

Key Aspects of Defence Offsets – Negotiating the MoU between Bidder and Offset Partner

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The DPP has proved to be a dynamic document, with improvements with every successive version minimising ambiguities. Documents where ambiguities are either absent or minimum; documents that are transparent and are open to anyone connected; and documents that have good guidelines and directives, serve as an anchor when resolving conflicts that may arise in execution of activities in the related field. The DPP is one such document in the process of defence procurement.

Introduction

Acquisition of defence capital equipment has been on the rise. With acquisitions, a few offset contracts have also been signed with many more to follow. Thus there is much importance for managing and benefiting from the offset opportunity, for both the Original Equipment Manufacturers (OEMs) and their Indian offset partners.

As per the Defence Procurement Procedures 2008 and its revised version of 2009, the following three agreements play a major role in meeting offset requirements. These are summarised below:

The offset contract includes the monetary value of the offset projects, the schedule for discharging the offset obligation and the penalties for not discharging the offset obligation as per schedule.

- (i) Memorandum of Understanding (MoU) signed between the bidder (potential vendor) and the Indian offset partner(s). The MoU are to be included along with the Technical Offset Offer which in turn is to be submitted along with the Technical proposal of the bid.
- (ii) The Offset Contract is signed between the successful bidder (vendor) and the Ministry of Defence (MOD) at the time of signing the main contract for the acquisition. The offset contract includes the monetary value of the offset projects, the schedule for discharging the offset

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obligation and the penalties for not discharging the offset obligation as per schedule.

- (iii) The Offset Programme Contract signed between the vendor and the offset partner(s), deals with offset contract requirements. These Offset Programme Contracts are to be signed and submitted to the Ministry of Defence within ninety days of signing the Offset Contract.

Defence procurement is a long drawn activity often taking several years to conclude and several more years to complete the contract. The defence offset programme in India is still in its infancy. Therefore, while some experience has been gained in signing of the MoUs between the bidder and the offset partner, not much experience has been gained in signing of offset programme contracts.

This paper outlines the key issues associated with the signing the MoU.

RFP Requirements Regarding Offset Obligations

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Having identified the offset partner(s), the bidder has to furnish a Technical Offset Offer in the Technical bid with the following details:

- Details of products/services to be contracted (and investment proposal if any)
 - Percentage of offset commitment to be met (through each product or service and through each identified offset partner)
- Enclose MoUs signed with each Indian Offset Partner in support of the offset offer.

The bidder needs to furnish at the same time (to be opened with the opening of the commercial bid) a Commercial Offset Offer with the commercial bid with the following additional details.

- Value in Monetary terms of the offer for each product or service.
- Time frame for discharging each offset product or service.

Identification of Offset Partner(s) – The Scenario

In the search for the bidder to identify offset partner(s), the question arises which Indian companies can qualify to be an offset partner with the foreign companies? Certainly Public Sector Units (PSUs) who are authorised to produce defence goods and sell. These companies are only nine in number. These companies have a rich experience in aerospace or/and defence.

With an aim to include private participation in defence, initially the Government of India attempted to identify Raksha Udyog Ratna (RUR) whom the bidders can choose as offset partners. Several companies from the private sector, aspired to be classified as RUR companies, applied for the same. About Fifteen companies were short-listed for the classification. However aspiring companies, who were not short-listed, were dissatisfied as this meant losing a major opportunity. Thus the RUR list of companies was never formally announced.

As of now any company is free to apply for license to participate in defence production, and a standing committee examines the same. Accordingly there are now a host of companies that have been granted licence to participate in defence production, The Confederation of Indian Industries (CII) in their directory of defence companies list over 200 companies.

Companies new to defence production are aware of the opportunities that are opened by partnering with bidders and hence are keen to sign MoUs with bidders.

Thus Hypothesis H1 is proposed: - Ceteris Paribus, the newer the Indian Company

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Since the field of the Indian companies seeking to be an offset partner is large, the bidders can pick and choose.

The foreign bidder would prefer to choose those Indian companies as partners who have relevant experience in Aerospace and Defence; who have a good technology base and established quality and traceability systems in place.

