

## Private industry gears up for bigger role in defence sector

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In a landmark policy change, the defence industry was thrown open to the private sector in May 2001 (Press Note 4 of 2001 Series).

The government allowed 100% equity with a maximum 26% foreign direct investment (FDI) component, both subject to licensing. Subsequently, the Department of Industrial Policy and Promotion issued detailed guidelines, after consultations with the Ministry of Defence, for the issuance of licences for the production of arms and ammunition in January 2002 (Note 2 of 2002 Series).

The basic aim of allowing FDI in the defence sector was to pool capital and introduce the latest technology to manufacture state-of-art defence equipment for India's armed forces and also to enter the export market at a significant scale.

### Public-private collaboration

The defence industry is gradually liberalizing and the public sector is facilitating greater private sector participation in the production of defence goods. More than 30% of India's defence procurement, in capital terms, is imported but this is expected to change with the creation of more public-private partnerships.

India's offset policy for defence goods has been designed to leverage the country's position as a large buyer and exporter.

The policy states that any purchase from a foreign supplier in excess of Rs3 billion (US\$75 million) will require a reinvestment of 30% of the total purchase amount in terms of components and services from India.

The offset policy applies to imports by defence public sector undertakings, ordinance factories and private participants of the industry.

The offset policy is also expected to act as a driver to create market-entry opportunities for mid-rung companies, which are looking at investing in research and development and manufacturing of defence goods. The offset policy may allow a larger presence for private companies.

### Present policy

Under the policy directive of 2002, licences for the production of arms and ammunition will be issued by the Department of Industrial Policy and Promotion (Ministry of Commerce and Industry) in consultation with Ministry of Defence, whereas all FDI cases will be considered by the Foreign Investment Promotion Board as well. But the Ministry of Defence will have the final say on procurements, sales and exports.

The applicant company has to be either an Indian company or a partnership firm. Management control must remain in Indian hands with majority representation in the board. The chief executive has to be a resident Indian. In other words, a foreign investor is expected to invest his resources without participating in decision making.

The licensing authority can also verify the antecedents of the foreign collaborators and domestic promoters including their financial standing and credentials in the world market. A foreign investor cannot transfer his equity before the expiry of the lock-in period of three years. Even after that, such transfers would require government approval.

The licence will contain capacity norms for production, which will be fixed after considering existing capacities of similar and allied products. This provision appears to be meant to protect the interests of the public sector by ruling out any competition to their existing monopoly. A licensee can pro-

duce only the licensed products and in the sanctioned quantity. He can neither diversify nor enhance production to deal with market dynamics. The government will verify all safety and security procedures once the production commences.

As regards the sale of the products, the government can give no purchase guarantee but the proposed quantity for acquisition and overall requirements may be made known. Purchase preference and price preference may be given to public sector producers.

The policy directive further stipulates that arms and ammunition will be primarily sold to the Ministry of Defence. Their sale to other security organizations in the country and exports will also require government approval. Non-lethal items may be sold to non-government agencies with the concurrence of the Ministry of Defence.

The applicant company has to provide the standards and testing procedures for equipment to be produced to the nominated quality assurance agency. Further, the government can inspect the finished product and conduct audit of quality assurance procedures.

The domestic capability of the Indian defence industry is largely concentrated on the production of the public sector undertakings and ordinance factories.

This trend is expected to change with the selective liberalization of the defence industry and offset policy, which are expected to create greater private sector participation and facilitate bigger FDI inflows into the Indian defence industry.

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