 million) from Rs. 300 crore. Although the reasons for the hike in the threshold is not clarified, it is assumed that the MoD's difficulty in implementing the existing offset contracts could be the main factor. Nonetheless, the hike is untenable not only from the point of view of the practices followed by other countries, but also in view of the 'Make in India' initiative. With regard to international practices, it may be noted that the offset threshold is as low as USD 5 to 15 million in many countries including Israel, Malaysia, Turkey and UAE. Moreover, countries generally lower the offset threshold over a period of time based on the experience gained.

The hike in the threshold would mean that fewer arms import contracts would now be eligible for offsets. This would be a big setback to the local industry, particularly the manufacturers of parts and components which have exploited the existing offset policy for boosting their export performance, and in the process have set up capability that could have been further exploited for the 'Make in India' initiative.

### Other Provisions

In addition to the above mentioned provisions, DPP-2016 also includes the following new provisions:

- Provision for Equipment Policy Committee (SEPC) to hire experts including from academia and industry for the purpose of "review, rationalisation and finalisation of SQRs." (The list of experts is to be maintained by HQ IDS and the SHQs). This is likely to help expedite the procurement process, particularly of the Army which often suffers from delays in acquisition due to deficiencies in SQR formulation, among other major reasons.
- No IC requirement from Indian companies in a 'Buy (Global)' contract if offset is waived off. This is intended to provide a level-playing field between foreign OEMs and Indian companies.
- Provision for change of name of vendor in any stage between RFI and execution of contract to enable un-hindered progress in procurement
- In certain cases specifically stipulated in the RFP, the cost of low-value items is to be reimbursed to vendors qualified in the FET stage. This is intended to incentivise wider participation, especially by the smaller companies which may have reservations due to the high cost of participation in extensive filed trials.
- The cost of Buyer Nominated Equipment (BNE) procured from the Ordnance Factory Board (the departmental production agency under the DDP) would not be taken into consideration for the purpose of selection of L1 vendor. This is intended to insulate the L1 vendors from an arbitrary hike in price by the OFB post submission of the commercial bid.
- In certain 'Buy and Make' programmes, in which foreign OEMs are allowed to select their Indian Production Agency (PA), the RFP would stipulate the eligibility criteria for selection. This would bring transparency in the selection process.

- The scope of Fast Track Procedures (FTP) is expanded to apply to items “where undue/unforeseen delay, due to reasons beyond the control of acquisition set up, seem to be adversely impacting the capacity and preparedness of the regular and special forces.”

## An Assessment

The introduction of ‘Buy (Indian-IDDMM)’ procurement category, the revamped ‘Make’ procedure, structural change in the AAP, and higher and flexible indigenous content requirement in certain procurement categories are some of new provisions in DPP-2016 that are likely to deepen the involvement of the domestic industry in defence production. At the same time, the reduced validity of AoN and its sanctity, together with the measures to undertake procurement in single-vendor situations, are likely to arrest some of the delays in the acquisition process. However, much of the effectiveness of these changes would depend on how the new measures are implemented by the SHQ, MoD, DRDO and HQ IDS, which, together, constitute the larger procurement set up. In this respect, DPP-2016 has done little to strengthen the current institutional mechanism which is now more than 15 years old. Despite some notable successes, the procurement set up has been constrained to own up responsibility and drive procurement at the desired pace. The biggest issue that the procurement machinery faces is its decentralised nature, resulting in lack of coordination, diffused accountability and delay. Given this, it would have been prudent if the new DPP had reflected upon some of the structural changes necessary in the procurement set up to complement the changes made in the procedures.

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