Foreign bidders have projected that purchases made against offset obligations is at a higher cost than what it would be if sourced by normal means. This is particularly highlighted when the company from which the purchase is made is new to Aerospace and Defence.

Thus from among the field of aspiring companies wishing to partner with the bidder, the bidder prefers companies who have proven experience in defence and aerospace. This will not only reduce the time and effort that would need to

be spent to develop the new companies to meet defence/aerospace standards, but will reduce the cost of purchase in comparison to what would have if the purchases were made with companies new to aerospace and defence.

Thus Hypothesis H2 is proposed: Ceteris Paribus, bidders prefer to partner with companies experienced in Aerospace and Defence to meet offset obligations rather than with those without experience in Aerospace and Defence.

Bidder and Offset Partner Seeking to Standardise the MoU

On identification of a partner, the foreign companies need to indicate number of partnership in the technical bids being submitted, as MoU signing between the partner company and the bidder is acceptable.

The DPP specifies certain clauses that are to be included in the Offset Contract. But this contract is signed only between the vendor (successful bidder) and the MOD. The bidder is not a party to this contract. The DPP does not specify the clauses and content that need to be incorporated in the MoU. Thus the MoU is open-ended with scope for the parties to add or delete clauses and hence open to arrive at a negotiated draft before signing.

For the reason that experienced Indian Companies in Aerospace and Defence are preferred by the bidders, several of the bidders against the same RFP would seek to sign an MoU with. Thus these companies hope to sign not just one MoU, but with

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most of the bidders. The basic areas of cooperation and export projects planned may differ depending on what each bidder offers. Each of these bidders are in competition with other bidders.

Therefore to be fair to the bidders, the experienced Indian company would seek to sign identical MoUs with identical terms and conditions with each bidder.

Thus Hypothesis H3 is proposed: Ceteris Paribus, established Aerospace and Defence offset partner companies seek to standardize and have identical terms and conditions in the MoUs signed between the company and the bidders.

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The converse is also true. Each bidder also expects to sign MoUs with several Indian companies as an offset partner. Bidders are large companies which seek to adhere to various guidelines. These guidelines stem from Company policy and the country's legislations.

This apart, the bidder being a large Aerospace/Defence company aspires to be fair to each potential offset partner. Therefore the bidder seeks to maintain a uniform set of terms and conditions in the MoU.

Thus Hypothesis H4 is proposed: *Ceteris Paribus*, the bidding companies seek to standardize and have identical terms and conditions in the MoUs signed between the bidder and the offset partner company.

Resolution of Conflict

Ceteris Paribus, the bidding companies seek to standardize and have identical terms and conditions in the MoUs signed between the bidder and the offset partner company.

Identification of a partner must result in a signed MoU. Thus there is a need to negotiate the terms and conditions in the MoU and sign.

At the time of negotiating the MoU for signature conflicts arise. This is no surprise as it is easy to note that there is a conflicting situation as seen from Hypotheses H3 and H4, where the offset partner company seeks to standardise the MoU among the interested bidders, while the bidder also seeks to standardise the MoU with the offset partners.

Some of the clauses where conflict arises are briefly described below:

Applicable Law and Arbitration Procedure

The DPP specifies that the offset contract shall be governed in accordance with the laws of India. This contract is between the successful bidder and the Ministry of Defence (MOD). What should be the applicable law for the MoU? But what should be the applicable law for the contracts to be entered into between the offset partner and the OEM (offset programme contract) to meet the offset commitment? Should the MoU stipulate the applicable law for the offset programme contract or should the MoU be silent on this aspect?

It is often the practice that the applicable law is that of the country which buys the product or service. The country that buys the product or service against the offset programme contract is the OEM country. Thus one view could be that the applicable law should be that of the bidder's country. However the offset MoU and offset programme contracts are a sequel to the main contract where the buyer is India's Defence Ministry. It can be viewed, therefore, that the applicable law for

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the offset programme contract should be that of the main buyer, namely India.

Negotiating the MoU to be signed between the bidder and the offset partner, as to which law should govern the MoU is a source of conflict.

Similarly the standard clauses proposed in the RFP as per DPP for the main contract specifies that the arbitration proceedings shall be conducted in India under the Indian Arbitration and Conciliation Act, 1996. The issue that arises is whether this clause should be reproduced in the same manner for the MoU. The opinion of the bidder and the opinion of the offset partner differ.

Thus conflicting positions are held on the applicable law and the arbitration procedure to be followed while negotiating the MoU for signature. But there is a dead line (submission of the Technical proposal date) by when the MoU needs to be signed and presented along with the proposal. This puts pressure on both sides, to come to an agreement.

Assurance of Minimum Work to be Executed through the Partner

The selected bidder would need to meet the offset obligation through several offset partners. Thus the pie is divided between the different partners. The bidder also needs to indicate as to how this pie is planned to be distributed in the technical offset proposal. However there is no indication in the DPP that the signed MoU enclosed with the technical offset proposal should also indicate the percentage of offset obligation planned to be liquidated by the partner.

The potential offset partner, particularly those with Aerospace and Defence experience would like to negotiate and agree before signing the MoU, on a commitment from the bidder to liquidate a minimum percentage of offset obligation which will be executed through the partner. The offset partner with valuable aerospace and defence experience, sees no specific gain in signing an MoU at the end of which the bidder chooses to only liquidate a miniscule portion of the offset obligation through the partner.

On the other hand the bidder wishes to sign the MoU without any commitment indicating a

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minimum percentage of offset obligation that would be liquidated through the partner. This position gives flexibility to the bidder in distributing the work to different partners till the offset contract is signed which is at a much later stage when the MoU is signed.

Thus this is another potential area of disagreement while negotiating the MoU.

Assurance for Technically Complex Work

The DPP specifies that the offset obligations are to be met by direct purchase of defence products and components (and also through services for defence products and foreign direct investments). The DPP also gives guidelines as to what constitutes defence products.

Companies with experience in Aerospace and Defence recognise that defence products consist of both complex and simple components. There is a very big difference in the technical complexity between production of a High Pressure Turbine Blade for an Aircraft jet engine and production of sheet metal components to mount avionics equipment fitted in an aircraft.

Companies expect assurance that the offset obligation being met would consist of production work packages that have a certain degree of complexity and would like the same to be incorporated in the MoU.

The bidder on the other hand wishes not to include such an assurance in the MoU, particularly since there is no such specific requirement to assure technically complex work as per DPP or as per the RFP. Thus this is another potential area of disagreement while negotiating the MoU.

The Purchase Terms and Conditions for the Offset Programme Contract

One party may wish that the MoU cover a great deal of detail. This minimises the conflicts that may arise at the time of signing the Offset Programme Contracts based on the MoU. The other party may wish not to negotiate details at this stage of MoU. As far as the RFP requirement is concerned there is no specific need that the MoUs entered into are in detail.

The bidder would like to confirm that the offset partner agrees to abide by all the standard terms and conditions of the bidder company as per the purchase procedures of the bidder company. If agreement can be reached at the stage of MoU,

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on the terms and conditions that would govern the offset programme contract, the negotiation procedure is simplified and the time for signing of Offset programme contracts are reduced. This is helpful for the successful bidder, as the vendor has only 90 days by when he needs to sign the offset programme contracts and submit the same to the MOD.

However agreeing to these details at the time of signing the MOU can be complex. From the offset partner company's point of view, the terms and conditions regarding the nature and value of the specific offset programme contracts will need to be

discussed and negotiated as part of the programme contract negotiations. Thus this is another potential area of conflict while negotiating the MoU.

Negotiation of the MoU

As has been seen there are several issues which need to be resolved before signing the MoU. Thus the negotiation between the parties is critical.

As per DPP, after the offset contract is signed, changes will not be permitted in offset partners or value. The documents that indicate the offset components and their value are the technical and commercial offset proposals submitted by the bidder in response to the RFP. The only document signed by the offset partner in the offset process before signing the offset programme contract is the MoU. Thus negotiating an appropriate MoU is critical.

It has been established that the ability to negotiate is a function of the Basic Alternative to a Negotiated Agreement (BATNA) position of each party.

Consider a negotiation between a bidder and a potential offset partner, who is experienced in Aerospace and Defence. It was reasoned that Ceteris Paribus bidders prefer to partner with companies experienced in Aerospace and Defence to meet offset obligations rather than with those without experience in Aerospace and Defence.

It was also reasoned that Ceteris Paribus, established Aerospace and Defence offset partner companies seek to standardize and have identical terms and conditions in the MoUs signed between the

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company and the bidders. Therefore the experienced companies also have more issues to negotiate before signing the MoU.

Under these conditions, the BATNA for the bidder is to find a partner company which is less experienced in Aerospace and Defence and sign the MoU. It was also reasoned that 'Ceteris Paribus the newer the Indian Company to Defence Aerospace the keener is the company to partner with the bidders and sign an MoU. Therefore it is easier for the bidder to sign MoUs with companies who are new to aerospace and defence, and who are more willing to make necessary compromises during the negotiation of the MoU.

Thus the bidder has a ready alternative if the negotiation with an experienced company fails to yield an MoU to support the offset proposals.

This alternative is expected to increase the cost of purchases and the effort required to develop the vendor to some extent. But this, in no way, will affect the eligibility criteria to meet the RFP requirement. Thus from the point of view of negotiating towards the position held by the bidder, the bidder is comfortable and can negotiate hard without yielding.

On the other hand what is the BATNA for the more experienced and preferred company? If the negotiations fail to arrive at an agreement on issues where the parties hold different positions, the BATNA for the experienced company is not to sign the MoU. This means foregoing the opportunity to market products and services of the experienced company through the offset opportunity that has been opened.

This is a costly alternative for the potential offset partner. Coupled to this is the fact that the companies not experienced in Aerospace and Defence are ready to

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sign MOUs with bidders with little negotiation. Thus the experienced company is in a weak position at the time of negotiating the MoU. Therefore these companies yield to the issues, and accept the positions proposed by the bidding company.

Thus Hypothesis H5 is proposed: Ceteris Paribus, the potential offset partner companies including those experienced in Aerospace and Defence, yield to the position of the bidder while negotiating the MoU rather than the other way round.

Discussion

Intense negotiations take place when both the parties negotiate from equal strength. An agreement

or an MoU signed after intense negotiation is long standing and reflects a win-win association. However, it is seen that the potential offset partner negotiates from a weaker platform than the bidder.

It was also seen that companies with Defence and Aerospace experience is a strength for the potential offset partner. However this strength is not adequate to resolve some of the conflicts that may arise during the negotiations, without quitting. This happens because of other potential offset partners who are also keen to sign MoUs with bidders.

This follows from the generalisation that strength for the potential offset partner comes if the potential offset partner has a competitive advantage that is remarkably higher than other potential offset partners. Companies that offer products or services which the bidder is looking to meet the offset obligations, must be produced at a significantly lesser cost as compared to what an alternative potential partner can produce. This is a difficult-to-reach situation for any company, although every company aspires for this in a free market competition. Companies must therefore strive to improve their competitive advantage.

In dealing with certain aspects of negotiation, strength can also come from the strength of regulations established in the country of the party negotiating. Consider

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a potential offset partner wishes to ask for rights to produce and export to Venezuela while negotiating with a bidder from the USA. This will be a non-negotiable issue as this will be a violation of the country's International Traffic in Arms Regulations (ITAR). The issue is a non-negotiable point without either party having to waste time or effort. Thus for the offset partner it can be the regulations in India which give strength for negotiations on certain issues. But these regulations in India are yet to mature to a level of regulations in the USA.

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Yet another source of strength for the potential offset partner is the publication of the Defence Procurement Procedures by the Ministry of Defence. The offset MoU signed between the offset partner and the bidder flows from the DPP.

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in the related field. The DPP is one such document in the process of defence procurement.

However the DPP in its current form does not specify a draft MoU for both the offset partner and the bidder to adhere to as a standard. Such a standard no doubt could be a source of strength for the potential offset partner to negotiate. Further this could also minimise time and effort spent on negotiating on certain issues depending on the preferences of each of the parties.

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